

WORLD COMMERCE REVIEW

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KORBINIAN RÜGER AND
BENJAMIN ZEEB DISCUSS
WHY THE EUROPEAN UNION
IS FAILING AND WHAT WE
CAN STILL DO TO SAVE IT

WILLIAM NORDHAUS
EXAMINES THE TRUMP
DOCTRINE ON INTERNATIONAL
TRADE, WHICH RISKS 100
YEARS OF COOPERATION

THE CHOICE FOR THE
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DECLINE, STEPHEN NAGY
ARGUES

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Four reasons why the EU is failing

Korbinian Rürger and Benjamin Zeeb discuss why
the European Union is failing and what we can still
do to save it

The recent victory of Emmanuel Macron as president of France has instilled in many on the continent a fresh hope that a new dawn for the EU might be just over the horizon. Could the coinciding shocks of Brexit and Mr Trump's election in 2016 become a galvanizing moment in Europe's history? Is this the turning point when the peak of crisis is finally overcome, and we Europeans can at long last start to look confidently towards a brighter future?

It certainly seems like the EU has gained some new fans recently, with people from Berlin to Rome taking to the streets under the banner of the 'Pulse of Europe' movement, waving the blue and yellow flag, loudly expressing their support for the historic project of European Integration. Unfortunately, however, there is little reason for jubilation as none of the continent's most pressing problems have come any closer to a solution. Nor are they likely to in time.

Still Europe treads dangerously close to the brink of ruin, with a long list of very real risks all individually capable of wiping away half a century's worth of progress within the blink of an eye. Meanwhile the actions required to put Europe back on track far exceed even the boldest proposals for reform coming out of Brussels and national capitals.

Under these circumstances it is no longer the duty of Europhiles to try to explain to our storm-tossed citizenry why the EU is good for them, why they should support it, and what it does for them. Instead it is our responsibility to convey why, in its current state, the EU can do remarkably little for them, and that, in any case, it probably won't be around for much longer if we don't radically change course to avert disaster.

Here are four reasons why the EU is going to fail and what - if anything - we can still do to save it.

A flawed structure

Historically, when it comes to the organization of political systems, there have essentially been two winning strategies. Either your state is very large and simply by virtue of size more powerful than almost all competitors. Think

the Roman Empire, Ancient China, the US today. Or you are very small and agile, creative and flexible, able to bend rather than break in the face of hostile acts by larger adversaries: Singapore, Switzerland, or the City States of Renaissance Upper Italy.

Both, being large and being small, come with upsides and downsides in statecraft, but, with the exception of the Holy Roman Empire, which eventually collapsed under its own weight, the EU stands alone in having accomplished a dubious feat. Despite its sheer size it manages to harness almost none of the benefits that have historically come with being large while at the same time suffering many of the downsides that should be reserved for much smaller entities.

... successful unions have resulted not from gradualist processes or legalistic procedures... Progress towards the formation of states with new political structures is usually caused by events, rather than processes. Europe needs such an event now

With being large, in Europe's case this includes commanding the world's biggest unified market, there should come economies of scale, massive negotiating power, the ability to project power and define rule-sets far beyond one's own geographic boundaries, as well as an ability to protect one's own citizens and immediate neighbours from war. Essentially, you don't get bullied as easily when you're big.

But very few of the benefits of being big apply to the EU today. At the same time it has managed to retain most of the downsides of size: a remote centre in charge of setting rules that is considered out of touch with the population, a sprawling bureaucracy with lacking legitimacy that has become the target of populists and separatists alike, and, maybe most consequentially, a high vulnerability to unforeseeable black swan events that threaten the intricately woven web of interactions, be they financial, political, or cultural, that hold the whole thing together.

All of this wouldn't matter as much, if Europe's member states were able to at least retain some of the benefits of being small. That would mean greater flexibility, a more immediate relationship and exchange between citizens and the ruling elite, greater flexibility, proper democratic representation and, crucially, fiscal independence. Being small means that you likely profit from your neighbours financial failings while it is less likely that you will be adversely affected by your competitor's profligacy or over-production. Member states of the Confederate System of the EU, of course, share traits of both small and big entities. However, they have uniquely failed to leverage the benefits of both.

An ill-designed currency union

In the perception of many people, when the financial crisis of 2008 hit Europe, was the moment it all started to go downhill for the project of European integration. Ever since then many see the EU as an institution in crisis, and to some extent rightly so. It is not that the EU's structural flaws were created then, but Europe's financial and wider economic crisis made them blatantly obvious. Unlike other economies worldwide also hit by recession, the euro-zone's countries were and still are trapped in a currency union that is incapable of reacting to external shocks be-

cause it lacks a common fiscal policy. This unprecedented design flaw in the creation of the Euro has more than once caused whole countries to nearly go under. That it hasn't been corrected to this day is simply unbelievable.

One thing that continues to stand in the way is Germany's shrieking horror in the face of a possible 'transfer union'. This has become most obvious again in the negotiations about the latest tranche of financial aid for Greece in June of this year. Greece is a country crippled by crisis for almost ten years now. Ever since the first of three bailout packages was signed by the IMF and eurozone governments in 2010 the Greek economy is being just barely kept alive.

The IMF and virtually all mainstream economists have by now acknowledged that the country will never get back on its feet without substantial debt relief. Consequently the IMF has made any future involvement in financial aid for Greece contingent on such debt relief. The Eurogroup under the leadership of German finance minister Wolfgang Schäuble in turn has so far blocked any attempts for substantive relief, while at the same time insisting that the IMF stay involved. June's agreement to release the latest funds, once again keeping Greece from immediate sovereign default, reflects these opposing views by making debt relief a future option to be reviewed next year with the IMF staying on board for now.

The German government cannot get itself to acknowledge that debt relief for Greece is one of the necessary transfers within the eurozone that have to be made to keep it from falling apart. Funds have to flow from richer parts of the Union to poorer parts to secure a minimum of fiscal harmonization. One of the most promising proposals to that effect is a European unemployment insurance scheme. Without such measures, part of which would also be a European finance ministry overseeing its own substantial budget, the eurozone, and with it the EU, will not survive.

An inadequate security setup

Another area where the EU is failing is its security policy. This is one of the areas where close cooperation between member states is absolutely indispensable. Bearing few exceptions, the member states have in effect no internal

borders and almost identical foreign policy and security interests. Border patrol, intelligence and military are thus three things that most naturally should be taken care of on a European level. Yet, very little progress has been made in recent years.

This has become blatantly obvious in the most tragic of ways when Europe proved unable to deal with the ongoing 'refugee crisis'. When refugees from the Middle East and Africa fled war and hunger in numbers unprecedented since World War 2, those countries with an external border have largely been left to their own devices and many of them are either unable (Greece, Italy) or unwilling (Hungary) to control it in a way that is in line with Europe's security concerns as well as with a humane and sensible immigration policy.

This is a task that needs to be taken care of on the European level. We need a European scheme that is in charge with securing the Union's external border, of course in close cooperation with regional authorities, handling all immigration, including the distribution of asylum seekers across the Union. This scheme needs to be financed entirely by European funds.

The same goes for intelligence. The security threats faced by EU member states are by and large the same. The top priority at the moment no doubt lies in preventing further attacks like the ones in Barcelona, Berlin, Brussels and Paris. Almost every one of those attackers has travelled or even lived in different European countries. All of them have benefitted from insufficient cooperation between national intelligence services and police forces. It is far from crazy to think that one or more of these attacks could have been prevented had this not been the case. It seems distasteful to mention how economically wasteful it is to run 28 intelligence services that do much of the same work. But, of course, this is also true.

This last point is also very relevant in terms of European military spending. There has been much discussion about European NATO members that spend far less on their defence budget than the agreed upon 2% of GDP. The far

more effective way to increase the military capacity of European countries to a level far beyond the 2% goal without even spending that amount, would be to form a European army under single command. Harmonization effects would increase Europe's defence capacity far more than simply pouring more money in to the same defective system would.

Of course, this would likely not satisfy Donald Trump, who thinks that European countries 'owe money' to the US for enjoying years of American defence without paying much for it. However, satisfying the US president should not be the goal in any case. Rather Europe should see the US's retreat as a welcome opportunity to grow up and develop a defence structure that is able to secure the safety of European citizens without having to rely on the goodwill of whoever happens to occupy the White House.

A crisis of democratic representation

With the formation of informal Institutions like the Troika, the Eurogroup, and later the ubiquitous 'Institutions', the traditional and constitutional right to determine a state's budget, which is one of the most essential rights of any democratically elected parliament, has disappeared in practice.

In many cases including Spain, Ireland, Italy, Portugal, Cyprus and Greece, parliaments can no longer make independent decisions on the state's financial resources and therefore are no longer able to properly represent the will of their respective national constituency. Even after the end the bailouts, the dependence continues. Essentially it doesn't matter who you vote for if you are a Greek or a Spaniard, economic policy (including on matters of taxation and government spending in your country) will be made in Brussels, Paris, and Berlin.

On the global stage, Europeans are supposed to gain greater weight through membership in the EU. However, does the EU even adhere to the will of a majority of Europeans in questions of trade, environment, and foreign policy? The answer is, it probably doesn't. How are we, under the current system, even supposed to discern what that will

is? The answer is, we can't. To solve this crisis of representation we need to push for a massive overhaul of Europe's democratic institutions.

Is there hope?

One (wo)man, one vote! This simple principle should guide all our ambitions for reform in Europe. Unfortunately, we can't leave this process to the national elites representing their respective member states and their diverging interests. We have to take matters into our own hands.

Historically, successful unions have resulted not from gradualist processes or legalistic procedures. They have come about through defining events in times of extreme crisis. Progress towards the formation of states with new political structures is usually caused by events, rather than processes. Europe needs such an event now.

Much like the Philadelphia convention, which gave the United States a constitution didn't reinvent the wheel as to how to form a federation, Europe does not have to do so either. After all, with more than two hundred years of federal practice, it is possible to analyse the costs and benefits of the United States' constitutional model and to create an adapted European one based on the outcomes. ■

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State of the European Union

Jean-Claude Juncker takes stock of Europe's current political and economic landscape, reviews the work of the EU over the past year, and looks ahead to the priorities of the coming year

Wind in our sails

This time last year it was plain for all to see that our Union was not in a good state. Europe was battered and bruised by a year that shook our very foundation. We only had two choices. Either come together around a positive European agenda or each retreat into our own corners. Faced with this choice, I argued for unity. I proposed a positive agenda to help create a Europe that protects, empowers and defends.

Over the past twelve months this agenda has been brought to life with the help of the European Parliament and the 27 leaders of our member states, who welcomed my agenda at their summit in Bratislava. In doing so they chose unity. They chose to rally around our common ground. Together, we showed that Europe can deliver for its citizens when and where it matters.

Ever since, we have been slowly but surely gathering momentum.

It helped that the economic outlook swung in our favour. We are now in the fifth year of an economic recovery that finally reaches every single member state. Growth in the European Union has outstripped that of the United States over the last two years. It now stands above 2% for the Union as a whole and at 2.2% for the euro area.

Unemployment is at a nine-year low. Almost 8 million jobs have been created during this mandate so far. With 235 million people at work, more people are in employment in the EU than ever before.

The European Commission cannot take the credit for this alone. Though I am sure that had 8 million jobs been lost, we would have taken the blame. But Europe's institutions played their part in helping the wind change. We can take credit for our European Investment Plan which has triggered €225 billion worth of investment so far. It has granted loans to over 445,000 small firms and more than 270 infrastructure projects. We can take credit for the fact that,

thanks to determined action, European banks once again have the capital firepower to lend to companies so that they can grow and create jobs.

And we can take credit for having brought public deficits down from 6.6% to 1.6%. This is thanks to an intelligent application of the Stability and Growth Pact. We ask for fiscal discipline but are careful not to kill growth. This is in fact working very well across the Union – despite the criticism.

Ten years since crisis struck, Europe's economy is finally bouncing back. And with it, our confidence. Our EU27 leaders, the Parliament and the Commission are putting the Europe back in our Union. Together we are putting the Union back in our Union.

Europe was not made to stand still. It must never do so. Helmut Kohl and Jacques Delors taught me that Europe only moves forward when it is bold

In the last year, we saw all 27 leaders walk up the Capitoline Hill in Rome, one by one, to renew their vows to each other and to our Union. All of this leads me to believe: the wind is back in Europe's sails. We now have a window of opportunity but it will not stay open forever. Let us make the most of the momentum, catch the wind in our sails. For this we must do two things:

First, we should stay the course set out last year. We have still 16 months in which real progress can be made by Parliament, Council and Commission. We must use this time to finish what we started in Bratislava and deliver on our positive agenda.

Secondly, we should chart the direction for the future. As Mark Twain wrote, years from now we will be more disappointed by the things we did not do, than by the ones we did. Now is the time to build a more united, stronger and more democratic Europe for 2025.

Staying course

As we look to the future, we cannot let ourselves be blown off course. We set out to complete an Energy Union, a Security Union, a Capital Markets Union, a Banking Union and a Digital Single Market. Together, we have already come a long way. As the Parliament testified, 80% of the proposals promised at the start of the mandate have already been put forward by the Commission. We must now work together to turn proposals into law, and law into practice.

As ever, there will be a degree of give and take. The Commission's proposals to reform our Common Asylum System and strengthen rules on the Posting of Workers have caused controversy. Achieving a good result will need all sides to move towards each other. I want to say today: as long as the outcome is the right one for our Union and is fair to all member states, the Commission will be open to compromise.

We are now ready to put the remaining 20% of initiatives on the table by May 2018. I have sent a Letter of Intent to European Parliament President Antonio Tajani and Prime Minister Jüri Ratas outlining the priorities for the year ahead. I will not list all our proposals here, but let me mention five which are particularly important.

Firstly, I want us to strengthen our European trade agenda. Yes, Europe is open for business. But there must be reciprocity. We have to get what we give. Trade is not something abstract. Trade is about jobs, creating new opportunities for Europe's businesses big and small. Every additional €1 billion in exports supports 14,000 extra jobs in Europe.

Trade is about exporting our standards, be they social or environmental standards, data protection or food safety requirements. Europe has always been an attractive place to do business. But over the last year, partners across the globe are lining up at our door to conclude trade agreements with us.

We have just secured a trade agreement with Canada that will provisionally apply as of next week. We have a political agreement with Japan on a new economic partnership. By the end of the year, we have a good chance of doing the same with Mexico and South American countries.

And today, we are proposing to open trade negotiations with Australia and New Zealand. I want all of these agreements to be finalised by the end of this mandate. And I want them negotiated in the fullest transparency.

Open trade must go hand in hand with open policy making. The European Parliament will have the final say on all trade agreements. So its members, like members of national and regional parliaments, must be kept fully informed from day one of the negotiations. The Commission will make sure of this. From now on, the Commission will publish in full all draft negotiating mandates we propose to the Council.

Citizens have the right to know what the Commission is proposing. Gone are the days of no transparency. Gone are the days of rumours, of incessantly questioning the Commission's motives. I call on the Council to do the same when it adopts the final negotiating mandates.

Let me say once and for all: we are not naïve free traders. Europe must always defend its strategic interests. This is why today we are proposing a new EU framework for investment screening. If a foreign, state-owned, company wants to purchase a European harbour, part of our energy infrastructure or a defence technology firm, this should only happen in transparency, with scrutiny and debate. It is a political responsibility to know what is going on in our own backyard so that we can protect our collective security if needed.

Secondly, I want to make our industry stronger and more competitive. This is particularly true for our manufacturing base and the 32 million workers that form its backbone. They make the world-class products that give us our edge, like our cars.

I am proud of our car industry. But I am shocked when consumers are knowingly and deliberately misled. I call on the car industry to come clean and make it right. Instead of looking for loopholes, they should be investing in the clean cars of the future. The new Industrial Policy Strategy we are presenting will help our industries stay or become the world leader in innovation, digitisation and decarbonisation.

Third: I want Europe to be the leader when it comes to the fight against climate change. Last year, we set the global rules of the game with the Paris Agreement ratified here, in this very House. Set against the collapse of ambition in the United States, Europe will ensure we make our planet great again. It is the shared heritage of all of humanity. The Commission will shortly present proposals to reduce the carbon emissions of our transport sector.

Fourth priority for the year ahead: we need to better protect Europeans in the digital age. In the past three years, we have made progress in keeping Europeans safe online. New rules, put forward by the Commission, will protect our intellectual property, our cultural diversity and our personal data. We have stepped up the fight against terrorist propaganda and radicalisation online. But Europe is still not well equipped when it comes to cyber-attacks.

Cyber-attacks can be more dangerous to the stability of democracies and economies than guns and tanks. Last year alone there were more than 4,000 ransomware attacks per day and 80% of European companies experienced at least one cyber-security incident. Cyber-attacks know no borders and no one is immune. This is why, today, the Commission is proposing new tools, including a European Cybersecurity Agency, to help defend us against such attacks.

Fifth: migration will stay on our radar. In spite of the debate and controversy around this topic, we have managed to make solid progress – though admittedly insufficient in many areas.

We are now protecting Europe's external borders more effectively. Over 1,700 officers from the new European Border and Coast Guard are now helping member states' 100,000 national border guards patrol in places like Greece, Italy, Bulgaria and Spain. We have common borders but member states that by geography are the first in line cannot be left alone to protect them. Common borders and common protection must go hand in hand.

We have managed to stem irregular flows of migrants, which were a cause of great anxiety for many. We have reduced irregular arrivals in the Eastern Mediterranean by 97% thanks our agreement with Turkey. And this summer, we managed to get more control over the Central Mediterranean route with arrivals in August down by 81% compared to the same month last year.

In doing so, we have drastically reduced the loss of life in the Mediterranean. Tragically, nearly 2,500 died this year. I will never accept that people are left to die at sea.

I cannot talk about migration without paying strong tribute to Italy for their tireless and noble work. This summer, the Commission again worked closely together with Prime Minister Paolo Gentiloni and his government to improve the situation, notably by training the Libyan Coast Guard. We will continue to offer strong operational and financial support to Italy. Because Italy is saving Europe's honour in the Mediterranean.

We must also urgently improve migrants' living conditions in Libya. I am appalled by the inhumane conditions in detention or reception centres. Europe has a collective responsibility, and the Commission will work in concert with the United Nations to put an end to this scandalous situation that cannot be made to last.

Even if it saddens me to see that solidarity is not yet equally shared across all our member states, Europe as a whole has continued to show solidarity. Last year alone, our member states resettled or granted asylum to over 720,000 refugees – three times as much as the United States, Canada and Australia combined. Europe, contrary to what some say, is not a fortress and must never become one. Europe is and must remain the continent of solidarity where those fleeing persecution can find refuge.

I am particularly proud of the young Europeans volunteering to give language courses to Syrian refugees or the thousands more young people who are serving in our new European Solidarity Corps. They are bringing European solidarity to life. We now need to redouble our efforts. Before the end of the month, the Commission will present a new set of proposals with an emphasis on returns, solidarity with Africa and opening legal pathways.

When it comes to returns: people who have no right to stay in Europe must be returned to their countries of origin. When only 36% of irregular migrants are returned, it is clear we need to significantly step up our work. This is the only way Europe will be able to show solidarity with refugees in real need of protection.

Solidarity cannot be exclusively intra-European. We must also show solidarity with Africa. Africa is a noble and young continent, the cradle of humanity. Our €2.7 billion EU-Africa Trust Fund is creating employment opportunities across the continent. The EU budget fronted the bulk of the money, but all our member states combined have still only contributed €150 million. The Fund is currently reaching its limits. We know the dangers of a lack of funding – in 2015 many migrants headed towards Europe when the UN's World Food Programme ran out of funds. I call on all Member States to now match their actions with their words and ensure the Africa Trust Fund does not meet the same fate.

We will also work on opening up legal pathways. Irregular migration will only stop if there is a real alternative to perilous journeys. We are close to having resettled 22,000 refugees from Turkey, Jordan and Lebanon and I support UN High Commissioner Grandi's call to resettle a further 40,000 refugees from Libya and the surrounding countries.

At the same time, legal migration is a necessity for Europe as an ageing continent. This is why the Commission made proposals to make it easier for skilled migrants to reach Europe with a Blue Card. I would like to thank the Parliament for your support and I call for an ambitious and swift agreement on this important issue.

Setting sail

I have mentioned just a few of the initiatives we should deliver over the next 16 months. But this alone will not be enough to regain the hearts and minds of Europeans. Now is the time to chart the direction for the future.

In March, the Commission presented our White Paper on the future of Europe, with five scenarios for what Europe could look like by 2025. These scenarios have been discussed, scrutinised and partly ripped apart. That is good – they were conceived for exactly this purpose. I wanted to launch a process in which Europeans determined their own path and their own future.

The future of Europe cannot be decided by decree. It has to be the result of democratic debate and, ultimately, broad consensus. This House contributed actively, through the three ambitious resolutions on Europe's future and your participation in many of the more than 2,000 public events that the Commission organised since March. Now is the time to draw first conclusions from this debate. Time to move from reflection to action. From debate to decision.

Today I would like to present you my view: my own 'scenario six', if you will. This scenario is rooted in decades of first-hand experience. I have lived and worked for the European project my entire life. I have seen good times and bad.

I have sat on many different sides of the table: as a Minister, as Prime Minister, as President of the Eurogroup, and now as President of the Commission. I was there in Maastricht, Amsterdam, Nice and Lisbon as our Union evolved and enlarged. I have always fought for Europe. At times I have suffered with and because of Europe and even despaired for it. Through thick and thin, I have never lost my love of Europe.

But there is rarely love without pain. Love for Europe because Europe and the European Union have achieved something unique in this fraying world: peace within and outside of Europe. Prosperity for many if not yet for all. This is something we have to remember during the European Year of Cultural Heritage. 2018 must be a celebration of cultural diversity.

A union of values

Our values are our compass. For me, Europe is more than just a single market. More than money, more than the euro. It was always about values. In my scenario six, there are three principles that must always anchor our Union: freedom, equality and the rule of law.

Europe is first of all a Union of freedom. Freedom from the kind of oppression and dictatorship our continent knows all too well – sadly none more than central and Eastern Europe. Freedom to voice your opinion, as a citizen and as a journalist – a freedom we too often take for granted. It was on these freedoms that our Union was built. But freedom does not fall from the sky. It must be fought for. In Europe and throughout world.

Second, Europe must be a Union of equality. Equality between its members, big and small, East and West, North and South. Make no mistake, Europe extends from Vigo to Varna. From Spain to Bulgaria. East to West: Europe must breathe with both lungs. Otherwise our continent will struggle for air.

In a Union of equals, there can be no second-class citizens. It is unacceptable that in 2017 there are still children dying of diseases that should long have been eradicated in Europe. Children in Romania or Italy must have the same access to measles vaccines as other children right across Europe. No ifs, no buts. This is why we are working with all member states to support national vaccination efforts. Avoidable deaths must not occur in Europe.

In a Union of equals, there can be no second-class workers. Workers should earn the same pay for the same work in the same place. This is why the Commission proposed new rules on posting of workers. We should make sure that all EU rules on labour mobility are enforced in a fair, simple and effective way by a new European inspection and enforcement body. It seems absurd to have a Banking Authority to police banking standards, but no common Labour Authority for ensuring fairness in our single market. We will create one.

In a Union of equals, there can be no second-class consumers. I will not accept that in some parts of Europe, people are sold food of lower quality than in other countries, despite the packaging and branding being identical. Slovaks do not deserve less fish in their fish fingers. Hungarians less meat in their meals. Czechs less cacao in their chocolate. EU law outlaws such practices already. We must now equip national authorities with stronger powers to cut out any illegal practices wherever they exist.

Third, in Europe the strength of the law replaced the law of the strong. The rule of law means that law and justice are upheld by an independent judiciary. Accepting and respecting a final judgement is what it means to be part of a Union based on the rule of law. Member states gave final jurisdiction to the European Court of Justice. The judgements of the Court have to be respected by all. To undermine them, or to undermine the independence of national courts, is to strip citizens of their fundamental rights.

The rule of law is not optional in the European Union. It is a must. Our Union is not a State but it is a community of law.

A more united Union

These three principles must be the foundations on which we build a more united, stronger and more democratic Union. When we talk about our future, experience tells me new Treaties and new institutions are not the answer people are looking for. They are merely a means to an end, nothing more, nothing less. They might mean something to us here in Strasbourg and in Brussels. But they do not mean a lot to anyone else.

I am only interested in institutional reforms if they lead to more efficiency in our Union. Instead of hiding behind calls for Treaty change – which is in any case inevitable – we must first change the mind-set that for some to win others must lose.

Democracy is about compromise. And the right compromise makes winners out of everyone. A more united Union should see compromise, not as something negative, but as the art of bridging differences. Democracy cannot function without compromise. Europe cannot function without compromise. This is what the work between Parliament, Council and Commission should always be about.

A more united Union also needs to become more inclusive. If we want to strengthen the protection of our external borders, then we need to open the Schengen area of free movement to Bulgaria and Romania immediately. We should also allow Croatia to become a full Schengen member once it meets all the criteria.

If we want the euro to unite rather than divide our continent, then it should be more than the currency of a select group of countries. The euro is meant to be the single currency of the European Union as a whole. All but two of our member states are required and entitled to join the euro once they fulfil all conditions.

Member states that want to join the euro must be able to do so. This is why I am proposing to create a Euro-accession Instrument, offering technical and even financial assistance. If we want banks to operate under the same rules and under the same supervision across our continent, then we should encourage all member states to join the Banking Union.

Completing the Banking Union is a matter of urgency. We need to reduce the remaining risks in the banking systems of some of our member states. Banking Union can only function if risk-reduction and risk-sharing go hand in hand. As everyone well knows, this can only be achieved if the conditions, as proposed by the Commission in November 2015, are met. To get access to a common deposit insurance scheme you first need to do your homework.

If we want to avoid social fragmentation and social dumping in Europe, then member states should agree on the European Pillar of Social Rights as soon as possible and at the latest at the Gothenburg summit in November. Na-

tional social systems will still remain diverse and separate for a long time. But at the very least, we should work for a European Social Standards Union in which we have a common understanding of what is socially fair.

Europe cannot work if it shuns workers. If we want more stability in our neighbourhood, then we must maintain a credible enlargement perspective for the Western Balkans. It is clear that there will be no further enlargement during the mandate of this Commission and this Parliament. No candidate is ready yet. But thereafter the European Union will be greater than 27 in number. Accession candidates must give the rule of law, justice and fundamental rights utmost priority.

This rules out EU membership for Turkey for the foreseeable future. Turkey has been taking giant strides away from the European Union for some time. Journalists belong in newsrooms not in prisons. They belong where freedom of expression reigns. The call I make to those in power in Turkey is this: let our journalists go. And not just them either. Stop insulting our member states by comparing their leaders to fascists and Nazis. Europe is a continent of mature democracies. Insults create roadblocks. Sometimes I get the feeling Turkey is intentionally placing these roadblocks so that it can blame Europe for any breakdown in accession talks. As for us, we will always keep our hands stretched out towards the great Turkish people and those who are ready to work with us on the basis of our values.

A stronger Union

Our Union must also grow stronger. I want a stronger single market. When it comes to important single market questions, I want decisions in the Council to be taken more often and more easily by qualified majority – with the equal involvement of the European Parliament. We do not need to change the Treaties for this. There are so-called “*passerelle clauses*” in the current Treaties which allow us to move from unanimity to qualified majority voting in certain areas – if all Heads of State or Government agree to do so.

I am also strongly in favour of moving to qualified majority voting for decisions on the common consolidated corporate tax base, on VAT, on fair taxes for the digital industry and on the financial transaction tax. Europe has to be able to act quicker and more decisively.

I want a stronger Economic and Monetary Union. The euro area is more resilient now than in years past. We now have the European Stabilisation Mechanism (ESM). I believe the ESM should now progressively graduate into a European Monetary Fund and be firmly anchored in our Union. The Commission will make concrete proposals for this in December.

We need a European Minister of Economy and Finance: a European Minister that promotes and supports structural reforms in our member states. He or she can build on the work the Commission has been doing since 2015 with our Structural Reform Support Service. The new Minister should coordinate all EU financial instruments that can be deployed when a member state is in a recession or hit by a fundamental crisis.

I am not calling for a new position just for the sake of it. I am calling for efficiency. The Commissioner for economic and financial affairs – ideally also a Vice-President – should assume the role of Economy and Finance Minister. He or she should also preside the Eurogroup. The European Economy and Finance Minister must be accountable to the European Parliament.

We do not need parallel structures. We do not need a budget for the euro area but a strong euro area budget line within the EU budget. I am also not fond of the idea of having a separate euro area parliament. The Parliament of the euro area is the European Parliament.

The European Union must also be stronger in fighting terrorism. In the past three years, we have made real progress. But we still lack the means to act quickly in case of cross-border terrorist threats. This is why I call for a Euro-

pean intelligence unit that ensures data concerning terrorists and foreign fighters are automatically shared among intelligence services and with the police. I also see a strong case for tasking the new European Public Prosecutor with prosecuting cross-border terrorist crimes.

I want our Union to become a stronger global actor. In order to have more weight in the world, we must be able to take foreign policy decisions quicker. This is why I want member states to look at which foreign policy decisions could be moved from unanimity to qualified majority voting. The Treaty already provides for this, if all member states agree to do it.

And I want us to dedicate further efforts to defence matters. A new European Defence Fund is in the offing. As is a Permanent Structured Cooperation in the area of defence. By 2025 we need a fully-fledged European Defence Union. We need it. And NATO wants it.

Last but not least, I want our Union to have a stronger focus on things that matter, building on the work this Commission has already undertaken. We should not meddle in the everyday lives of European citizens by regulating every aspect. We should be big on the big things. We should not march in with a stream of new initiatives or seek ever growing competences. We should give back competences to Member States where it makes sense.

This is why this Commission has been big on big issues and small on the small ones, putting forward less than 25 new initiatives a year where previous Commissions proposed over 100. We have handed back powers where it makes more sense for national governments to deal with things. Thanks to the good work of Commissioner Vestager, we have delegated 90% of state aid decisions to the regional or local level.

To finish the work we started, I am setting up a Subsidiarity and Proportionality Task Force as of this month to take a very critical look at all policy areas to make sure we are only acting where the EU adds value. First Vice-President

Frans Timmermans, who has a proven track record on better regulation, will head this Task Force. The Timmermans Task Force, which should include members of this Parliament as well as members of national Parliaments, should report back in a year's time.

A more democratic Union

Our Union needs to take a democratic leap forward. I would like to see European political parties start campaigning for the next elections much earlier than in the past. Too often Europe-wide elections have been reduced to nothing more than the sum of national campaigns. European democracy deserves better.

The Commission is proposing new rules on the financing of political parties and foundations. We should not be filling the coffers of anti-European extremists. We should be giving European parties the means to better organise themselves. I also have sympathy for the idea of having transnational lists – though I am aware this is an idea more than a few of you disagree with. Such lists would help make European Parliament elections more European and more democratic.

I also believe that, over the months to come, we should involve national Parliaments and civil society at national, regional and local level more in the work on the future of Europe. Over the last three years, members of the Commission have visited national Parliaments more than 650 times. They also debated in more than 300 interactive Citizens' Dialogues in more than 80 cities and towns across 27 member states. But we can still do more. This is why I support President Macron's idea of organising democratic conventions across Europe in 2018.

As the debate gathers pace, I will personally pay particular attention to Estonia, Latvia, Lithuania and Romania in 2018. This is the year they will celebrate their 100th anniversary. Those who want to shape the future of our continent should well understand and honour our common history. This includes these four countries – Europe would not be whole without them.

The need to strengthen democracy also has implications for the European Commission. Today, I am sending the European Parliament a new Code of Conduct for Commissioners. The new Code first of all makes clear that Commissioners can be candidates in European Parliament elections under the same conditions as everyone else. The new Code will of course strengthen the integrity requirements for Commissioners both during and after their mandate.

If you want to strengthen European democracy, then you cannot reverse the democratic progress seen with the creation of lead candidates – ‘Spitzenkandidaten’. I am convinced that any future President will benefit greatly from the unique experience of having campaigned in all quarters of our beautiful continent. To understand the challenges of his or her job and the diversity of our member states, a future President should have met citizens in the townhalls of Helsinki as well as in the squares of Athens. In my personal experience of such a campaign, it makes you more humble, but also strengthens you during your mandate. And you can face the other leaders in the European Council with the confidence that you have been elected, just as they have. This is good for the balance of our Union.

More democracy means more efficiency. Europe would function better if we were to merge the Presidents of the European Commission and the European Council. This is nothing against my good friend Donald, with whom I have worked seamlessly together for the past three years. This is nothing against Donald or against me. Europe would be easier to understand if one captain was steering the ship. Having a single President would better reflect the true nature of our European Union as both a Union of States and a Union of citizens.

Our Roadmap

The vision of a more united, stronger and more democratic Europe I am outlining today combines elements from all of the scenarios I set out in March. But our future cannot remain a scenario, a sketch, an idea amongst others. We have to prepare the Union of tomorrow, today.

I have sent a Roadmap to President Tajani, President Tusk as well as to the holders of the rotating Presidencies of the Council between now and March 2019, outlining where we should go from here. An important element will be the plans the Commission will present in May 2018 for how the future EU budget can match our ambition and make sure we can deliver on everything we promise.

On 29 March 2019, the United Kingdom will leave the European Union. This will be a very sad and tragic moment. We will always regret it. But we have to respect the will of the British people. On 30 March 2019, we will be a Union of 27. I suggest that we prepare for this moment well, amongst the 27 and within the EU institutions.

European Parliament elections will take place just a few weeks later, in May 2019. Europeans have a date with democracy. They need to go to the polls with a clear understanding of how the European Union will develop over the years to come.

This is why I call on President Tusk and Romania, the country holding the Presidency in the first half of 2019, to organise a Special Summit in Romania on 30 March 2019. My wish is that this summit be held in the beautiful ancient city of Sibiu, or Hermannstadt as I know it. It should be the moment we come together to take the decisions needed for a more united, stronger and democratic Europe.

My hope is that on 30 March 2019, Europeans will wake up to a Union where we all stand by our values. Where all member states firmly respect the rule of law. Where being a full member of the euro area, the Banking Union and the Schengen area has become the norm for all EU member states. Where we have shored up the foundations of our Economic and Monetary Union so that we can defend our single currency in good times and bad, without having to call on external help.

Where our single market will be fairer towards workers from the East and from the West. Where we managed to agree on a strong pillar of social standards. Where profits will be taxed where they were made. Where terrorists have no loopholes to exploit. Where we have agreed on a proper European Defence Union. Where a single President leads the work of the Commission and the European Council, having been elected after a democratic Europe-wide election campaign.

If our citizens wake up to this Union on 30 March 2019, then they should be able to vote in the European Parliament elections a few weeks later with the firm conviction that our Union is a place that works for them.

Conclusion

Europe was not made to stand still. It must never do so. Helmut Kohl and Jacques Delors taught me that Europe only moves forward when it is bold. The single market, Schengen and the single currency were all written off as pipe dreams before they happened. And yet these three ambitious projects are now a reality.

I hear those who say we should not rock the boat now that things have started to get better. But now is not the time to err on the side of caution. We started to fix the roof. But we must complete the job now that the sun is shining and whilst it still is. Because when the next clouds appear on the horizon – and they will – it will be too late. So let's throw off the bowlines. Sail away from the harbour. And catch the trade winds in our sails. ■

Jean-Claude Juncker is President of the European Commission

Based on the [State of the Union Address](#) given to Members of the European Parliament, Brussels, 13 September 2017

Making the most of Europe's strengths



Margrethe Vestager on creating the right conditions for European companies to succeed

Introduction

Europe's future depends on being competitive. It depends on jobs for our young people. On the growth that creates opportunities for them. And to produce those jobs, and that growth, we need businesses that can compete in markets all around the world.

Right now – ten years after the financial crisis began – jobs and growth are back in Europe. Every EU economy grew last year. Some 234 million people have jobs in the EU – that's more than ever before.

To build on that recovery, so it makes life better for all Europeans, we need to make our economy even more competitive. And we have what it takes. Of the top 20 countries in the World Bank's *Doing Business* rankings, nine are members of the European Union. In the World Intellectual Property Organisation's Global Innovation Index, ten of the top 20 countries were from the EU.

So Europe starts from a strong position. With skilled people, and innovative businesses. And being competitive is really about making the most of those strengths.

Competition and competitiveness

It's about having a single market where innovative businesses can thrive. And for that, we need competition. Competition keeps down the cost of the things our businesses rely on. Last year, our decisions on cartels and mergers saved customers – including businesses – some €30 billion.

Those are cases like a cartel that fixed gross list prices of trucks for fourteen years. Or the merger between two shipping companies, Maersk and Hamburg Süd, which would have raised shipping costs if we hadn't stepped in.

Defending competition also means dealing with government subsidies. So that every business in Europe can compete on equal terms. And so success goes to the companies that are most efficient and innovative – not to the ones that get most help from government.

That's what's at stake when we deal with state aid in the form of special tax treatment. Or when we make sure that state support for banks uses as little public money as possible, and doesn't undermine competition.

Competition and innovation

Because competition gives our most innovative companies a chance to thrive. But the link between competition and innovation goes even deeper. Because it's competition that drives companies to innovate.

*... fair competition is the way for Europe to succeed.
But it needs to be based on a real level playing field*

Look at our decision involving Google. In most European countries, Google's search engine has more than 90% of the market. And we don't object to that success – after all, it inspires others to innovate. But we do have a problem with Google using that dominance to deny others a chance to compete. By making sure its own comparison shopping service was always at the top of the first page of its search results – and its rivals, on average, only on page four.

Because that sort of behaviour discourages innovation. There's no point innovating, if consumers will never know your service is there. And if successful companies can hold back innovation, we won't get the most out of Europe's potential.

We deal with the same issue when we look at mergers. Earlier this year, we found that the merger between Dow and DuPont would not just raise prices, but also hold back innovation. Because they were two of only five companies that were active in all stages of developing pesticides, to meet the needs of farmers throughout the world. And we found evidence that they were planning to cut back their research efforts after the merger.

So we only approved that deal after the companies agreed to sell large parts of DuPont's pesticide business, which brought in revenues of about 1.4 billion dollars last year, and which included DuPont's worldwide research arm for pesticides.

Financing innovation

But competition alone isn't enough. To get new ideas to the market in the first place, our innovators need money. And this Commission is determined to help them find that money. That's why our plan for a Capital Markets Union will unlock new sources of money for growing companies. In May, the European Parliament and the Council reached agreement on our proposal to make it easier for venture capital funds to invest in smaller companies.

It's why innovation is an essential part of the Juncker Investment Plan. The projects that have already been approved under that plan could trigger more than 225 billion euros of investment – and more than a fifth of that is aimed at research, development and innovation.

And it's why the Horizon 2020 programme – our biggest ever programme for research and innovation – will provide money to help take new ideas from the lab to the market.

State aid rules and innovation

Of course, when EU governments hand out support for innovation, they need to follow the state aid rules. We have to make sure that support really does help innovation, without harming competition.

But there's no reason why that should stop money getting where it's needed, quickly and efficiently.

In the last few years, we've been working to make it even simpler for EU governments to give state aid that doesn't harm competition – including state support for innovation. Last year, almost all state aid measures for research and innovation were given without needing our approval in advance.

And even when support does need our approval, that doesn't stand in the way of innovation. We've approved projects like the more than €350 million that France and Germany are providing to help Airbus develop an innovative new helicopter.

Under our rules, governments can cover up to 90% of the costs for small companies doing applied research. The rules allow even higher levels of support, if a similar project outside the EU is supported by state aid.

And for multinational projects of common European interest – projects where a number of EU countries and companies cooperate, and which benefit Europe as a whole – governments can provide up to 100% of the missing funds.

Because state aid rules shouldn't get in the way of supporting innovation. And we take that pledge very seriously indeed. It's why, for example, we're about to launch a study, to collect evidence that will help us better understand how the state aid rules affect public support for innovation.

International control of subsidies

But of course, to give European companies a real chance to succeed, we need fair competition, not just in Europe, but all around the world. In many areas, like dealing with climate change or preventing tax avoidance, the EU has given the lead that has made international agreement possible. We should do the same when it comes to the rules that make international trade not just free, but also fair.

Our state aid rules can be a model for a better international approach to subsidies. In the last few months, the leaders of the G7 and the G20 have made clear that we need to deal with subsidies that undermine competition.

We've signed an agreement with China, to set up a dialogue on state aid that will help us discuss subsidies that can harm competition. And we've reached agreement in principle on a free trade agreement with Japan, including a commitment to be more open about subsidies, and to avoid the most harmful types of support.

Those experiences can help us to work with partners around the world, to improve the WTO rules that deal with subsidies. So transparency about those subsidies really works in practice. And so the rules cover more of the support that harms competition the most.

Conclusion

Because we know that fair competition is the way for Europe to succeed. But it needs to be based on a real level playing field. In the last few months, we've heard concerns about foreign – often state-owned – investors taking over European companies that control key technologies.

This issue isn't simple. It needs careful consideration, before we decide how to act. We're working on this issue now, and we plan to put forward concrete proposals in the autumn.

Because European businesses have what it takes to succeed. Our job is to build the right conditions, so they – and we – can make the most of that potential. ■

Margrethe Vestager is the European Commissioner for Competition

Based on a [speech](#) delivered at the Ambrosetti Forum, Villa d'Este, 2 September 2017



Should the EU have the power to vet foreign takeovers?

André Sapir and Alicia García-Herrero debate the issue,
which has become topical in view of recent Chinese
investment in Europe

In July, the German government expanded its powers to block the foreign takeover of German companies. The decision was a reaction to the accelerating acquisition of German high-tech firms by Chinese companies, including the landmark purchase last year of Kuka, Germany's largest maker of industrial robotics, by Midea, a Chinese appliance maker.

The move by the German government followed almost immediately an aborted attempt by France, Germany and Italy to set up an EU mechanism to monitor and, if needed, veto third country buyouts.

According to [press reports](#), the three countries' demand was met with strong opposition from a majority of EU countries at this year's June European Council summit. As a result, the summit conclusion did not include an invitation to the Commission to *"examine the need and ways to screen investment from third countries in strategic sectors"*, as a previous draft had proposed. Instead it simply called on the Commission to *"analyse investments from third countries in strategic sectors, while fully respecting member states' competences"*.

But this setback for France, Germany and Italy may only be temporary. The *Financial Times* [recently reported](#) that, in his State of the Union speech on 13 September, the European Commission president, Jean-Claude Juncker, *"will call for more rigorous screening of foreign takeovers of European companies, as it seeks to address mounting concerns about a surge of Chinese investment into the bloc's high-tech manufacturing, energy and infrastructure sectors."*

So, should the EU rethink its position and give the Commission the power to vet foreign takeovers? Here two Bruegel scholars give different answers to this timely question.

André Sapir: YES, but...

There are three reasons why the EU should have the power to vet foreign takeovers.

The first reason is that 13 of the EU's 28 members already have national legislation for screening takeovers to evaluate whether they constitute a threat to national security or other public policy goals¹. Having an EU mechanism instead of national mechanisms would be preferable. It would be better for the functioning of the single market. Having different national rules creates problems for dealing with firms that operate in several EU countries. Better to have a single EU rule for the smooth functioning of the single market. An EU-level vetting process also offers greater size and leverage. Having a single EU rule gives each EU country greater leverage over foreign countries than having a national rule.

EU competition policy could become a convenient substitute for a European-level investment protection policy in the same way as EU competition policy has long been known for being used for trade policy purposes

There is obviously a counter-argument to this reasoning. It is that 15 EU members do not feel the need for legislation to screen foreign takeovers, presumably because they consider that foreign investment is always desirable. Moreover, even among the 13 countries that currently have a system to vet foreign takeovers, there are many differences in the rules which reflect differences in national preferences.

The question, therefore, is whether the benefits of a single EU rule (smoother functioning of the single market and greater leverage vis-à-vis foreign countries) outweigh the costs associated with different national preferences. This is obviously a difficult question. However, we should remember that EU members have extended, with the Lisbon Treaty, the EU's exclusive competence in the field of trade to cover foreign direct investment (with the [exception](#) of dispute settlement between investors and states). This implies that EU countries may be willing to forego national preferences for common EU action in the area of foreign takeovers as well.

The second reason is that the United States has long vetted foreign takeovers, through its Committee on Foreign Investment (CFIUS). CFIUS has sometime even prevented foreign firms from buying EU companies. For instance, last year CFIUS blocked the purchase of a US-based unit of Philips, the Dutch giant, and of a German-based chip equipment maker, Aixtron, by Chinese companies on national security grounds.

The third reason is China. There is a strong asymmetry between the EU and China regarding the treatment of foreign investment by state authorities. This asymmetry basically stems from the fact that Chinese state-owned enterprises (SOEs) are *"bigger, more pervasive and more dominant than their EU counterparts"*, as Alicia García-Herrero and Jianwei Xu explain in a recent [Bruegel paper](#). The implication is that Chinese investors in the EU are often connected to the Chinese state, which potentially raises national security issues that are rarely scrutinised by EU states. Typically, whether they are connected to the Chinese state or not, Chinese investors are treated on equal footing with EU investors in the EU. On the other hand, EU investors in China are rarely connected to EU states, yet they often en-

counter great difficulty both in setting up production and, if they succeed, in competing with local firms that benefit from state connections.

An EU mechanism to vet third country buyouts, including from China, would strengthen the hand of the EU in its bilateral investment negotiations with China. These started more than three years ago and are making slow progress due to the vexing (for the EU) SOE question.

Taken together, these three reasons seem compelling in favour of setting up an EU mechanism to monitor and, if needed, stop foreign takeovers.

There are, however, two important questions that need to be addressed before signing up to the idea.

The first concerns the scope of the strategic sectors or assets that would be scrutinised by the new mechanism. This is crucial to ensure that this mechanism serves genuine security concerns rather than protectionist interests.

The second question concerns the heterogeneity of preferences within the EU. For instance, there is understandable worry in some EU countries, especially those where foreign direct investment is badly needed to improve their growth prospects, that an EU mechanism to vet takeovers may slow down the inflow of such investment. One way to deal with this issue, and more broadly with the heterogeneity of preferences within the EU towards, would be to let EU states activate the EU mechanism at their request rather than having the EU decide when to activate it, except under certain well-specified conditions.

Combining these two questions, the scope and the heterogeneity, one could have a two-level system. Under certain narrow conditions, the EU mechanism would need to give its green light for a foreign takeover. Under some-

what broader conditions, the EU mechanism could be involved if the relevant member state so wishes.

For the cases when the involvement of the EU mechanism would be mandatory, the body in charge of the mechanism (presumably the European Commission) would make a recommendation to the Council, which would ultimately decide whether to block or not the proposed takeover².

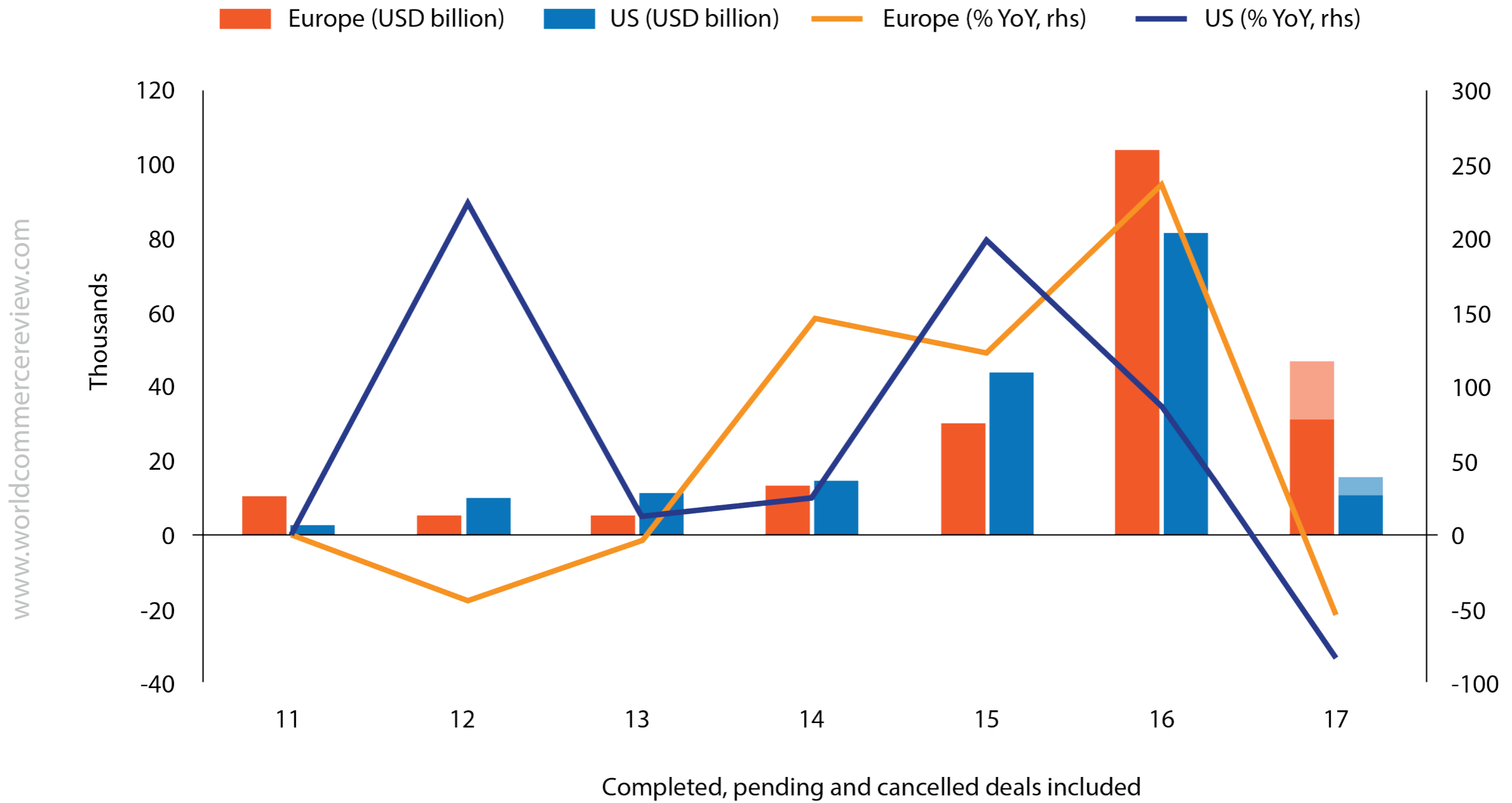
Alicia García-Herrero: NO, but...

There are many reasons for the rising chorus of voices asking to protect European companies from foreign buyers. But China comes to mind first. Chinese companies have been acquiring foreign targets at an astounding pace, with over 30 billion USD in confirmed deals in 2016 and close to USD 100 billion if we were to add all deals which have been announced and not completed. Beyond the high numbers, one should note that both the announced and the completed Chinese acquisitions of European targets were larger than those of US targets (See Figure 1).

The sharp slowdown in mergers and acquisitions (M&A) in 2017 is actually not only for European targets but for China's M&A globally (with a 20% reduction in the first half of 2017)³. In the absence of a global slowdown or tightening of financial conditions, such a sharp slowdown in Chinese M&A can only be explained by the recent change of direction of the Chinese government as regards foreign acquisitions, or at least 'too exuberant' in less economically important sectors.

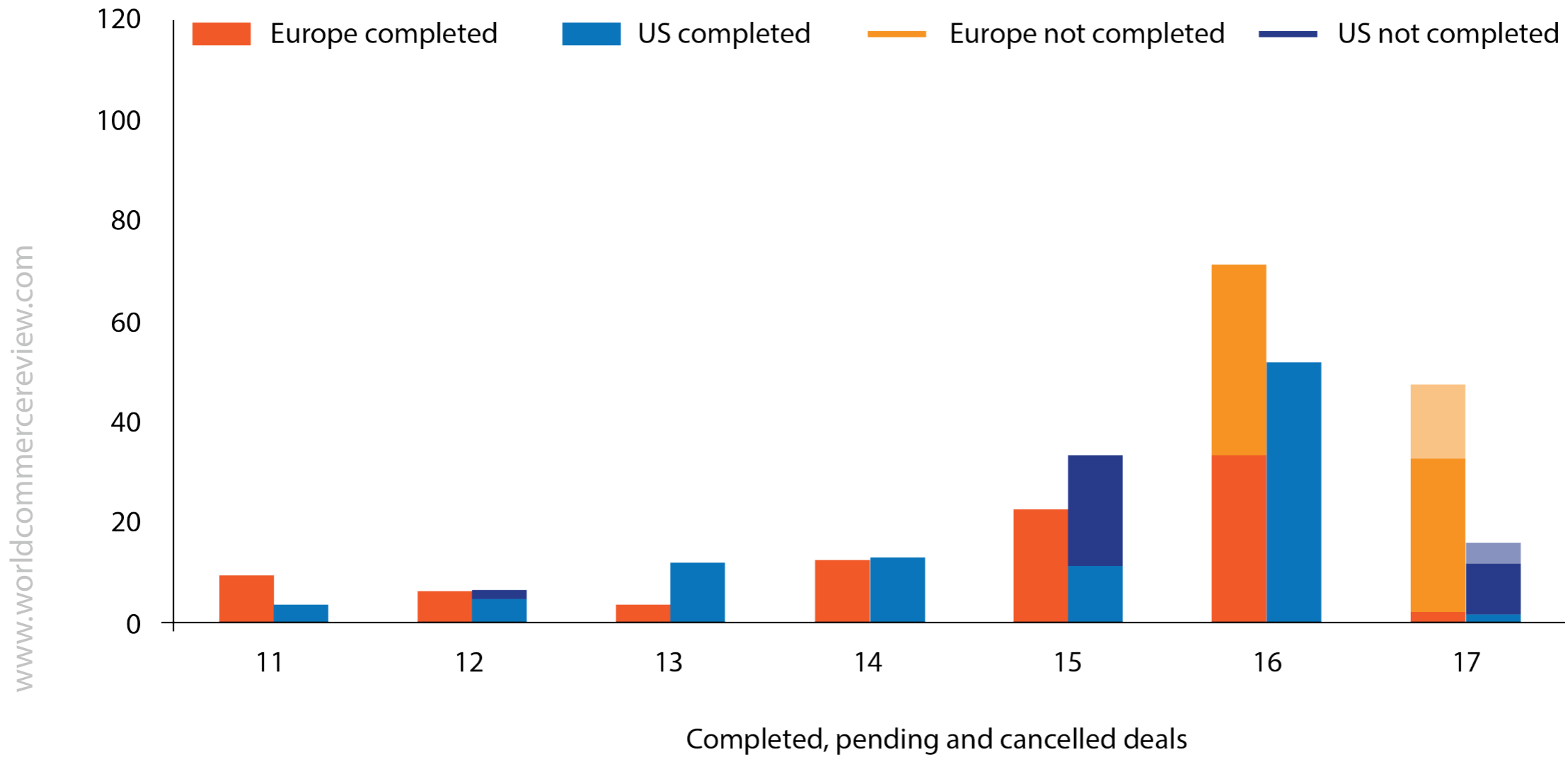
However, the headline figures hide a more interesting story. Fewer Chinese takeovers succeed in Europe than in the US. When analysing the M&A data more carefully, it appears that a smaller percentage of deals has been completed successfully in Europe as compared to the US during the last few years (Figure 2). This evidence runs counter to the presumption that an investment protection agency, like CFIUS, would reduce the number of deals completed. In reality, there are many other reasons why potential merger and acquisitions do not come through, the most obvious

Figure 1. Cross border M&A deals by Chinese corporates



Source: Natixis, Bloomberg *2017 data as of 29 August 2017 and interpolated

Figure 2. Cross border M&A deals by Chinese corporates by deal status (USD billion)



Source: Natixis, Bloomberg *2017 data as of 29 August 2017 and interpolated

one being the lack of agreement on the terms between the two parties as well as the difficulties that the buyer may find to finance the operation. In fact, when one looks at US M&A operations in Europe, the percentage of deals that are completed is nearly as low as those of Chinese corporates trying to acquire targets in Europe (Figure 3 a,b c). In other words, it seems difficult to argue that Chinese investors are being pushed out of Europe, at least not more than US investors.

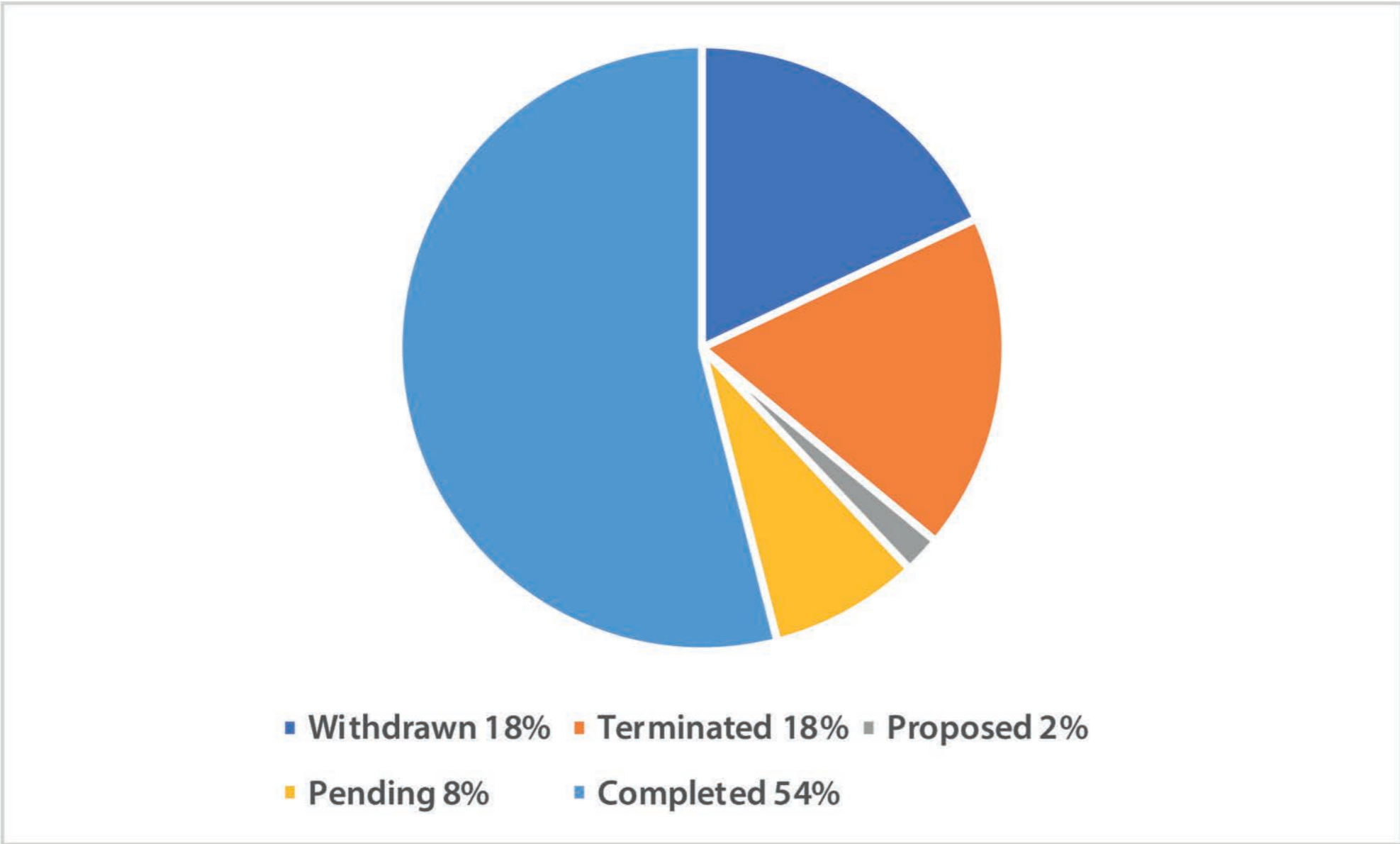
While the aggregate numbers do not show a clear protectionist trend in Europe yet, the reality is that warning signals are rising. There are a number of reasons for this. The first, and probably most important, is related to China's economic model and, more importantly, company ownership structure. Still today, 64% of China's listed corporates are state-owned, which raises eyebrows in European circles regarding potential national security threats. A second one, also important, is Europe's fear of losing its comparative advantage as China moves up the ladder, which can be facilitated through the technological transfers embedded in China's acquisition of European high-tech companies.

While understandable, such arguments need to come to terms with standard economic theory by which openness to foreign direct investment (FDI) should bring net benefits to a country. As for international trade, openness to foreign investment promotes competition and, thus, benefits consumers. Full openness to foreign investors should, thus, be the first-best approach. But this is with one very important assumption, namely that all countries follow the same reasoning: there is no free rider, or at least not a systemically important one.

China, the second largest economy in the world and second largest foreign direct investor in 2016, is the fourth most restrictive country for FDI in a sample of sixty-three major countries, after the Philippines, Saudi Arabia and Myanmar⁴.

Figure 3a. Cross border M&A deals by Chinese corporates by deal status (2011 – 2017, Europe)

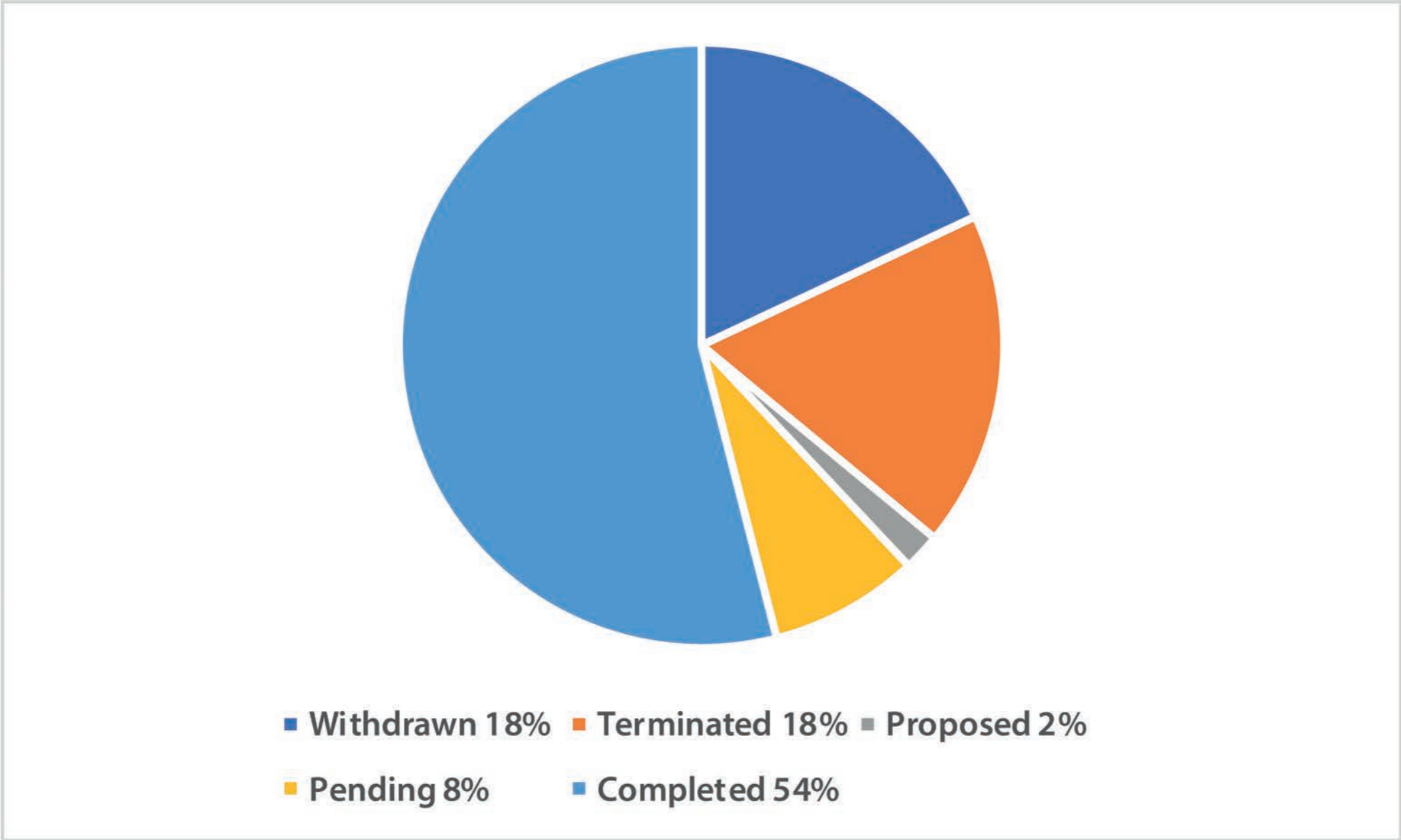
www.worldcommercereview.com



Source: Natixis, Bloomberg *2017 data as of 29 August 2017

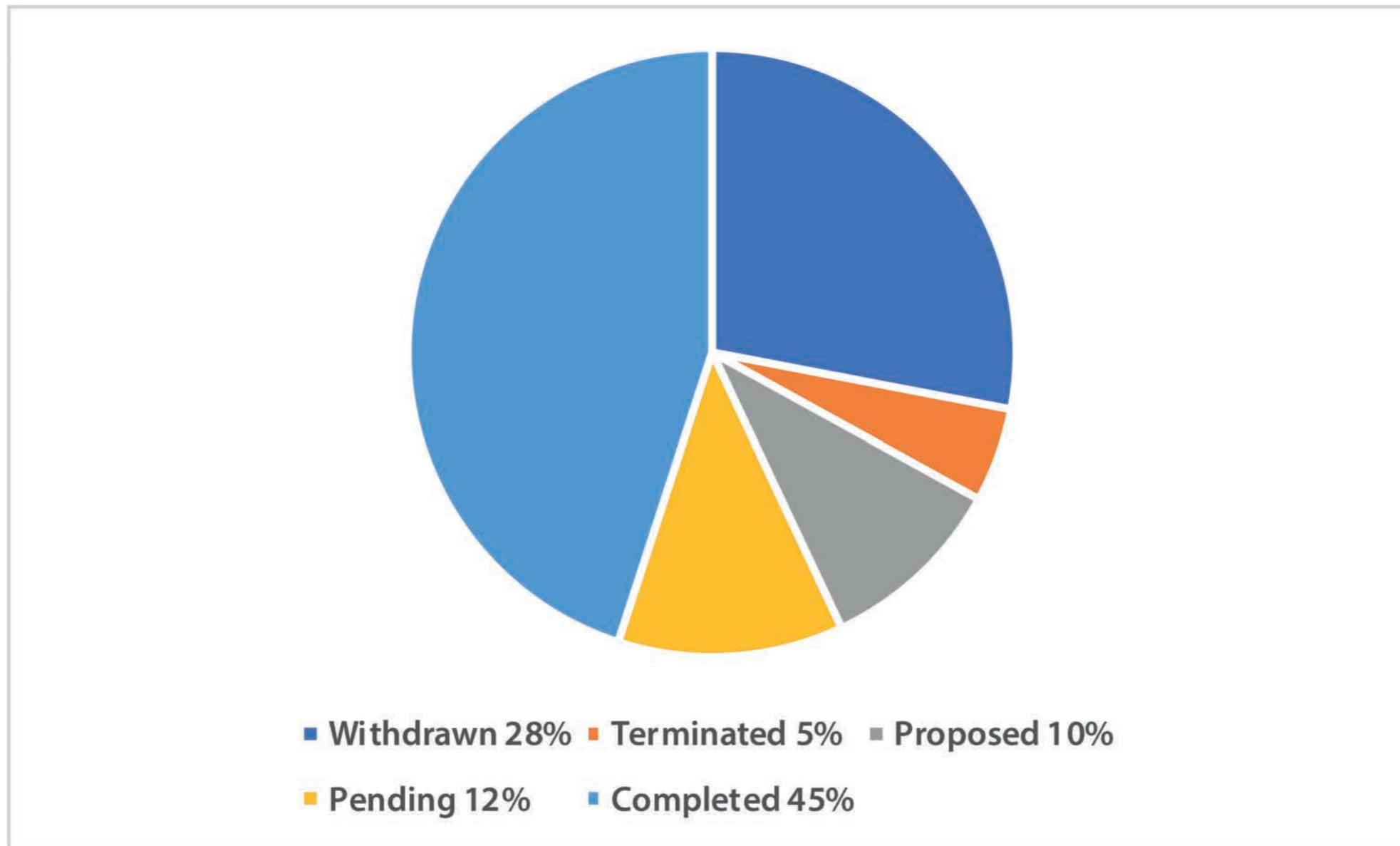
Figure 3b. Cross border M&A deals by Chinese corporates by deal status (2011 – 2017, US)

www.worldcommercereview.com



Source: Natixis, Bloomberg *2017 data as of 29 August 2017

Figure 3c. Cross border M&A deals by US corporates into Europe by deal status (2011 – 2017)



Source: Natixis, Bloomberg *2017 data as of 29 August 2017

With this background, and given the size of China's domestic market and the increasingly globalised business of corporations, it seems farfetched to solve Europe's challenges with Chinese investment with a new European agency in charge of investment protection. Such an agency could potentially stop some of the most problematic deals, especially if related to European-level security threats. But it would not solve a much wider issue for European interests, namely the threat of unfair competition – not only in Europe but actually globally.

Such unfair competition could stem from Chinese corporates preferential – sometimes even oligopolistic – access to the world's largest – but also very protected – market in many sectors, namely that of China⁵. In fact, the combination of such a protected market with the very large share of state ownership complicates matters even further: European concerns on national security issues cannot always be disentangled from competition issues.

In that regard, pushing for more market access in China seems like the best way for European companies to protect themselves and, clearly, also a more optimal solution globally. There are two ways forward to ensure this first-best solution (equally free access by foreign investors in China and Europe). The first is multilateral and the second is bilateral.

The multilateral route is extremely difficult, if not impossible with the current international financial architecture. Multilateral processes for investment liberalisation are less institutionalised than for trade and, even there, there is no room for optimism in the current geopolitical juncture.

The latter option, the bilateral route, is currently being pursued by the Chinese government and EU Commission, which have been negotiating a bilateral investment agreement since late 2013. Unfortunately, the prospects for China agreeing to open its market to foreign investors on an equal footing, in exchange for keeping its ability to purchase companies in Europe, are quite dim. China's access to M&A deals is relatively ample (USD 30 billion in com-

pleted acquisitions in 2016 says it all) so the only threat is that action is taken to reduce it. The reality is that it will take time for the EU to come up with a formalised vetting system as member states clearly have different opinions in this issue. It is much more likely that member states come up with new restrictions at the national level, further harming the European single market.

Moving to a second-best world – in which granting free access to Chinese investors does not correspond with more market access for European companies in China – Europe may prefer a more realistic and quicker solution to deal with any potential threats stemming from Chinese purchases of European corporations. The most obvious one is the application of Europe's competition rules. More specifically, Chinese companies operating in Europe – or exploring new acquisitions in Europe – need to comply with European competition rules, which include the avoidance of a dominant position negatively affecting the functioning of the European Single Market.

The Glencor-Lonhor case in 1999 shows that EU Commission's powers can go as far as refusing a merger of two foreign companies already approved by the local regulator if it creates a dominant position globally, affecting the good functioning of the European single market. This case is increasingly relevant for China, which has embarked on a process of mergers to rationalise large SOEs, creating national champions to compete globally. The most recent Google case, relating to its abuse of dominance in search, also constitutes a good warning signal for Chinese tech companies with global/European ambitions of.

More generally, EU competition policy could become a convenient substitute for a European-level investment protection policy in the same way as EU competition policy has long been known for being used for trade policy purposes (especially for antidumping)⁶. Beyond competition policy, Europe can make use of its very high environmental and labour protection standards, which every company operating in Europe should comply with. The fundamental principle is that the best way to keep an open investment environment is to protect Europe's single market

with its existing rules and regulations – which not only European companies but also foreign ones need to abide to.

In sum, beyond the wishful thinking of a first-best world, full application of European competition policy and other rules and regulations to protect the European single market seems to be quickest and most efficient way to go to confront potential issues with Chinese investment. ■

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Japan's choice

Stephen Nagy discusses the choice for the Japanese; stability, security and growth vs. stagnation, insecurity and relative decline

“Given his long record of broken promises and unrealized goals, collective amnesia is his best bet for regaining voters’ trust”.¹

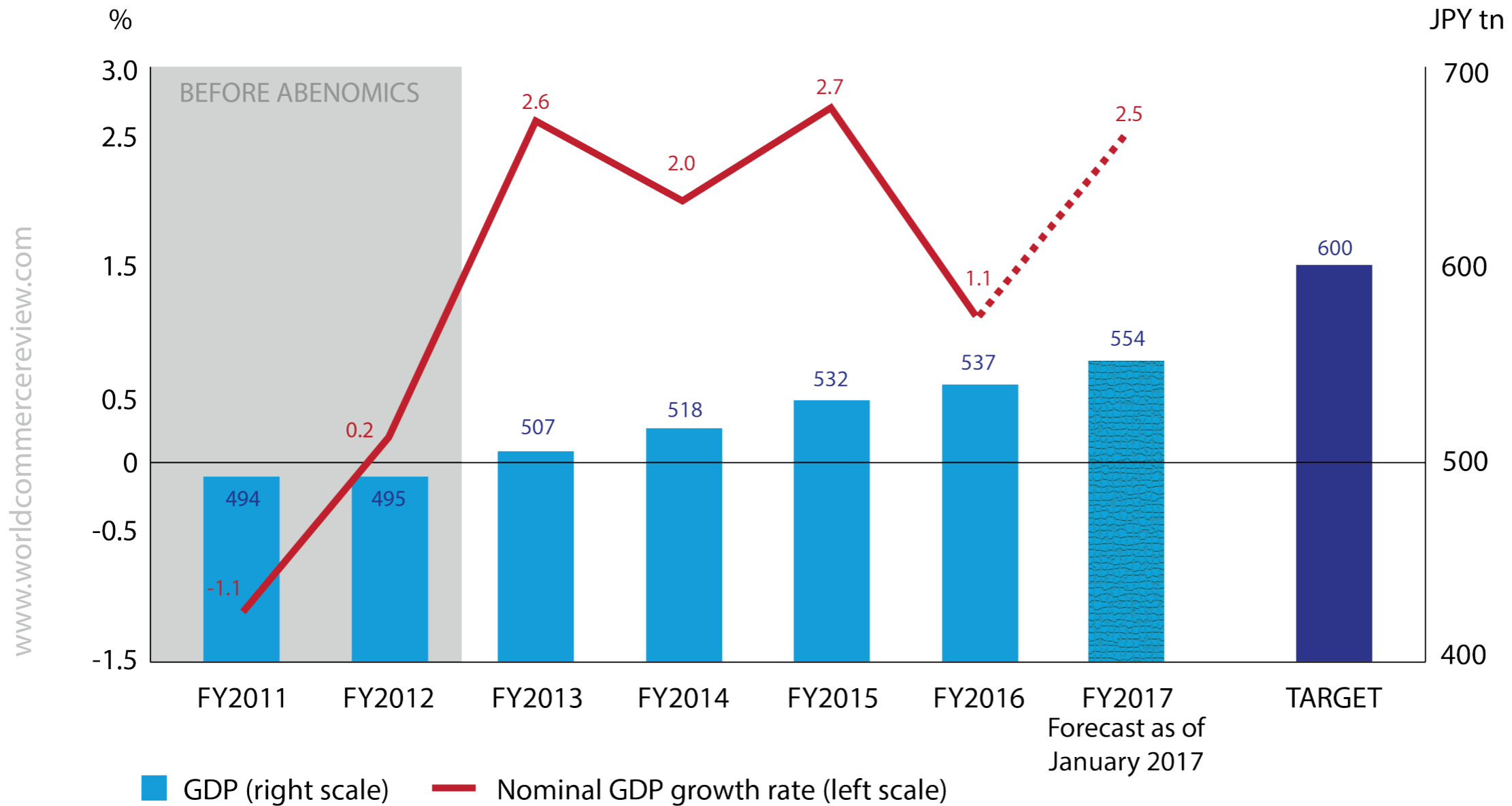
You may have been forgiven for thinking the writer of the comment above was speaking of President Trump. In fact, the quote comes from a recent commentary on PM Abe’s second tenure as PM following the Governor Koike’s Tomin First victory in the Tokyo Metropolitan election².

PM Abe’s return as Prime Minister in December 2012 brought with it economic growth (Figure 1), growing security ties in and outside the region³, expanded consumer confidence and political stability. This in part has been related to a plethora of policies that falls under rubric of Abenomics⁴ which includes but is not exclusive to quantitative easing, deregulation, improved corporate governance⁵ standards and a host of other policies. The results have been increased capital investment (Figure 2) and increased corporate profits (Figure 3).

Figures from the Cabinet Office since 2010 are evidence that the policy approach, although not without problems and concerns has delivered economic growth. At the same time, PM Abe’s push for constitutional reform⁶, his right leaning conservative track record⁷, and a series of scandals⁸ and gaffs⁹ involving members of his Cabinet and even himself has shaken his support amongst his conservative base. This drop resulted in a Cabinet reshuffle in early August allowing him to regain some of his support¹⁰.

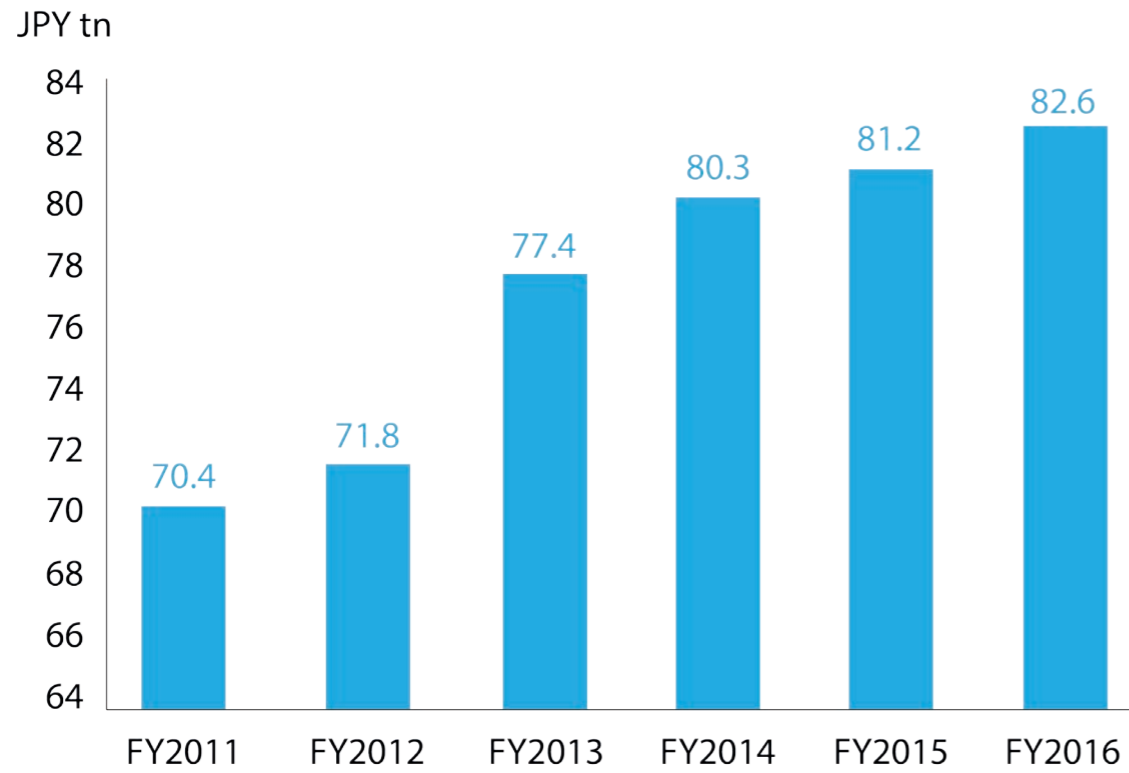
While PM Abe’s second stint as PM has not been without problems, missteps and questionable relationships, characterizing it as a *“long list of broken promises and unrealized goals”* fails to recognize the achievements of arguably

Figure 1. Nominal GDP and growth rate



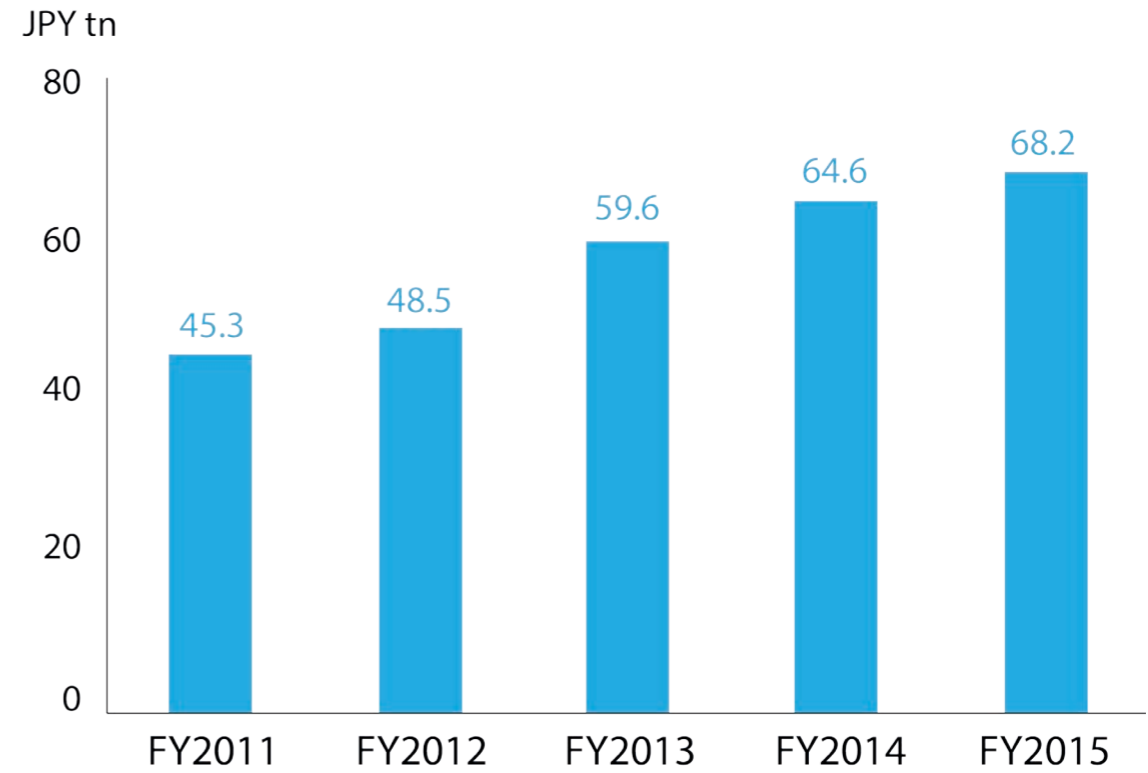
Source: Cabinet Office "National Accounts"; "Fiscal 2017 Economic Outlook and Basic Stance for Economic and Fiscal Management"

Figure 2. Capital investment



Source: Cabinet Office, "National Accounts;" private non-residential investment

Figure 3. Corporate profits



Source: Ministry of Finance "Financial Statements Statistics of Corporations by Industry," all industries, all (firm) sizes, seasonally adjusted figures

the most consequential PM in Japanese post WW 2 history. At the same time, the comments fail to highlight where the current administration could and should have done better.

It is in this environment that voters are now faced with a dilemma, do they continue to support a leader that has brought political stability, increased security through a tightening of the US-Japan Alliance and a series of strategic partnerships with intra and extra regional powers such as Australia¹¹, India¹², and Vietnam¹³, and economic growth or do they choose economic stagnation, increased insecurity and relative decline owing to weak leadership and incoherent policy?

The Japanese would need to ask themselves, why throw out a leader that has been successful and stable domestically, regionally and on the world stage as well?

While this is not a binary choice, investors should be concerned as well as a change in government in Japan could lead to a return to the revolving door of Prime Ministers and policy inconsistency that plagued Japan for much of the past 20 years.

Questionable right-wing associations and controversial policies

PM Abe's refusal to distance himself from right-wing organizations such as the Nippon Kaigi¹⁴ has tarred PM Abe with a far-right wing reputation, despite his track record as pragmatic PM that governs more from the centre than we would have expected by examining his pre-PM political career¹⁵.

These groups are problematic for PM Abe as they argue that in order to reinvigorate Japan, the Japanese Constitution needs to be revised to include the following principles:

- 1) To nurture patriotism and position the Imperial Family at the centre of Japan's identity;
- 2) To create a new Constitution based on Japan's traditional characteristics;
- 3) To safeguard the sovereignty and honour of Japan;
- 4) To include the teaching of tradition in education to inculcate pride and love of citizens for their nation;
- 5) To cultivate a willingness to protect the nation and to provide it with enough defensive power to secure its safety and contribute to world peace; and lastly
- 6) To foster coexistence and contribute to promoting the nation's status in the global community and to building friendship¹⁶.

Japan PMs revolving door legacy

Shinzō Abe returned as prime minister following five in five years



Yasuo Fukuda
September 2007 -
September 2008
Abruptly resigned as
he faced deadlocked
parliament and
dwindling popularity



Taro Aso
September 2008 -
September 2009
Stepped down after
massive election
defeat



Yukio Hatoyama
September 2009 -
June 2010
Resigned after row
over the relocation of a
US base



Naoto Kan
June 2010 -
August 2011
Resigned after turbulent
term and post-tsunami
criticisms



Yoshihiko Noda
September 2011 -
December 2012
Resigned after severe
election defeat



Shinzō Abe
Assumed office
December 2012, and is
the third longest serving
Prime Minister of post-
war Japan

While these proposals are supported by some political elites with roots in Japan's imperial past, they do not represent mainstream Japanese citizens with no ties to Japan's imperial past¹⁷.

At the same time, PM Abe has pushed through rational yet, controversial collective security legislation¹⁸ that the public has misgivings about do to deeply held post WW 2 pacifist norms and a lack of security literacy amongst quotidian Japanese¹⁹.

Critics of PM Abe have also voice concern over the new anti-conspiracy bill raising important questions about the state's commitment to democracy²⁰. While timely and needed to deal with the growing threat of terrorism and growing threats from abroad, the legislation has been perceived by voters as not having been accurately vetted and explained to citizens.

To gain back some of his credibility amongst voters PM Abe has pushed out some of the more extreme elements of his Cabinet during the recent Cabinet shuffle²¹, suggesting a more centrist approach to governance and the avoidance of ideologically-based politics which could upset trade relations with both China and South Korea, important markets for Japan's export dependent economy.

The jury is still out though whether these changes will be enough to allay the concerns of voters or prevent a political insurgence from within the LDP to push PM Abe out. What is clear though that questionable right-wing associations and controversial policies are leading voters to explore other political alternatives that may not lead to further political, economic and foreign policy insecurity.

Lukewarm commitment to reform

Critics of PM Abe have argued that his Abenomics has only half succeeded mostly because of lukewarm commitment to essential structural reform²². Whereas large exporters benefit from the yen's devaluation, domestically ori-

ented small and mid-sized businesses as well as families are said not to receive the benefits of Abenomics, only the higher prices of imports.

Others have argued that Abenomics has been hobbled by *“Japan’s consensus-based society, not favouring top down decision making”* stressing that *“it takes time to change long-standing policies, in particular those relating to labour markets”*.²³

The agriculture sector is a particularly illustrative example of a tepid commitment to structure reform. Instead of a full commitment to agreements signed in the initial TPP, we see the ‘agricultural tribe’ (nōrin zoku) of the ruling Liberal Democratic Party (LDP) pour cold water on real agricultural reforms through advocating a series of proposals, subsidies and assistance programs to blunt the impact that a fully implemented TPP would have on the agricultural sector²⁴.

The International Monetary Fund’s (IMF) Country Report on Japan which was released on July 31st, 2017 which outlined a series of nuanced assessments on the success or failure of Abenomics. In the report, the IMF stresses that *“structural impediments underlie Japan’s struggle with stagnant growth and deflation”* and that *“Abenomics has improved economic conditions and engendered structural reform, but key policy targets remain out of reach under current policies”*²⁵.

The report stressed that low birth rates and its ageing society are structural pressures that are preventing growth from gathering momentum and productivity increasing. Through committed labour market reform, increasing the number of foreign workers and the adoption of horizontal labour mobility policies, the IMF stresses that Abenomics would garner more momentum.

In short, greater commitment by political leaders in pushing through structural reforms is needed.

Security and economic achievements

PM Abe's star has shined most brightly in the areas of security and economic policy, a welcome relief to voters and investors. Sustained strategic commitment to expanding the number and quality of security partnerships in South-east Asia, South Asia as well as with extra-regional powers such as Australia, the UK, France and the UK are noteworthy achievements in that they strengthen Japan's security while abiding by Article 9 of Japan's Pacifist constitutional.

Focusing on capacity building, multi-layered and multidimensional security cooperation with ASEAN and other countries, Japan under PM Abe has taken an important role in alleviating some of its and her neighbours security concerns²⁶. This has been welcomed by Southeast Asian and South Asian countries but also by voters who have growing concerns about North Korea's belligerence and Chinese behaviour in the East China Sea and South China Sea. This support has deepened in light of the missile and nuclear tests by Pyongyang in the summer of 2017 and the island building activities in the South China Sea.

The advent of the strategic partnerships with India and Vietnam are significant as they expand the geographic cooperation of Japan through the Indo-Pacific bringing in new security partners. Above and beyond their security partnerships, the Indo-Pacific framework increases the scope of economic cooperation by connecting the capital rich, developed Japanese market to India and Vietnam, both developing countries with young populations to act as labourers for Japanese manufactures but also consumers of Japanese products.

While security achievements have infused a sense of stable stewardship of Japan's foreign policy, in the economic realm Yen devaluation through quantitative easing has increased the competitiveness of Japanese exports in and

outside the region. These policies alongside the relaxation of visa requirements for Southeast Asian countries and China have dramatically boosted the number of tourists from the region into Japan.

Tourism related industries such as hotels, restaurants, tour copies, ski and hot spring resorts, temples, and some rural areas have been transformed from a domestically oriented tourist business model to one that actively seeks out and accommodates foreign tourists.

Government policies to promote corporate governance and economic leadership in terms of signing the Japan -EU Economic Partnership (EPA) in July 2017 and PM Abe's commitment to realizing the TPP 11 are important markers that the current leadership in Tokyo is committed to bolstering trade, deregulation and creating new trade rules that project intellectual property rights.

Japan's choice

Pragmatism, not ideology has driven Japan's security and economic achievements since 2012. More needs to be done to ensure that the rural areas such as those in Northeast Japan and the Fukushima area benefit from policies associated with Abenomics and PM Abe that are positively impacting Japan's urban areas such as Tokyo, Osaka and Kyoto. To date, reforms initiated under PM Abe haven't much effect on the rural areas that are plagued a rapidly greying population and an exodus of the youth.

As to the political fate of PM Abe? What is important is a continuation and deepening commitment to current policies rather than PM Abe remaining Prime Minister. That being said, despite the stability that ordinary Japanese have experienced during PM Abe's tenure, the recent scandals have had less of an effect on voters than the idea of a third term. For the average Tanaka, right or wrong, this smells like dictatorship. Businesses and investors on the other hand, may give more leeway on the possibility of a third term for PM Abe if it means political stability and deeper and broader economic reform.

With that, there is one more important consideration, the penchant of ordinary Japanese to prefer stability and to avoid risk. Voting out PM Abe can be understood as a high-risk choice. The Japanese would need to ask themselves, why throw out a leader that has been successful and stable domestically, regionally and on the world stage as well?

This is Japan's choice. The answer to this question will have ramifications for Japanese citizens, investors and the region as a dynamic, economically invigorated, democratic Japan could provide an essential leadership role in the region.

It would be a beacon for developing countries by demonstrating that in East Asia and other regions, that open and democratic societies can prosper and provide sustainable economic growth without sacrificing their freedom, openness and independence. ■

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Central banks still run money creation

Daniel Dăianu argues that a very radical reform of the financial system will happen if there is another financial crisis

The Great Recession has reignited the debate on 'who creates money', on the relationship between base money/outside money supplied by central banks and the inside money, which is created by commercial banks. It is in this context that the old controversy regarding the fractional-reserve banking system should be placed. This dispute should be linked with the equally old observation that the financial system is prone to crises, to instances of panic – to 'runs'.

What has been quite surprising to not a few is that a deep crisis hit so badly advanced economies which rely, presumably, on solid institutions and knowledgeable regulatory authorities. No wonder then that some voices have gone beyond the need for tight financial regulation and supervision and have come up with proposals aimed at a fundamental rethinking of the banking/financial system.

Mervyn King¹ (who was governor of the Bank of England until 2013), Adair Turner² (former Chairman of the UK's Financial Services Authority), John Kay³, Jaromir Benes and Michael Kumhof [BNR1]⁴, Martin Wolf, are among those involved in this debate. How banks are perceived by many citizens in not a few countries is also the proposal made in Switzerland for a referendum on fractional-reserves; similar heated debates have raged in other countries too.

The thoughts below dwell on money creation and the relationship between central banks and commercial banks, the money vs. credit debate, money creation and financial stability, unconventional policies, crypto-currencies and the money supply.

Commercial banks precede central banks

Central banks came up long after commercial banks; over time they developed their functions as we know them today: currency issue, monetary policy, lender of last resort (LoLR), deposit guarantee, safeguarding financial stability⁵. Some 'central banks' were established to serve another purpose as well: to finance military state campaigns, as was

the case in England and France. This is what we would nowadays refer to as direct financing of general government budget deficits via money printing.

Commercial banks went through a period of 'free banking', which translated into unhindered competition and the absence of a central bank as issuer of a single currency and lender of last resort. The fractional-reserve system does not, therefore, originate in a philosophy (paradigm) of central bank functioning; it precedes the advent of central banks and is the outcome of commercial banks' realizing that they can grant loans and expand their balance sheets/business way beyond own funds and deposits taken. It may be asserted that central banks inherited the fraction-

There is need for an effective regulation of the financial system... including shadow banking, stronger capitalization of financial entities, capping leverage, etc. The purpose of macro-prudential tools is to cool down dangerous credit expansion

al-reserve system, but imposed prudential rules on the banking system – reserves to be held at the central bank, capital and liquidity requirements to be met in relation to bank assets, etc.

A central bank, as an issuing house, must ensure trust in the currency, particularly when dealing with fiat money. Modern economies are monetary par excellence, using money in financial and exchange transactions⁶.

When central banks became issuing houses and LoLR, fractional reserves interacted with monetary policy. This happened because central banks tried to ensure price stability by controlling the quantity of money (monetary aggregates) and, during the past decades, especially via monetary policy rates (inflation targeting) – through the price of money. The shift away from controlling the quantity of money (monetary aggregates) to controlling the price of money, via the monetary policy rate, was grounded in the excessive variability of the relationship between base money and broad money, between the money issued by the central bank and the ‘inside money’ created by commercial banks.

The money vs. credit debate

The money vs. credit argument is old, amid the evolution of the fractional-reserve banking system. More than half a century ago, a much-debated report in the UK claimed that credit is also money (the *Radcliffe Report*). This thesis is revisited in a Bank of England study by Michael McLeay, Amar Radia and Ryland Thomas⁷, which triggered, arguably, overdone controversy. This holds true to the extent one considers that inflation targeting, through the control over the price of money (via the policy rate), has stimulated credit expansion and made the financial cycle⁸ more ample.

However, even by assuming that commercial banks create ‘money’ (inside money) via lending, it should be stressed that this is done by virtue of a mandate. The latter means that commercial banks work with/multiply base money (high powered money); they do not work with their own money. Banks use equity and deposits to acquire mon-

etary resources. That in the UK, for instance, the central bank's money creation has come to account for merely around 3 percent of broad money does not change the process of money creation fundamentally, in the sense that the Bank of England can, ultimately, contain credit expansion through the price of money (through the policy rate and the transmission of the signal to money/financial markets).

Refuting this causality chain is like denying the role of prices in the economy, in the expansion or contraction of economic activity; or it would be tantamount to the assumption that commercial banks ignore the price of money pursued by the central bank – and, hence, that there would not be a monetary policy any longer. It is true that the transmission mechanism can be impaired, even break down, particularly during hard times (like in the recent financial crisis), but this does not invalidate the role of central banks in fulfilling their basic functions.

A telling evidence shows that the cash injected by a central bank into the banking system lies at the root of money creation. When the financial system ran the risk of collapse, as in the recent big financial crisis, central banks in the US and in EU member states, the ECB itself, had no choice but to inject massive liquidity, base money; it was not commercial banks that 'injected themselves' with money they had created. There is one more thing worth mulling over: when panic strikes, people withdraw their money from banks and may choose to keep it in 'money vaults'. Money could be transferred over to banks perceived as safer, yet a system-wide run on banks can be countered only via liquidity injections from a credible LoLR, which is an issuing house (a central bank).

Even if cash were abolished, things would not fundamentally be different because the functions of cash would be taken over by e-money (there are already suggestions in this regard, based on the need to cap the outflow of cash from the banking system). Cash could be replaced, let's say, by purchasing power units (PPUs) that would circulate electronically only. Banks' equity and deposits would be solely in this form; reserves at the central bank would also consist of such units. In other words, cash would drop out of the money-creation process without altering the rela-

relationship between base money and broad money. Commercial banks would provide loans in PPU and credit expansion would hinge on household and corporate demand relative to the price of money (interest rates).

Commercial banks cannot create inside money (by granting loans) in an unlimited manner, by disregarding the price of money which is set by the monetary policy rate and the monetary transmission mechanism. It is true that, in an environment of very low policy rates (as is currently the case), monetary policy effectiveness is very much reduced. But even so, if demand for credit is highly subdued, commercial banks cannot embark on a money creation spree.

Several observations are warranted with regard to the relationship between central banks and commercial banks in today's world, when banking systems are no longer based on a gold standard or other metal equivalents:

- money in the system is fiduciary, it is based on trust, on the guarantees provided by public authorities (the state);
- commercial banks may not supply other money than that which is sanctioned by central banks. In economies where other currencies are in circulation as well (with substantial dollarization, euroization), it is possible to grant loans denominated in foreign currencies which are accepted by the central bank (though other currencies may also circulate in the informal economy);
- commercial banks are licensed by central banks;
- commercial banks are under the central bank's regulatory and supervisory scope.

Periods of time with intense deleveraging are also proof that base money sets the tone in the economy. Inside money (ie. the money created by commercial banks via multiplying credit) may vanish suddenly, whereas base money is not affected unless there is an outflow of non-residents' funds. This is what happened in numerous economies during the current crisis' years. While the stock of 'inside money' may contract via deleveraging, base money does not automatically decrease – unless the system witnesses outflows of funds. Granted, the monetary base could be caught in what Keynes called the 'liquidity trap', for during a deep crisis and very low inflation, the liquidity preference skyrockets⁹.

Lending should be viewed in relation to the expansion of banks' financial operations. It is noteworthy that, in the context of over-financialization, the bulk of large banks' net income comes from trading, arbitrage, derivatives. Given growing interconnectedness, the result is an increasing fragility of the banking system as a whole.

Money creation and financial stability

There are two big challenges that a central bank has to deal with when it comes to monetary/financial stability: a) the effectiveness of the monetary policy transmission mechanism, via monetary aggregates control, or through the monetary policy rate – both instruments (a quantitative and a price tool respectively) trying to influence the level of economic activity, price dynamics (inflation); and b) what the money that is multiplied by banks is used for.

In recent decades monetary transmission has relied in most of the industrialized world on inflation targeting (IT), after it had been noticed that a control of monetary aggregates was pretty approximate, mainly due to money demand instability. But the recent financial crisis, while not bringing the end of IT, has shown major drawbacks of this regime too; these drawbacks refer to an under-looking of systemic risks and overreliance on price stability at the expense of financial stability (by disregarding financial asset prices).

Extreme events ('Black Swans', as named by Nassim Taleb), as well as rising uncertainty (Mervyn King calls it 'radical uncertainty', op.cit) which is to be distinguished from risk¹⁰, have also revealed the limitations of approaches which presume a smooth functioning of markets ('the efficient markets hypothesis'). Hence, a growing dissatisfaction has emerged with macroeconomic models. As Claudio Borio from the Bank of International Settlements (BIS) put it, models in which the role of finance is underplayed are like 'Hamlet without the Prince'.

The other challenge, which does not pertain solely to a central bank, but rather to the financial system in its entirety, to the economy, is what is done with money. When the prevailing use is speculation deeply distorted financial cycles take shape, and this ends up in boom and bust episodes. A financial system that fosters speculation and indebtedness¹¹ is disruptive for the economy and unavoidably leads to deep crises – especially when contagion effects are strong. The past decades have witnessed a huge rise in the interconnectedness among banking/financial entities through the sheer size of derivatives.

When the US Fed was established back in 1913, what JP Morgan and others had in mind was the need for a lender of last resort in order to put an end to financial panic, to contagion (like that of 1907). But saving someone who deserves to live on is one thing, and rescuing an entity just because it is 'too big to fail' is another. There is a big dilemma in this respect. Similarly, the bail-in procedure, which is part of an overhaul of the functioning of banks in the European Union, is an attempt to involve investors in solving highly intricate situations, against the backdrop of very strained public budgets.

However, bailing-ins themselves present pitfalls. And in the case of big banks, gigantic financial entities, bail-outs will probably be resorted to eventually for fear of system contagion. No wonder Simon Johnson (former chief economist of the IMF), Neel Kashkari (one of the promoters of the package of measures known as TARP, whereby the collapse of the financial system in the US, and actually worldwide, was averted in 2008) and others advocate a break-

up of giant banks. In his current position as president of the Federal Reserve Bank of Minneapolis, Kashkari said that huge banks are a systemic risk in itself to the economy, that they are 'too big to fail', and that they need to be broken 'into smaller pieces', to be shrunk¹². Size is clearly a huge policy issue, but not less is interconnectedness; this is because even smaller entities can bring the whole system down if contagion is unstoppable.

The problem for central banks is therefore two-pronged: a) what kind of monetary policy to pursue (alongside macro-prudential measures/MPP) and b) how to regulate the financial system so as to mitigate/prevent crises. This is the context that has triggered debates on regulatory and supervision reform, as well as on the reform of the banking/financial system.

Unconventional policies

Quantitative easing (QE), which has been resorted to by major central banks as a means to stimulate economic activity – in an environment of very low monetary policy rates (ZLB - zero lower bound), translates into bond purchases on secondary markets; this is tantamount to injecting base money into the system (also through purchases of government securities). For instance, the Fed's balance sheet ballooned from USD 800 billion in 2008 to more than USD 4 trillion at end 2014. At the same time, inflation was stuck to very low level, with the 'liquidity trap' and disinflationary (deflationary) pressures at work globally.

In economies where capital markets play a major role (the US being the outstanding case), quantitative easing seeks to alter bonds' yields to maturity, which in turn would, arguably, entail a change in the propensity for current vs. future consumption; the assumption is that the economy faces an aggregate demand shortfall, to which adds a strong hysteresis effect (amid chronic underutilization of resources). In Europe, where banks account for three fourths of economy funding, bets are particularly on the impact exerted by low interest rates on lending. However, the limited effectiveness of QE in this respect is quite visible. The problem is that the transmission mechanism is

fractured, as lowering of interest rates do not stimulate credit demand as it is hoped for. But this should not be surprising in an environment of big debt overhang and high uncertainty.

Unconventional policies are an expression of concern about the state of economies, about the dwindling effects of implemented policies; some officials have dubbed the current state of affairs as 'sailing in uncharted territories'. Yet unorthodox policies themselves have limitations and twisted effects. That concerns are running high is also obvious in that some prominent voices allude to 'helicopter money', a phrase which was coined by Milton Friedman decades ago; this money, it is imagined, would feed through into consumption not via commercial banks, but as fiscal stimulus from the public budget. Budget deficits could be monetized as well through this method.

When the financial system ran the risk of collapse major central banks had no choice but to inject massive liquidity, base money; it was not commercial banks that 'injected themselves' with money they had created

One should not forget that, in the early years of post-communist transition, deficit monetization was carried out to the dismay of many who underestimated the structural strain in economic systems when new relative prices called for a drastic reallocation of resources. But price liberalization caused pretty high inflation in transition (post-communist) economies (where repressed inflation was the modus operandi of the command system) whereas the Great Recession has entailed a much keener appetite for liquidity holdings, the so called 'liquidity trap' being at work.

Crypto (parallel)-currencies and the money supply

Bitcoin and other crypto-currencies (currencies that are not issued by central banks) have made a name for themselves against the backdrop of the Great Recession. At the start, it may have been the fear of huge instability and, eventually, of big inflation, which has fostered the emergence of parallel currencies as safer assets. But inflation has hardly materialized (at least, until now) and, instead, deflation (debt-deflation) has turned into a major headache for central banks and governments. And instability, disruptions and rising uncertainty are ongoing concerns in the global economy.

Crypto-currencies epitomize another feature of the impact of the Great Recession on society: a dramatic diminution of the trust citizens have in governments, policy elites; and central banks are seen as key institutional constructs of the modern public policy architecture and guardians of economic stability in a broad sense. The Crisis has shaken the trust in the capacity of governments and central banks to secure essential public goods.

A simplistic economic paradigm, with its ensuing reflection in the regulatory framework (light touch regulation), the belief in price stability as automatic purveyor of financial stability, are at the roots of the deep malaise. Bitcoin and other crypto-currencies mirror this mistrust; they are an attempt to create parallel money markets, to provide a medium of exchange which is not under the control of central authority (central banks), and which would fit non-hierarchical structures in society. Their social and economic significance runs consequently quite deeply.

Is money creation given an altered life by crypto-currencies? The latter are still an insignificant portion of the amount of money that serves as medium of exchange and store of value. And the propensity of cash to leave banks and circulate through non-bank circuits (not least owing to very low deposit rates) does not seem to have grown to a relevant extent.

In addition, it is not clear that crypto-currencies are as trustworthy as some claim them to be. Some of them have also been associated with online drug sales and hackers asking for ransom¹³; and they witness extreme volatility, which is not a commendable feature for a store of value. In the end, what matters for money to be accepted and used on a big scale is the comparative trust one puts in the issuer and its capacity to deliver what it claims to do.

Central banks, in spite of the huge psychological, social and economic fallout from the Great Recession, have been – as Mohamed El Erian put it – ‘the only game in town’, and the rescuer of last resort, as they are supposed to be. And this is likely to stay so for a long time. This said, however, finance has to change its behaviour and central banks and governments have a long way to go in order to redeem their reputation when it comes to the regulation and supervision of banks and non-banks alike. For business (finance) conduct has become a big systemic risk.

Fintech, however, with the block-chain as a formidable technological(financial) innovation can help banks and central banks to make payment systems more robust. Fintech, in general, is a formidable challenge for the financial industry, for banking. And central banks need to consider carefully the proliferation of non-banks, of companies that provide financial services which were, traditionally, in commercial banks’ yard.

Financial system overhaul proposals

Some reform proposals are aimed at tightening regulation and supervision, without touching the core architecture of the banking/financial system – recourse is made to higher capital and liquidity requirements, restraining certain

operations, increased transparency, capping bankers' income, etc. The massive reduction in leverage (the possibility of using borrowed funds) is such a proposal¹⁴.

It is worth mentioning here is the distortion brought about by practices in the logic of the Miller-Modigliani theorem and related theses, which posit that the capital structure (issuing debt instead of equity) is irrelevant. This kind of thinking had a twisted effect on the conduct of banks, which have increased their leverage (indebtedness) in a bid to improve their return on equity. With higher risk-taking, the system as a whole is ever more fragile.

Assertions that banks know how to manage their own risks become less credible considering the implicit subsidy they enjoyed over time (which also translates into moral hazard), the manner of determining the risk-adjusted value of assets (with underlying models being questionable), as well as the business conduct of many banks - in blatant disregard of what is lawful and ethical, and of central banks' prudential norms.

Mike Carney, the current Governor of the Bank of England and Chair of the Financial Stability Board, pointed several times to a big issue of 'banking culture', of banks' behaviour – an idea reiterated by top IMF and BIS officials. The market rigging that not a few large banks resorted to and many toxic products that clients were cheated into buying substantiate this profound ethical problem. This business conduct has enhanced the functioning of a banking/financial system as a quasi-perpetual source of systemic risks. The taxation system, which makes interest expenses tax deductible, has also added to the distortion that is linked with the logic of the Miller-Modigliani theorem.

The Dodd-Frank Act in the US and the reforms launched in Europe (in the EU) seek to regulate banking activity more strictly, shadow banking included. But there are numerous loopholes and the banking lobby goes to great lengths to 'sweeten' the legislation in line with the industry's own interests. In Europe, an attempt has been underway to separate retail from investment banking, yet universal banks are still standing. It is noteworthy that the *Liika-*

nen Report speaks about the separation of activities, but does it with much caution, understandably so by considering the source of banks' income – mostly from trading.

There are also reform proposals aimed at changing the design of the system, at changing business models. Eyes are set on the 'structure' of the banking system, which still enhances the use of derivatives, speculation; to this end there are opinions which support the introduction of a financial transaction tax (Tobin tax)¹⁵. In the EU, some member states (France and Germany, among others) advocate the taxation of short-term financial transactions.

Other views are quite radical and call for the demise of the fractional-reserve system; they have in mind ideas which were proposed, in the wake of the Great Depression, by Irving Fisher, Frank Knight (to whom we owe the distinction between risk and uncertainty), Henry Simons and Paul Douglas through The Chicago Plan. This plan was revisited by Jaromir Benes and Michael Kumhof (from the IMF) and is alluded to by Mervyn King (op. cit.).

Essentially, it is about breaking the link between base money and credit in the sense that banks which attract deposits should not extend credit by multiplying the funds taken in (or, as it is groundlessly claimed, that money is created out of nothing). The authors of the Plan and those who embrace this idea would break the banking system in two parts: deposit banks, which should not extend credit (and should be 100 percent backed by their assets), and lending banks, funded via private capital and long-term loans or via borrowings from the central bank. Thus, the whole money supply would consist of base money.

Finance reform proposals and what would happen to credit

None of the proposals to reform the banking system denies the need for and the usefulness of credit. The issue at stake concerns credit dynamics and, in this context, what is done with money. The use of money, which may cause excessive instability, is worth looking into. Along this line of reasoning one meets the financial cycle concept, which

– according to BIS experts – may reveal substantial misallocation of resources (Jaime Caruana¹⁶, Claudio Borio). Therefore, credit dynamics and what money is used for present much interest.

When resources are grossly misallocated, with ensuing major imbalances, the stage is set for a big crisis. A lesson of the recent crisis is that it makes sense to contemplate and use credit restriction measures (macro-prudential measures) while not ignoring market failures in resource allocation (for instance, the ‘boom’ in non-tradables).

But who is to supply credit? Even by assuming, in fantasy scenario, that base money alone (ie. money created by central banks) were to mediate transactions (narrow banks, as deposit banks, would no longer create ‘inside money’), it would still end up in crises if investment failed on a large scale. What is envisaged here is not a natural cyclical motion of the economy, but rather a severe recession. If recourse were made to strict narrow banking (no credit done on banks’ part), credit would migrate towards other financial institutions; this is already noticeable with shadow banking development.

Systemic risks would show up and would intensify in other areas of the financial system; panic and runs would take place on those particular segments of the financial system. All the more so if one considers the expansion of shadow banking and the very large volume of transactions which are conducted through it, the amounts of funds that move markets, as well as financial asset prices.

Moreover, it is natural to wonder whether, or to what extent the government is entitled, in a market economy, to control credit allocation. In so doing, not only that it may not foster good allocation, but it could undermine the very logic of market functioning, the free choices of firms and households alike. That a central bank may resort to macro-prudential measures to limit credit expansion, and possibly to influence certain trends, is a different story.

One question would be whether regulation can shape the system so that speculation made by banks can be diminished. That this is the case can be seen from the focus of regulators on the functioning of shadow banking, of capital markets with a huge turnover¹⁷. Could a financial transaction tax downsize on the volume of speculation? The answer is not clearly cut.

Financial markets in emerging economies are in general less developed, but this state of affairs is not necessarily negative; the thesis that economic development calls for deep financial markets should be fine-tuned – not least in light of the lessons of the Great Recession. Because what finance does, what money is used for matters enormously. It is a good thing for capital markets to develop, but it should finance, primarily, the economy alongside banks, or as an alternative to bank financing (when banks are reluctant to extend credit); if the stock market merely serves as a playing field, a 'casino' does not benefit the economy too much.

Concluding remarks

Monetary policy, in the future, will probably be a mix of monetary aggregates control (via the use of macro-prudential measures – which are a euphemism for capital movement control) and more pragmatic inflation targeting¹⁸. Banking, financial markets in general, will evolve along lines that are mentioned below:

- a clearer segregation between banking functions (retail vs. investment);
- tighter regulation and supervision, with limits on leverage and higher reserves;
- clients might have to pay for deposits (the other way round than is the case now): an effect of very low interest rates and savings on the rise (fear of sitting on a cash pile will make up for the lack of remuneration of deposits)

- regulation of shadow banking, given that it plays an increasing role and may compound systemic risks;
- capital markets will be regulated more tightly (not least due to quasi-banking type activities)
- fintech will also have to be regulated.

Crises cannot be eliminated; however, they can be contained in terms of magnitude, and systemic risks can be mitigated, although not completely done away with. There is need for an effective regulation of the financial system (and separation of retail banking from investment banking – restoration of a Glass-Steagall type legislation makes sense), including shadow banking, stronger capitalization of financial entities, capping leverage, etc. The purpose of macro-prudential tools is to cool down dangerous credit expansion.

Unless we manage to stave off a new major crisis in the near future, a very radical reform of monetary/financial systems cannot be ruled out, similar in spirit to the proposals aimed at separating lending banks from deposit banks (with full coverage of deposits by liquid assets), in a 'narrow banking' vein, and at ensuring a very strict regulation of banks and non-banks that provide credit. ■

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17. ESMA (The European Securities Markets Authority) is the European authority which regulates capital markets; it focuses increasingly on systemic risks which emerge on capital markets. ESMA, alongside EBA (The European Banking Authority) and EIOPA (The European Insurance and Occupational Pensions Authority), is part of the new architecture of the European system that regulates financial markets. ESRB (The European Systemic Risk Board) is the systemic risks focused watchdog for financial markets overall.

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Financial stability a decade after the onset of the crisis

Janet Yellen defends financial rules introduced after the 2008-2009 financial crisis, backing policies that President Trump has deemed “a disaster”

A decade has passed since the beginnings of a global financial crisis that resulted in the most severe financial panic and largest contraction in economic activity in the United States since the Great Depression. Already, for some, memories of this experience may be fading - memories of just how costly the financial crisis was and of why certain steps were taken in response. I will look back at the crisis and discuss the reforms policymakers in the United States and around the world have made to improve financial regulation to limit both the probability and the adverse consequences of future financial crises.

A resilient financial system is critical to a dynamic global economy. A well-functioning financial system facilitates productive investment and new business formation and helps new and existing businesses weather the ups and downs of the business cycle. Prudent borrowing enables households to improve their standard of living by purchasing a home, investing in education, or starting a business. Because of the reforms that strengthened our financial system, and with support from monetary and other policies, credit is available on good terms, and lending has advanced broadly in line with economic activity in recent years, contributing to today's strong economy¹.

At the same time, reforms have boosted the resilience of the financial system. Banks are safer. The risk of runs owing to maturity transformation is reduced. Efforts to enhance the resolvability of systemic firms have promoted market discipline and reduced the problem of too-big-to-fail. And a system is in place to more effectively monitor and address risks that arise outside the regulatory perimeter.

Nonetheless, the scope and complexity of financial regulatory reforms demand that policymakers and researchers remain alert to both areas for improvement and unexpected side effects. The Federal Reserve is committed to continuing to evaluate the effects of regulation on financial stability and on the broader economy and to making appropriate adjustments.

I will start by reviewing where we were 10 years ago. I will then walk through some key reforms our country has put in place to diminish the chances of another severe crisis and limit damage during times of financial instability. After reviewing these steps, I will summarize indicators and research that show the improved resilience of the US financial system-resilience that is due importantly to regulatory reform as well as actions taken by the private sector. I will then turn to the evidence regarding how financial regulatory reform has affected economic growth, credit availability, and market liquidity.

... if we keep this lesson fresh in our memories... we have reason to hope that the financial system and economy will experience fewer crises and recover from any future crisis more quickly

Developments 10 years ago

The US and global financial system was in a dangerous place 10 years ago. US house prices had peaked in 2006, and strains in the subprime mortgage market grew acute over the first half of 2007². By August, liquidity in money markets had deteriorated enough to require the Federal Reserve to take steps to support it³. And yet the discussion here at Jackson Hole in August 2007, with a few notable exceptions, was fairly optimistic about the possible economic fallout from the stresses apparent in the financial system⁴.

As we now know, the deterioration of liquidity and solvency within the financial sector continued over the next 13 months. Accumulating strains across the financial system, including the collapse of Bear Stearns in March 2008, made it clear that vulnerabilities had risen across the system.

As a result, policymakers took extraordinary measures: the Federal Open Market Committee (FOMC) sharply cut the federal funds rate, and the Federal Reserve, in coordination with the Treasury Department and other agencies, extended liquidity facilities beyond the traditional banking sector, applying to the modern structure of US money markets the dictum of Walter Bagehot, conceived in the 19th century, to lend freely against good collateral at a penalty rate⁵. Still, the deterioration in the financial sector continued, with Fannie Mae and Freddie Mac failing in early September⁶.

But the deterioration from early 2007 until early September 2008—already the worst financial disruption in the United States in many decades—was a slow trickle compared with the tidal wave that nearly wiped out the financial sector that September and led to a plunge in economic activity in the following months. Not long after Fannie and Freddie were placed in government conservatorship, Lehman Brothers collapsed, setting off a week in which American International Group, Inc. (AIG), came to the brink of failure and required large loans from the Federal Reserve to

mitigate the systemic fallout; a large money market fund 'broke the buck' (that is, was unable to maintain a net asset value of \$1 per share) and runs on other money funds accelerated, requiring the Treasury to provide a guarantee of money fund liabilities; global dollar funding markets nearly collapsed, necessitating coordinated action by central banks around the world; the two remaining large investment banks became bank holding companies, thereby ending the era of large independent investment banks in the United States; and the Treasury proposed a rescue of the financial sector.

Within several weeks, the Congress passed-and President Bush signed into law-the Emergency Economic Stabilization Act of 2008, which established the \$700 billion Troubled Asset Relief Program; the Federal Reserve initiated further emergency lending programs; and the Federal Deposit Insurance Corporation (FDIC) guaranteed a broad range of bank debt⁷. Facing similar challenges in their own jurisdictions, many foreign governments also undertook aggressive measures to support the functioning of credit markets, including large-scale capital injections into banks, expansions of deposit insurance programs, and guarantees of some forms of bank debt.

Despite the forceful policy responses by the Treasury, the Congress, the FDIC, and the Federal Reserve as well as authorities abroad, the crisis continued to intensify: the vulnerabilities in the US and global economies had grown too large, and the subsequent damage was enormous. From the beginning of 2008 to early 2010, nearly 9 million jobs, on net, were lost in the United States. Millions of Americans lost their homes. And distress was not limited to the US economy: global trade and economic activity contracted to a degree that had not been seen since the 1930s. The economic recovery that followed, despite extraordinary policy actions, was painfully slow.

What the crisis revealed and how policymakers have responded

These painful events renewed efforts to guard against financial instability. The Congress, the Administration, and

regulatory agencies implemented new laws, regulations, and supervisory practices to limit the risk of another crisis, in coordination with policymakers around the world.

The vulnerabilities within the financial system in the mid-2000s were numerous and, in hindsight, familiar from past financial panics. Financial institutions had assumed too much risk, especially related to the housing market, through mortgage lending standards that were far too lax and contributed to substantial overborrowing. Repeating a familiar pattern, the 'madness of crowds' had contributed to a bubble, in which investors and households expected rapid appreciation in house prices. The long period of economic stability beginning in the 1980s had led to complacency about potential risks, and the buildup of risk was not widely recognized⁸.

As a result, market and supervisory discipline was lacking, and financial institutions were allowed to take on high levels of leverage. This leverage was facilitated by short-term wholesale borrowing, owing in part to market-based vehicles, such as money market mutual funds and asset-backed commercial paper programs that allowed the rapid expansion of liquidity transformation outside of the regulated depository sector. Finally, a self-reinforcing loop developed, in which all of the factors I have just cited intensified as investors sought ways to gain exposure to the rising prices of assets linked to housing and the financial sector. As a result, securitization and the development of complex derivatives products distributed risk across institutions in ways that were opaque and ultimately destabilizing.

In response, policymakers around the world have put in place measures to limit a future buildup of similar vulnerabilities. The United States, through coordinated regulatory action and legislation, moved very rapidly to begin reforming our financial system, and the speed with which our banking system returned to health provides evidence of the effectiveness of that strategy. Moreover, US leadership of global efforts through bodies such as the Basel

Committee on Banking Supervision, the Financial Stability Board (FSB), and the Group of Twenty has contributed to the development of standards that promote financial stability around the world, thereby supporting global growth while protecting the US financial system from adverse developments abroad. Preeminent among these domestic and global efforts have been steps to increase the loss-absorbing capacity of banks, regulations to limit both maturity transformation in short-term funding markets and liquidity mismatches within banks, and new authorities to facilitate the resolution of large financial institutions and to subject systemically important firms to more stringent prudential regulation.

Several important reforms have increased the loss-absorbing capacity of global banks. First, the quantity and quality of capital required relative to risk-weighted assets have been increased substantially⁹. In addition, a simple leverage ratio provides a backstop, reflecting the lesson imparted by past crises that risk weights are imperfect and a minimum amount of equity capital should fund a firm's total assets. Moreover, both the risk-weighted and simple leverage requirements are higher for the largest, most systemic firms, which lowers the risk of distress at such firms and encourages them to limit activities that could threaten financial stability¹⁰.

Finally, the largest US banks participate in the annual Comprehensive Capital Analysis and Review (CCAR)-the stress tests. In addition to contributing to greater loss-absorbing capacity, the CCAR improves public understanding of risks at large banking firms, provides a forward-looking examination of firms' potential losses during severely adverse economic conditions, and has contributed to significant improvements in risk management.

Reforms have also addressed the risks associated with maturity transformation. The fragility created by deposit-like liabilities outside the traditional banking sector has been mitigated by regulations promulgated by the Securities and Exchange Commission affecting prime institutional money market funds. These rules require these prime

funds to use a floating net asset value, among other changes, a shift that has made these funds less attractive as cash-management vehicles. The changes at money funds have also helped reduce banks' reliance on unsecured short-term wholesale funding, since prime institutional funds were significant investors in those bank liabilities. Liquidity risk at large banks has been further mitigated by a new liquidity coverage ratio and a capital surcharge for global systemically important banks (G-SIBs). The liquidity coverage ratio requires that banks hold liquid assets to cover potential net cash outflows over a 30-day stress period. The capital surcharge for US G-SIBs links the required level of capital for the largest banks to their reliance on short-term wholesale funding¹¹.

While improvements in capital and liquidity regulation will limit the reemergence of the risks that grew substantially in the mid-2000s, the failure of Lehman Brothers demonstrated how the absence of an adequate resolution process for dealing with a failing systemic firm left policymakers with only the terrible choices of a bailout or allowing a destabilizing collapse. In recognition of this shortcoming, the Congress adopted the orderly liquidation authority in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to provide an alternative resolution mechanism for systemically important firms to be used instead of bankruptcy proceedings when necessary to preserve financial stability.

The orderly liquidation authority contains a number of tools, including liquidity resources and temporary stays on the termination of financial contracts, that would help protect the financial system and economy from the severe adverse spillovers that could occur if a systemic firm failed. Importantly, any losses incurred by the government in an Orderly Liquidation Authority resolution would not be at the expense of taxpayers, since the statute provides that all such losses must be borne by other large financial firms through subsequent assessments. In addition, the Congress required that the largest banks submit living wills that describe how they could be resolved under bankruptcy¹². And the Federal Reserve has mandated that systemically important banks meet total loss-absorbing ca-

capacity requirements, which require these firms to maintain long-term debt adequate to absorb losses and recapitalize the firm in resolution. These enhancements in resolvability protect financial stability and help ensure that the shareholders and creditors of failing firms bear losses. Moreover, these steps promote market discipline, as creditors - knowing full well that they will bear losses in the event of distress - demand prudent risk-taking, thereby limiting the problem of too-big-to-fail.

Financial stability risks can also grow large outside the regulated banking sector, as amply demonstrated by the events of 2007 and 2008. In response, a number of regulatory changes affecting what is commonly referred to as the shadow banking sector have been instituted. A specific example of such risks, illustrative of broader developments, was the buildup of large counterparty exposures through derivatives between market participants and AIG that were both inappropriately risk-managed and opaque. To mitigate the potential for such risks to arise again, new standards require central clearing of standardized over-the-counter derivatives, enhanced reporting requirements for all derivatives, and higher capital as well as margin requirements for non-centrally cleared derivatives transactions¹³.

Another important step was the Congress's creation of the Financial Stability Oversight Council (FSOC). The council is responsible for identifying risks to financial stability and for designating those financial institutions that are systemically important and thus subject to prudential regulation by the Federal Reserve. Both of these responsibilities are important to help guard against the risk that vulnerabilities outside the existing regulatory perimeter grow to levels that jeopardize financial stability¹⁴.

The financial system is safer

The evidence shows that reforms since the crisis have made the financial system substantially safer. Loss-absorb-

ing capacity among the largest banks is significantly higher, with Tier 1 common equity capital more than doubling from early 2009 to now¹⁵. The annual stress-testing exercises in recent years have led to improvements in the capital positions and risk-management processes among participating banks. Large banks have cut their reliance on short-term wholesale funding essentially in half and hold significantly more high-quality, liquid assets. Assets under management at prime institutional money market funds that proved susceptible to runs in the crisis have decreased substantially. And the ability of regulators to resolve a large institution has improved, reflecting both new authorities and tangible steps taken by institutions to adjust their organizational and capital structure in a manner that enhances their resolvability and significantly reduces the problem of too-big-to-fail.

The progress evident in regulatory and supervisory metrics has been accompanied by shifts in private-sector assessments that also suggest enhanced financial stability. Investors have recognized the progress achieved toward ending too-big-to-fail, and several rating agencies have removed the government support rating uplift that they once accorded to the largest banks. Credit default swaps for the large banks also suggest that market participants assign a low probability to the distress of a large US banking firm. Market-based assessments of the loss-absorbing capacity of large US banks have moved up in recent years, and market-based measures of equity now lie in the range of book estimates of equity.

To be sure, market-based measures may not reflect true risks - they certainly did not in the mid-2000s - and hence the observed improvements should not be overemphasized¹⁶. But supervisory metrics are not perfect, either, and policymakers and investors should continue to monitor a range of supervisory and market-based indicators of financial system resilience.

Economic research provides further support for the notion that reforms have made the system safer. Studies have demonstrated that higher levels of bank capital mitigate the risk and adverse effects of financial crises¹⁷. Moreo-

ver, researchers have highlighted how liquidity regulation supports financial stability by complementing capital regulation¹⁸. Economic models of the resilience of the financial sector - so called top-down stress-testing models - reinforce the message from supervisory stress tests that the riskiness of large banks has diminished over the past decade¹⁹. Similarly, model-based analyses indicate that the risk of adverse fire sale spillovers across banks or broker-dealers have been substantially mitigated²⁰.

Is this safer system supporting growth?

I suspect many would agree with the narrative of my remarks so far: the events of the crisis demanded action, needed reforms were implemented, and these reforms have made the system safer. Now - a decade from the onset of the crisis and nearly seven years since the passage of the Dodd-Frank Act and international agreement on the key banking reforms - a new question is being asked: have reforms gone too far, resulting in a financial system that is too burdened to support prudent risk-taking and economic growth?

The Federal Reserve is committed individually, and in coordination with other US government agencies through forums such as the FSOC and internationally through bodies such as the Basel Committee on Banking Supervision and the FSB, to evaluating the effects of financial market regulations and considering appropriate adjustments. Furthermore, the Federal Reserve has independently taken steps to evaluate potential adjustments to its regulatory and supervisory practices. For example, the Federal Reserve initiated a review of its stress tests following the 2015 cycle, and this review suggested changes to reduce the burden on participating institutions, especially smaller institutions, and to better align the supervisory stress tests with regulatory capital requirements²¹.

In addition, a broader set of changes to the new financial regulatory framework may deserve consideration. Such changes include adjustments that may simplify regulations applying to small and medium-sized banks and enhance resolution planning²².

More broadly, we continue to monitor economic conditions, and to review and conduct research, to better understand the effect of regulatory reforms and possible implications for regulation. I will briefly summarize the current state of play in two areas: the effect of regulation on credit availability and on changes in market liquidity.

The effects of capital regulation on credit availability have been investigated extensively. Some studies suggest that higher capital weighs on banks' lending, while others suggest that higher capital supports lending²³. Such conflicting results in academic research are not altogether surprising. It is difficult to identify the effects of regulatory capital requirements on lending because material changes to capital requirements are rare and are often precipitated, as in the recent case, by financial crises that also have large effects on lending.

Given the uncertainty regarding the effect of capital regulation on lending, rulemakings of the Federal Reserve and other agencies were informed by analyses that balanced the possible stability gains from greater loss-absorbing capacity against the possible adverse effects on lending and economic growth²⁴. This ex ante assessment pointed to sizable net benefits to economic growth from higher capital standards - and subsequent research supports this assessment²⁵. The steps to improve the capital positions of banks promptly and significantly following the crisis, beginning with the 2009 Supervisory Capital Assessment Program, have resulted in a return of lending growth and profitability among US banks more quickly than among their global peers.

While material adverse effects of capital regulation on broad measures of lending are not readily apparent, credit may be less available to some borrowers, especially homebuyers with less-than-perfect credit histories and, perhaps, small businesses. In retrospect, mortgage borrowing was clearly too easy for some households in the mid-2000s, resulting in debt burdens that were unsustainable and ultimately damaging to the financial system.

Currently, many factors are likely affecting mortgage lending, including changes in market perceptions of the risk associated with mortgage lending; changes in practices at the government-sponsored enterprises and the Federal Housing Administration; changes in technology that may be contributing to entry by nonbank lenders; changes in consumer protection regulations; and, perhaps to a limited degree, changes in capital and liquidity regulations within the banking sector. These issues are complex and interact with a broader set of challenges related to the domestic housing finance system.

Credit appears broadly available to small businesses with solid credit histories, although indicators point to some difficulties facing firms with weak credit scores and insufficient credit histories²⁶. Small business formation is critical to economic dynamism and growth. Smaller firms rely disproportionately on lending from smaller banks, and the Federal Reserve has been taking steps and examining additional steps to reduce unnecessary complexity in regulations affecting smaller banks²⁷.

Finally, many financial market participants have expressed concerns about the ability to transact in volume at low cost—that is, about market liquidity, particularly in certain fixed-income markets such as that for corporate bonds. Market liquidity for corporate bonds remains robust overall, and the healthy condition of the market is apparent in low bid-ask spreads and the large volume of corporate bond issuance in recent years. That said, liquidity conditions are clearly evolving. Large dealers appear to devote less of their balance sheets to holding inventories of securities to facilitate trades and instead increasingly facilitate trades by directly matching buyers and sellers. In addition, algorithmic traders and institutional investors are a larger presence in various markets than previously, and the willingness of these institutions to support liquidity in stressful conditions is uncertain.

While no single factor appears to be the predominant cause of the evolution of market liquidity, some regulations may be affecting market liquidity somewhat. There may be benefits to simplifying aspects of the Volcker rule, which

limits proprietary trading by banking firms, and to reviewing the interaction of the enhanced supplementary leverage ratio with risk-based capital requirements. At the same time, the new regulatory framework overall has made dealers more resilient to shocks, and, in the past, distress at dealers following adverse shocks has been an important factor driving market illiquidity. As a result, any adjustments to the regulatory framework should be modest and preserve the increase in resilience at large dealers and banks associated with the reforms put in place in recent years.

Remaining challenges

So where do we stand a decade after the onset of the most severe financial crisis since the Great Depression? Substantial progress has been made toward the Federal Reserve's economic objectives of maximum employment and price stability, in putting in place a regulatory and supervisory structure that is well designed to lower the risks to financial stability, and in actually achieving a stronger financial system. Our more resilient financial system is better prepared to absorb, rather than amplify, adverse shocks, as has been illustrated during periods of market turbulence in recent years. Enhanced resilience supports the ability of banks and other financial institutions to lend, thereby supporting economic growth through good times and bad.

Nonetheless, there is more work to do. The balance of research suggests that the core reforms we have put in place have substantially boosted resilience without unduly limiting credit availability or economic growth. But many reforms have been implemented only fairly recently, markets continue to adjust, and research remains limited. The Federal Reserve is committed to evaluating where reforms are working and where improvements are needed to most efficiently maintain a resilient financial system.

Moreover, I expect that the evolution of the financial system in response to global economic forces, technology, and, yes, regulation will result sooner or later in the all-too-familiar risks of excessive optimism, leverage, and ma-

turity transformation reemerging in new ways that require policy responses. We relearned this lesson through the pain inflicted by the crisis. We can never be sure that new crises will not occur, but if we keep this lesson fresh in our memories - along with the painful cost that was exacted by the recent crisis - and act accordingly, we have reason to hope that the financial system and economy will experience fewer crises and recover from any future crisis more quickly, sparing households and businesses some of the pain they endured during the crisis that struck a decade ago. ■

Janet L Yellen is Chair of the Federal Reserve

Endnotes

- 1. Over the 12 quarters ending in the first quarter of this year, borrowing by the nonfinancial business sector increased at an annual rate just above 6 percent, on average, and borrowing by households and nonprofit institutions rose at an annual rate of 3-1/4 percent, on average; the corresponding average pace of increase in nominal gross domestic product was 3-3/4 percent. Over the same period, lending by private depository institutions advanced at an annual rate of nearly 6-1/2 percent.*
- 2. A contemporaneous perspective on subprime mortgage market developments at this time is provided in Ben S Bernanke (2007), "The Subprime Mortgage Market," speech delivered at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, May 17.*
- 3. On August 17, 2007, the Federal Reserve Board reduced the primary credit rate at the discount window by 50 basis points and announced a change to the Reserve Banks' usual practices to allow the provision of term financing for as long as 30 days, renewable by the borrower. The changes were announced to remain in place until the Federal Reserve deter-*

mined that market liquidity had improved materially. See Board of Governors of the Federal Reserve System (2007), *"Federal Reserve Board Discount Rate Action,"* press release, August 17.

4. The proceedings from the 2007 conference are instructive about the range of views regarding housing-related developments preceding the acute phase of the financial crisis. See Federal Reserve Bank of Kansas City (2007), *"Housing, Housing Finance, and Monetary Policy,"* proceedings of an economic policy symposium (Kansas City: FRBKC).

5. For a discussion of the correspondence between the steps taken by the Federal Reserve and those suggested by Walter Bagehot in the 19th century, see Brian F Madigan (2009), *"Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis,"* speech delivered at the Federal Reserve Bank of Kansas City's annual economic symposium, Jackson Hole, Wyo., August 21.

6. A timeline of developments in the United States over the financial crisis is available on the Federal Reserve Bank of St. Louis's website at <https://www.stlouisfed.org/financial-crisis/full-timeline>. The failure of Fannie Mae and Freddie Mac is marked by the decision of the Federal Housing Finance Agency (FHFA) to place Fannie Mae and Freddie Mac in government conservatorship on September 7, 2008. Links to documents outlining the actions taken around this time are available on the FHFA's website at <https://www.fhfa.gov/Media/PublicAffairs/Pages/Conservatorship-of-Fannie-Mae-and-Freddie-Mac.aspx>.

7. In the fall of 2008, the three largest investment banks were (in alphabetical order) Goldman Sachs, Merrill Lynch, and Morgan Stanley. Merrill Lynch agreed to be acquired by Bank of America, and the remaining two firms became bank holding companies.

8. The notion that popular sentiment may contribute to mispricing of assets--for example, the power of the madness of crowds--is attributed to Charles Mackay (1841), *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds* (London: Richard Bentley). A more modern perspective, and one using a phrase as memorable as the madness of crowds, is provided by Robert J Shiller (2016), *Irrational Exuberance*, 3rd ed. (Princeton, NJ: Princeton University Press). The notion that economic stability can generate a buildup of imbalances that subsequently contributes to instability is presented in Hyman P Minsky (1974), *"The Modeling of Financial Instability: An Introduction,"* in *Modeling and Simulation*, Vol. 5, Part

1, proceedings of the Fifth Annual Pittsburgh Conference (Pittsburgh: Instrument Society of America), pp. 267-72. A related discussion of how financial excesses often precede downturns (and even panics) is provided in Charles P Kindleberger and Robert Z Aliber (2005), *Manias, Panics, and Crashes: A History of Financial Crises*, 5th ed. (Hoboken, NJ: John Wiley & Sons).

9. These improvements encompass a number of changes. The regulatory requirements for capital have been increased and focus on Tier 1 common equity, which proved more capable of absorbing losses than lower-quality forms of capital. The role of bank internal models in determining risk-weighted assets also has been significantly constrained in the United States. In addition, exposures previously considered off balance sheet have been incorporated into risk-weighted assets.

10. The Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency adopted a final rule to strengthen the leverage ratio standards for the largest, most interconnected US banking organizations on April 8, 2014. Under the final rule, covered bank holding companies must maintain a leverage buffer of 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of 5 percent, to avoid restrictions on capital distributions and discretionary bonus payments (see Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2014), [“Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule and Issue Supplementary Leverage Ratio Notice of Proposed Rulemaking,”](#) joint press release, April 8). The Federal Reserve approved a final rule imposing risk-based capital surcharges on the largest, most systemically important US bank holding companies on July 20, 2015; in connection with the final rule, the Board issued a white paper describing the calibration of the risk-based capital surcharges (see Board of Governors of the Federal Reserve System (2015), [“Federal Reserve Board Approves Final Rule Requiring the Largest, Most Systemically Important US Bank Holding Companies to Further Strengthen Their Capital Positions,”](#) press release, July 20).

11. Moreover, the Federal Reserve’s Comprehensive Liquidity Analysis and Review, in which supervisors analyze the liquidity risks and practices at large banks, has promoted improvements in liquidity-risk management. The US banking agencies also have proposed a net stable funding ratio (NSFR) to help ensure that large banks have a stable funding profile over a one-year horizon, and we are working toward finalization of the NSFR.

12. In addition to these steps, the Board issued another proposal to make G-SIBs more resolvable in May of last year (see Board of Governors of the Federal Reserve System (2016), [“Federal Reserve Board Proposes Rule to Support US Financial Stability by Enhancing the Resolvability of Very Large and Complex Financial Firms,”](#) press release, May 3). This proposed rule would impose restrictions on G-SIBs’ qualified financial contracts—including derivatives and repurchase agreements (or repos) - to guard against the rapid, mass unwinding of those contracts during the resolution of a G-SIB. The proposed restrictions are a key step toward G-SIB resolvability because rapidly unwinding these contracts could destabilize the financial system by causing asset fire sales and toppling other firms.

13. One area in which regulations have shifted to a lesser degree in the United States is that of time-varying macroprudential tools, in which regulatory requirements are adjusted to address changes in vulnerabilities that may affect the financial system. For example, US regulatory authorities have adopted rules that allow use of the countercyclical capital buffer, but other time-varying tools are limited in the United States. This issue is discussed in, for example, Stanley Fischer (2015), [“Macroprudential Policy in the US Economy,”](#) speech delivered at “Macroprudential Monetary Policy,” 59th Economic Conference of the Federal Reserve Bank of Boston, Boston, October 2.

14. For example, the FSOC contributed, through its identification process, to the development of the Securities and Exchange Commission reforms affecting money market funds. The FSOC has also designated four firms as systemically important-AIG, GE Capital, Prudential, and MetLife. GE Capital chose to shrink, adjust its business model, and reduce its footprint in short-term wholesale funding markets—and hence reduce a source of systemic risk. These actions caused the FSOC to subsequently remove its designation as systemically important last year—illustrating how the designation process allows both identifying systemic firms and removing such designations when appropriate.

15. The increase in Tier 1 common equity among bank holding companies has been sizable, especially for the largest banks. If the largest banks are defined as either the eight US global systemically important banks or the US bank holding companies that participated in the CCAR in 2017 (and for which data are available for 2009:Q1), Tier 1 common equity has more than doubled in dollar terms and relative to risk-weighted assets from the first quarter of 2009 to the most recent observations.

16. For example, Natasha Sarin and Lawrence Summers have reviewed market-based measures of bank equity and related measures of bank risks and concluded that such measures have not improved since the mid-2000s. This assessment may understate the improvement in fundamental risk within the banking sector, as it takes the elevated valuations and low assessment of default risk implied by market prices during the earlier period as indicative of fundamentals. Despite these shortcomings, their analysis is a useful reminder of the importance of considering both regulatory metrics and assessments implied by market prices. See Natasha Sarin and Lawrence H. Summers (2016), [“Understanding Bank Risk through Market Measures \(PDF\)”](#), *Brookings Papers on Economic Activity*, Fall, pp. 57-109.

17. For example, see the review of evidence in Simon Firestone, Amy Lorenc, and Ben Ranish (2017), [“An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US \(PDF\)”](#), *Finance and Economics Discussion Series 2017-034* (Washington: Board of Governors of the Federal Reserve System, April). Some research is less supportive of the role of bank capital in limiting the risk of financial crises but suggests that higher levels of bank capital limit the economic costs of a financial crisis (for example, Òscar Jordà, Björn Richter, Moritz Schularick, and Alan M. Taylor (2017), [“Bank Capital Redux: Solvency, Liquidity, and Crisis”](#), *NBER Working Paper Series 23287* (Cambridge, Mass.: National Bureau of Economic Research, March)). Some of the differences in findings across studies may be due to the degree to which the studies incorporate data from different countries and over different periods, as researchers disagree over the extent to which comparisons across countries or periods appropriately account for other factors that differ across such dimensions.

18. For example, Charles AE Goodhart, Anil K Kashyap, Dimitrios P Tsomocos, and Alexandros P Vardoulakis (2013), [“An Integrated Framework for Analyzing Multiple Financial Regulations”](#), *International Journal of Central Banking*, supp. 1, vol. 9 (January), pp. 109-43; and Gazi I Kara and S Mehmet Ozsoy (2016), [“Bank Regulation under Fire Sale Externalities \(PDF\)”](#), *Finance and Economics Discussion Series 2016-026* (Washington: Board of Governors of the Federal Reserve System, April).

19. For example, researchers at the Federal Reserve Bank of New York have developed a top-down stress-testing model, and simulation results from the model suggest that the resilience of the US banking system has improved since the crisis;

see Beverly Hirtle, Anna Kovner, James Vickery, and Meru Bhanot (2014), [“Assessing Financial Stability: The Capital and Loss Assessment under Stress Scenarios \(CLASS\) Model \(PDF\)”](#), Staff Report 663 (New York: Federal Reserve Bank of New York, February; revised July 2015).

20. For example, see Fernando Duarte and Thomas Eisenbach (2013), [“Fire-Sale Spillovers and Systemic Risk \(PDF\)”](#), Staff Report 645 (New York: Federal Reserve Bank of New York, October; revised February 2015).

21. In response to the Federal Reserve’s review and other information, the Board finalized a rule adjusting its capital plan and stress-testing rules, effective for the 2017 cycle, on January 30, 2017. The final rule removes large and noncomplex firms from the qualitative assessment of the Federal Reserve’s CCAR, reducing significant burden on these firms and focusing the qualitative review in CCAR on the largest, most complex financial institutions. More generally, changes to improve regulatory and supervisory practices related to stress testing by reducing unnecessary burden while preserving resilience are under consideration. Possible changes have been discussed in Daniel K Tarullo (2016), [“Next Steps in the Evolution of Stress Testing”](#), speech delivered at the Yale University School of Management Leaders Forum, New Haven, Conn., September 26.

22. An overview of a set of principles that may guide such adjustments is discussed by Jerome H Powell (2017), [“Relationship between Regulation and Economic Growth”](#), statement before the Committee on Banking, Housing, and Urban Affairs, US Senate, June 22. In addition, the Federal Reserve Board has continued to engage in international efforts to assess the effects of reforms and possible adjustments; in this context, the FSB has developed a framework for the post-implementation evaluation of the effects of the Group of Twenty financial regulatory reforms; see Financial Stability Board (2017), [Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms \(PDF\)](#) (Basel, Switzerland: FSB, July).

23. The related literature is sizable. An early contribution is Ben S Bernanke and Cara S Lown (1991), “The Credit Crunch,” *Brookings Papers on Economic Activity*, no. 2, pp. 205-47. Research finding a sizable negative relationship between capital requirements and lending includes Shekhar Aiyar, Charles W Calomiris, and Tomasz Wieladek (2014), “Does Mac-

ro-Prudential Regulation Leak? Evidence from a UK Policy Experiment," *Journal of Money, Credit and Banking*, vol. 46 (s1; February), pp. 181-214. Research finding little relationship between lending and capital ratios (outside financial crises) includes Mark Carlson, Hui Shan, and Missaka Warusawitharana (2013), "Capital Ratios and Bank Lending: A Matched Bank Approach," *Journal of Financial Intermediation*, vol. 22 (October), pp. 663-87. Research suggesting that higher capital levels may increase lending includes Leonardo Gambacorta and Hyun Song Shin (2016), "[Why Bank Capital Matters for Monetary Policy \(PDF\)](#)," BIS Working Papers 558 (Basel, Switzerland: Bank for International Settlements, April).

24. For example, see Basel Committee on Banking Supervision (2010), "[An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements \(PDF\)](#)" (Basel, Switzerland: BCBS, August); and Macroeconomic Assessment Group (2010), "[Interim Report: Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements \(PDF\)](#)" (Basel, Switzerland: MAG, August).

25. The ex ante studies from the Basel Committee and the Macroeconomic Assessment Group referenced in note 24 pointed to sizable net benefits from higher capital requirements. More academic research pointing to similar conclusions using macroeconomic models (and typically focused on model-specific measures of economic welfare) includes Michael T Kiley and Jae W Sim (2014), "Bank Capital and the Macroeconomy: Policy Considerations," *Journal of Economic Dynamics and Control*, vol. 43 (June), pp. 175-98; Laurent Clerc, Alexis Derviz, Caterina Mendicino, Stephane Moyen, Kalin Nikolov, Livio Stracca, Javier Suarez, and Alexandros P Vardoulakis (2015), "Capital Regulation in a Macroeconomic Model with Three Layers of Default," *International Journal of Central Banking*, vol. 11 (June), pages 9-63; and Juliane Begenau (2016), "Capital Requirements, Risk Choice, and Liquidity Provision in a Business Cycle Model," unpublished paper, Harvard Business School, September. Subsequent analyses, albeit ones that follow similar approaches, also suggest that there are net benefits to higher capital standards. One example is the analysis by Firestone, Lorenc, and Ranish, "An Empirical Economic Assessment," in note 17. Another is Ingo Fender and Ulf Lewrick (2016), "[Adding It All Up: The Macroeconomic Impact of Basel III and Outstanding Reform Issues \(PDF\)](#)," BIS Working Papers 591 (Basel, Switzerland: Bank for International Settlements, November). Indeed, this research points to benefits from capital requirements in excess of those adopted, a con-

clusion also reached in Wayne Passmore and Alexander H von Hafften (2017), [“Are Basel’s Capital Surcharges for Global Systemically Important Banks Too Small? \(PDF\)”](#) Finance and Economics Discussion Series 2017-021 (Washington: Board of Governors of the Federal Reserve System, February).

26. This conclusion is consistent with, for example, the findings in Federal Reserve Banks (2017), [2016 Small Business Credit Survey: Report on Employer Firms \(PDF\)](#) (New York: Federal Reserve Bank of New York, April).

27. As I have discussed previously, the Federal Reserve has been considering improvements through a number of work streams. For example, the Federal Reserve and the other banking agencies have recently completed the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) review. Under EGRPRA, the federal banking agencies are required to conduct a joint review of their regulations every 10 years to identify provisions that are outdated, unnecessary, or unduly burdensome. The Federal Reserve viewed this review as a timely opportunity to step back and identify ways to reduce regulatory burden, particularly for smaller or less complex banks that pose less risk to the US financial system. I discussed preliminary emerging themes from this review in Janet L Yellen (2016), [“Supervision and Regulation,”](#) statement before the Committee on Financial Services, US House of Representatives, September 28. For the final EGRPRA report to the Congress, see Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and National Credit Union Administration (2017), [Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act \(PDF\)](#) (Washington: Federal Financial Institutions Examination Council, March).

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Sustaining openness in a dynamic global economy

Stronger productivity growth is needed to combat the debt and demographic challenges faced by advanced economies, asserts Mario Draghi

The global recovery is firming up. In some countries like the United States, this process has been visible for some years, in others like Europe and Japan, the consolidation of the recovery is at an earlier stage. So it is fitting that our discussions are now focusing not only on how to stabilise the economy, but also on how to make it more dynamic – while at the same time improving people’s welfare. At the centre of this debate is the question of how to raise potential output growth, which has slowed from around 2% in OECD countries in 2000 to around 1% today¹.

Without stronger potential growth, the cyclical recovery we are now seeing globally will ultimately converge downwards to those slower growth rates. Slower growth will in turn make it harder to work through the debt and demographic challenges facing many advanced economies.

With the population growth rate in those economies projected to slow, the burden of raising potential growth must fall on productivity. There are a number of areas in which domestic policies can encourage an upward shift in productivity growth, such as competition, research and development, and insolvency regimes.

But when thinking about the global economy, one of the key ingredients for raising productivity is openness. Open trade, investment and financial flows play a key role in the diffusion of new technologies across borders that drive forward efficiency improvements.

The social consensus on open markets has, however, been weakening in recent years. This is driven not so much by a belief that open markets no longer create wealth, but by the perception that the collateral effects of openness outweigh its benefits. People are concerned about whether openness is *fair*, whether it is *safe* and whether it is *equitable*.

As Karl Polanyi observed many years ago, if the dislocation created by an open market goes beyond a certain point, protectionism is society's natural response².

So a central element of efforts to raise productivity growth – and build a dynamic global economy – must involve responding to these concerns about openness. And this is a feat countries cannot accomplish by themselves. Although domestic welfare policies are, of course, essential to the task, a commitment to working together through multilateral institutions is just as important.

Multilateral cooperation is crucial in responding to concerns about fairness, safety and also equity... it helps protect people from the unwelcome consequences of openness. And protection ensures that we do not lapse into protectionism over time

This is because fears about fairness, safety and equity ultimately reflect a lack of trust in other countries' regulation and enforcement. One of the main reasons why multilateral institutions exist is to create regulatory convergence, and therefore to increase trust between countries³. And perhaps the most important area where this applies today is global financial sector regulation.

Openness as the key to a dynamic global economy

One of the key questions facing the global economy is whether the trend towards ever greater economic openness, which has defined the last three decades, is coming to an end. Temporary trade barriers have indeed risen from covering around 1% of products in 2000 to more than 2.5% today, with the crisis accelerating this pattern. The same is true of anti-dumping actions⁴.

That said, at the global level openness is still viewed favourably; three-quarters of people consider growing trade and business ties with other countries to be a positive trend. But those polled in rich countries are more negative than in the pre-crisis period⁵.

Given the established gains of trade, this is plainly a concerning trend for the global economy. International trade results in a more efficient use of production factors and in specialisation where comparative advantage exists, thereby raising productivity growth⁶. And welfare gains from trade for firms and consumers follow from the wider availability of cheaper and better quality products⁷.

Moreover, for advanced economies the importance of trade may actually be growing. As economies converge towards the global technological frontier, innovation becomes more important for sustained productivity growth. And as OECD research has shown, openness to trade is a crucial factor in enabling an economy to benefit from frontier innovation⁸.

According to OECD estimates, in the case of a 2% acceleration in multi-factor productivity (MFP) growth in a frontier economy, the productivity spillover will be 0.3 percentage points higher for a country that trades intensively with the frontier economy than for one which trades less intensively. To put this in context, MFP growth has averaged only around 0.5% in OECD countries since 2000⁹.

Thus a turn towards protectionism would pose a serious risk for continued productivity growth and potential growth in the global economy. And this risk is particularly acute in the light of the structural challenges facing advanced economies.

Old-age dependency ratios are rising, putting more pressure on public finances. By 2025 there will be 35 people aged 65 and over for every 100 persons of working age in OECD countries, compared with 14 in 1950¹⁰. At the same time, public debt levels have surged in those countries from 56% of GDP in 2007 to around 87% today¹¹. Only higher potential growth can provide a lasting solution. So, clearly, to foster a dynamic global economy we need to resist protectionist urges. But to do so, we also need to identify how best to respond to protectionism.

The role of multilateral cooperation in making openness sustainable

Much has been written over the past few years about the negative effects of free trade and the need to pay more attention to those who benefit less from it. The debate has typically focused on the extent to which welfare policies can be used to share the gains of trade more evenly.

Though this is a complex issue¹², I have no doubt that making better use of public policies to support the more vulnerable members of society, not just financially but also through education and retraining, is a vital part of the equation. More work needs to be done in this area and it is important to learn from best policy practices.

But the other key question is: how can we work together to make openness sustainable? What role can multilateral cooperation play towards this goal? This is the angle I would like to address today. Its importance becomes clear when one thinks about the three main areas of concern that people have about open markets that I mentioned earlier.

First, there is the concern about whether openness is fair – ie. whether all are playing by the same rules and applying the same standards. This manifests itself in fears about currency manipulation by trading partners, dumping practices and lack of reciprocal market access.

Second, there is the concern about whether openness is safe – ie. whether it exposes people to harmful spillovers from abroad. This is perhaps most visible, at least for economists, in the case of cross-border capital flows¹³, but it also applies in areas such as agriculture and biotechnology.

Third, there is the concern about whether openness is equitable – that is, whether it disproportionately benefits some groups in society over others. Though it is not straightforward to disentangle the effects of trade and technology on inequality – and they may in fact be linked¹⁴ – the perception that openness contributes to inequality has become more widespread.

In each case, multilateral cooperation, leading to regulatory convergence, is a precondition for addressing the underlying causes of these concerns. To demonstrate this, let me draw on our experience of managing openness within the European Union¹⁵.

As regards fairness, the point is obvious: regulatory convergence provides the strongest assurance that the playing field is level right across the European market. This is why, as borders have opened within Europe, common supra-national powers of legislation and enforcement have strengthened in parallel.

For example, the Single European Act in 1986 not only launched the single market, it also substantially extended the powers of the EU to make laws, the role of the European courts to rule on them, and the powers of the Commission to execute them. The logic was that a single market could only be sustainable over time if all participants could be certain that they faced the same rules, and had recourse to the same courts in the case of infractions.

Despite the political events of last year, this symmetry between regulatory convergence and market deepening has, by and large, been a success. In fact, the free movement of people, goods and services within Europe is regularly mentioned in polls as one of the two most positive aspects of the EU, the other being peace among its member states¹⁶.

Similarly, what has permitted the Single Market to survive various financial and consumer protection crises is its ability to restore safety by adapting market-wide regulation and enforcement.

To give an illustration, the internal market for frozen foods overcame the mis-selling scandal of 2013, when horse-meat was sold as beef, in large part because it was met with an improved food labelling and EU-wide inspection regime that restored trust. By contrast, a perceived lack of regulatory convergence between the EU and other countries, especially regarding food safety, is one reason for opposition to preferential trade agreements, such as the TTIP.

More fundamentally, following the sovereign debt crisis, the euro area experienced first-hand the risks of a diverging supervisory and regulatory framework for cross-border finance – and faced a serious threat of financial market fragmentation when those flows reversed. Safety was restored by elevating supervision and resolution to the European level with the banking union. This was key to re-establishing trust in the banking system and reviving cross-border capital flows within Europe. These are only the first steps, but the direction of travel has been drawn.

When it comes to the effects of openness on equity, it is admittedly less obvious how multilateral cooperation represents a solution to the fears being expressed. As I said, such fears typically have to be addressed by national distributional policies. But there is also an important international dimension, in particular related to tax avoidance.

Indeed, the problem many have with openness is not just that it redistributes income between different social groups. Almost everything that happens in a market economy – skill-biased innovation, churning of firms – redistributes income in some way, and we have in place mechanisms to deal with those outcomes, such as tax systems.

Where trade may differ from these other market forces, however, is in the perception that, in Dani Rodrik's words, it *"undercuts the social bargains struck within a nation and embedded in its laws and regulations"*¹⁷. For example, increasing openness to trade and finance is perceived by some to shift the burden of taxation from footloose capital to labour, or to create pressures to reduce labour protections to boost the competitiveness of domestic producers – the 'race to the bottom'.

Such perceptions, and the sense of injustice they fuel, are deeply damaging to public faith in open markets – and this is where multilateral solutions can play a role.

Addressing tax arbitrage between jurisdictions, for instance, can clearly best be achieved by countries cooperating via international institutions. Likewise, taking a stand against race-to-the-bottom dynamics that threaten labour protections, calls for a common regulatory approach. Again, our experience in Europe offers some insights into how this can work, as well as into some of the difficulties involved.

Thanks to its common legal framework, the EU has successfully upheld labour standards even as its market has expanded to lower-income countries. The Single Market has no doubt prompted some relocation of jobs across coun-

tries, and this has at times triggered fears of 'social dumping'¹⁸. But in fact openness has not fundamentally challenged labour protections.

One main reason for this is that safeguards central to the European social model have been progressively embedded in European law, ensuring gradual convergence in labour standards among EU countries. Thus, while there is still heterogeneity, the gap between them is narrowing.

Preferences about the degree and type of social and labour protection differ across the world, and I am not claiming that those in the EU should be a model for everybody. The point here is that through multilateral decision-making, the EU has successfully built and defended the single market, addressing the perception that openness is always a source of inequality.

At the same time, in areas where unanimous decision-making is more prevalent, Europe has not always used the potential of its multilateral structure to the same extent. This is the case, for instance, in combatting profit-shifting and tax avoidance, although progress is now being made¹⁹, which clearly chimes with the mood of EU citizens²⁰.

In short, there are certain concerns about equity that can most effectively – and perhaps only – be addressed through multilateral actions. As such, in tandem with well-targeted welfare policies, they are a key part of the policy toolbox for making openness sustainable.

Implications for the global economy

Clearly, the European model involves several unique features. In particular, it depends on a relatively advanced political structure that helps reconcile multilateral cooperation with democratic control, which is difficult to replicate elsewhere. Still, EU countries are generally more open than other advanced economies and perhaps have fewer

problems of skewed income distribution²¹. So what lessons can we draw for the global economy from our experience?

The most salient is that, at a time when disaffection with openness is growing, multilateral institutions become more, not less important. They provide the best platform to address concerns about openness without sacrificing open markets.

So organisations like the WTO, which make sure that trade is governed by rules and is subject to fair arbitration, remain vital to ensuring that global trade is perceived as fair and safe – while at the same time avoiding protectionism in disguise. And bodies that foster global cooperation, such as the G20, remain just as necessary to reconcile openness with equity. The OECD/G20 initiative to combat tax base erosion and profit-shifting is just one example of such cooperation.

That said – and going by our experience in Europe – the area where we need a special focus today is cross-border finance. Organisations that facilitate convergence in financial regulation and supervision, such as the Financial Stability Board and the Basel committees, are key in this context.

Within these committees, a substantial amount of work has been done since the crisis to strengthen microprudential regulation, as well as to design and calibrate macroprudential tools. This work has been essential for at least three reasons.

The first reason is that finance is the most mobile production factor, and therefore the most likely to cause dangerous spillovers. This makes convergence in financial regulation one of the most important components of a sustainable open economy.

And we should remember that diverging financial regulation would endanger not only financial openness, but also global trade, since they are often two sides of the same coin: finance and trade are complementary in spreading knowledge and underpinning global value chains. A striking feature of the global financial crisis was indeed the collapse in world trade: between the third quarter of 2008 and the second quarter of 2009 global trade volumes declined by approximately 15%.

The second reason is that we have only recently witnessed the dangers of financial openness combined with insufficient regulation. International financial flows both contributed to and propagated the global financial crisis and the ensuing collapse of trade, output and employment.

Financial integration only survived relatively unscathed because the global regulatory response was swift and decisive, creating a financial system that posed fewer risks to the world economy. Any reversal would call into question whether the lessons of the crisis have indeed been learnt – and thus whether financial integration can still be considered safe.

Third, financial regulation interacts critically with monetary policy. Lax regulation implies an underestimation by regulators of incentives which lead to behaviour that is individually profitable, but socially costly. Given the large collective costs that we have observed, there is never a good time for lax regulation. But there are times when it is especially inopportune.

Specifically, when monetary policy is accommodative, lax regulation runs the risk of stoking financial imbalances. By contrast, the stronger regulatory regime that we have now has enabled economies to endure a long period of low interest rates without any significant side-effects on financial stability²², which has been crucial for stabilising demand and inflation worldwide.

With monetary policy globally very expansionary, regulators should be wary of rekindling the incentives that led to the crisis.

To design and agree, in reciprocal trust, a regulation that preserves financial stability without unnecessarily restricting the flow of credit to the economy, while revisiting the post-crisis regulatory framework where necessary, the FSB and the Basel committees remain essential. This is also because, for large economies, changes in domestic regulation have international consequences. Global financial conditions account for 20-40% of the variation in countries' domestic financial conditions, as shown by recent research from the IMF²³.

Conclusion

To inject more dynamism into the global economy we need to raise potential output growth, and to do so with ageing societies we need to lift productivity growth. For advanced economies that are close to the technological frontier, this depends crucially on openness to trade.

Yet openness to trade is under threat, and this means that policies aimed at answering this backlash are a vital part of the policy mix for dynamic growth. Some of those policies can be implemented domestically, but some can only be effectively enacted through multilateral cooperation.

Multilateral cooperation is crucial in responding to concerns about fairness, safety and also equity. By encouraging regulatory convergence, it helps protect people from the unwelcome consequences of openness. And protection ensures that we do not lapse into protectionism over time.

The European experience provides some insights into the opportunities and challenges involved. It also shows the importance of ensuring that, at all times, openness remains under democratic control. Multilateral institutions are

necessarily staffed by experts. But it is essential that they always remain accountable to elected representatives who set the parameters and have the final say. ■

Mario Draghi is President of the ECB

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Endnotes

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Looking forwards

Forward-looking Malta has laid the groundwork for a strong economy, with an internationally-recognised financial centre, FinanceMalta write

For centuries Malta has stood at the commercial crossroads linking Europe, Africa and the Middle East. The Phoenicians, Romans, Carthaginians, Arabs, Ottomans, Knights of St John, French and the British all ruled the island at one time and contributed to the mosaic that is modern Malta.

Britain's legacy has lasted the longest as Malta was part of the British Empire for over 150 years, until independence in 1964. Not surprisingly, English remains one of the national languages. The use of a legal system based on English law and the English language are international advantages, as well as a business-first climate and can-do attitude.

This is reflected in the education system, which is globally-recognised as being of high quality and producing a flexible skilled pool of workers for local and incoming business. To aid the economy further the communications network is constantly upgraded to leverage the latest technology and, crucially, network capacity is expanded as required.

Since independence in 1964 Malta has developed its role as a strategic business and trading hub, and since the 1980s Malta has pursued a strategy of developing a financial services centre.

While starting out as an offshore hub, Malta decided to move its financial services onshore. By introducing a strong supervisory framework as well as a competitive, transparent regime approved by both the European Union and the Organisation for Economic Cooperation and Development, Malta sought to distance itself from secrecy jurisdictions and tax havens.

The country's decision to join the EU in 2004, and later the eurozone in 2008, was integral to the expansion of its horizons and bolstered its status as a key business hub in the Euro-Mediterranean region.

With its successful economic track record, it is no surprise that Malta has constantly attracted steady inflows of foreign direct investment across all sectors of the economy, with the finance sector currently accounting for more than 90 per cent of the total.

Malta's EU membership has been the key attraction for companies to set up operations on the island, while Malta's proximity to and cultural links with North African and Middle East countries are particularly attractive to companies that use the island as a stepping stone for trading, distribution and marketing of their international operations in North Africa.

Forward-looking Malta has laid the groundwork for a strong economy and an International Finance Centre of repute. A range of emerging sectors and business opportunities will help it retain its competitive position.

Some prominent companies that have invested in Malta are HSBC, Microsoft, Playmobil, Uniblue, Betfair, Cardinal Health and Lufthansa Technik. In addition to strong historical and commercial ties to Italy and the UK, Malta enjoys healthy trade with France, Germany and Greece. The country's exposure to international commerce is one of the highest worldwide, and Malta has a wide network of some 70 tax treaties. The island's leaders are also constantly working on developing new ties with foreign governments in order to facilitate worldwide market access for all industries. Trade with Asia (mainly China and Singapore), Russia and the US is increasing.

Over the years, Malta has become a significant exporter of financial services and has accelerated efforts to increase the depth and breadth of its finance industry. The sector has demonstrated consistent annual growth over recent years. It now accounts for an estimated 13 per cent of the island's GDP and provides close to 10,000 jobs. Rated repeatedly as the 10th soundest banking system in the world by the World Economic Forum's Competitiveness Index, Malta's banking sector is thriving.

The Government has provided critical support, and a range of opportunities exist for financial institutions to expand and grow their business in Malta. The scale of this transformation has been enough to position Malta as an alternative to established finance hubs such as Dublin, London and Luxembourg. Malta's finance sector has also been given a clean bill of health by rating agencies, the EU Commission and the International Monetary Fund.

Malta provides a broad and integrated suite of financial services, and the various parts of the financial sector not only serve important functions in their own right but are mutually reinforcing. The island has strong banking, insurance, investment funds and wealth management sectors, all of which are underpinned by EU-compliant legislation and regulation. Malta has gained a reputation as a jurisdiction for smaller financial services companies and startups, which offer clients more personalised services than those provided by the bigger firms.

The Maltese authorities' efforts over the last few years have also successfully attracted a large number of international banks such as Banif Bank, Deutsche Bank, FIMBank and HSBC. Fund administrators such as Apex, Citco and Custom House all have a presence in Malta, along with insurance managers such as AON, Marsh and Munich Re.

In addition, a number of Fortune 100 companies have set up operations here, including multinationals such as BMW, Citroën, Peugeot and Vodafone. Malta also boasts considerable expertise in the field of trusts and foundations, with many legal and accounting firms operating in-house trust companies in addition to international advisory networks. Malta is committed to ensuring that those companies and their clients in the financial services sector can enjoy a first-class regulatory regime and benefit from the Malta's pursuit of excellence. ■





The Trump doctrine on international trade: Part one

William Nordhaus argues that President Trump embraces fallacies as facts, and that the efforts to reform tax are flawed and will make tax law more complex

President Trump's doctrine on trade represents a radical break with previous US policy. This column, the first of two examining the Trump doctrine, argues that he embraces fallacies as facts, and that the efforts to reform tax are flawed and will make tax law more complex. If enacted, the Auerbach-Ryan Tax Plan would be a mechanism by which the US government collects taxes to benefit rich citizens at the expense of the country's trading partners.

You might hear someone say, *"That's a fact. People can look it up."* It was not always so. The modern concept of a 'fact' emerged with the scientific revolution of the 16th century. Before that, descriptions of the natural world were determined by religious or secular authorities. The discovery of a new star by Tycho Brahe in 1572 was a 'killer fact' that ultimately destroyed the earlier conception of the heavens. In a well-functioning society, the status of a fact is decided by evidence and experiment¹.

Or so we thought. In a scene reminiscent of medieval times, the administration of President Donald Trump has turned the clock back to an era in which authority determines which facts are fake and which are real. This plays out daily in tweets and press conferences. The English language has been enriched with phrases such as 'fake news' and 'alternative facts.'

The notion of alternative facts was well described by George Orwell in *Nineteen Eighty Four* (Orwell 1949) as *"to be conscious of complete truthfulness while telling carefully constructed lies."* Even alternative facts can change, as when former White House press secretary Sean Spicer defended the employment data after attacking them, quoting Trump as saying, *"They may have been phony in the past, but it's very real now."* The White House is said to be considering creating alternative facts about trade by excluding re-exports from the trade balance (Maudlin and Barrett 2017), in effect creating a trade deficit for the entire world.

While the President and the press battle daily over facts, the more consequential struggle over ideas has been overshadowed. What are Mr Trump's economic ideas and philosophy? The Trump administration has largely embraced the standard Republican agenda items of lowering taxes, cutting spending, reducing the burden of regulation, and freeing the market.

There is one area where Trump as candidate and president has espoused an economic policy that is dramatically opposed to traditional Republican policies, however, and that is his embrace of trade protectionism. Since his rejection of free trade is so unusual, and so quintessentially Trump, it is worth a careful review.

The verdict on this new corporate tax proposal is that it has many attractive features, but it also has many disadvantages. It is mightily complicated, both domestically as a matter of tax law, and internationally in meshing with other countries' tax systems

The Trump campaign rhetoric is familiar to those who followed the 2016 presidential campaign. Here is a sample from 25 February 2016:

"It's not free trade; it's stupid trade.... I don't mind trade wars when we're losing \$58 billion a year.... We are killing ourselves with trade pacts.... Free trade can be wonderful if you have smart people, but we have people that are stupid.... I think NAFTA has been a disaster."

What lies behind the bluster? The Trump Theory of Trade has four strands at variance with modern economic analysis: overlooking the gains from trade, focusing on the trade deficit, ignoring the changing nature of trade, and disdaining the need for cooperation in international affairs. In this column, I review current thinking on these as well as losses from trade and the business tax proposal with border tax adjustment.

The gains from trade

The most fundamental point is that trade – whether domestic or international – is mutually beneficial. The basic analysis was developed exactly 200 years ago by David Ricardo in his theory of comparative advantage (Ricardo 1817). Ricardo used the examples of Portuguese wine and English cloth. Today, the examples have changed but the principles are the same. By specialising in the production and export of goods that countries make relatively cheaply, and importing and consuming goods that the country makes relatively expensively, each country can improve its living standards.

While wine and clothing continue to be staples of international trade, we can use the iPhone as an example of the benefits of trade in the modern era. Some people may remember the first mobile telephone produced by Motorola in 1973. It was nicknamed 'the brick' – heavy, huge, and costing \$10,000 in today's prices. Over the next four dec-

ades, vigorous competition between many companies around the globe led to the smart phone that is probably one of the most cherished products today, with 3 billion users².

One of the most fascinating stories about trade is a 'teardown' analysis of how the Apple iPod is made (Varian 2007). Our trade statistics record the iPod as made in China, but the analysis finds that China added only \$4 of the \$299 retail price, with the 451 parts being made by companies around the world. Apple earned about \$80 for its design, research, and marketing. However, all this would not have been possible without the free trade in electronic products that allows easy exchange of the parts built into iPods and iPhones. The cameras in today's smart phones cost about \$20 and produce a trillion pictures a year. These show, in vivid colour, how people around the world benefit from the vigorous competition inherent in international trade.

Suppose you were a reader of *Mad Magazine* when it was first published in 1952. You would need to wait for the US Postal Service to get your copy. Today, you can read the latest issue on your smart phone – after having used your phone to locate a coffee shop, buy the coffee, email your family, take a picture and send it to your family, check on your flight delay, read the news, and play a game. These would not have been possible without the gains from trade.

Focus on the trade deficit

One of Trump's major themes is that the US is losing in its trade policies, and the trade deficit shows the score. The administration's economic theory of trade was described at length by Peter Navarro, director of the White House National Trade Council in the Trump administration. His argument is as follows:

"The economic argument that trade deficits matter begins with the observation that growth in real GDP depends on only four factors: consumption, government spending, business investment and net exports (the difference between

exports and imports). Reducing a trade deficit through tough, smart negotiations is a way to increase net exports—and boost the rate of economic growth". (Wall Street Journal, 5 March 2017)

Navarro's statement is simply an accounting identity and does not recognize the effect of policies, trade or other, on output and employment. As economics, it fails on three grounds.

- A first mistake is to read any significance into bilateral trade balances. Here is a typical claim from Trump, made on Twitter on 26 January 2017: *"The US has a 60 billion dollar trade deficit with Mexico. It has been a one-sided deal from the beginning of NAFTA..."* One of the first lessons in economics is that bilateral trade balances have no significance in a multi-country world.

A simple example with triangular trade will illustrate. Suppose the US exports \$100 billion of computers to Australia, which exports \$100 billion of wheat to China, which exports \$100 billion of clothing to the US. The US has a \$100 billion deficit with China, but each of the three countries has a zero overall trade deficit. So what is the true 'score' for Mexico, its current account? Mexico was actually running a \$36 billion deficit in 2016. While Mexico had a bilateral surplus with the US, it had large bilateral deficits with China, the EU, and Japan. So while the bilateral deficit is a fact, it is an irrelevant fact.

- A second mistake is the belief that trade deficits are an economic malady. Modern macroeconomics looks at the issue completely differently: trade deficits are the counterpart of low domestic saving and high foreign saving. My second column in this two-part series explains this as the paradox of the tail wagging the dog.
- The third flaw, closely related to the second, is the idea that trade deficits and job losses are the result of 'bad trade deals'. Actually, to a first approximation, trade deals have no impact on the unemployment rate or the

trade deficit. Trade deals are important. They increase imports and exports of all sides of the deal. They increase the volume and variety of goods consumed and exported. Along the way, they produce economic benefits to both the US and its trading partners. However, trade deals have minimal effect on joblessness. For the US, trends in unemployment are largely determined by monetary and fiscal policy as well as shocks such as wars and financial crises. And, to reiterate the second point, trade deals do not affect the trade deficit – this is determined by saving and investment trends at home and abroad.

The Auerbach-Ryan Tax Plan and border tax adjustment

Suppose that policymakers are alarmed about the trade deficit and wish to ‘do something’. While economists might argue this is wrong-headed, or that the way to deal with trade deficits is through fiscal policy, one interesting new approach involves business tax reform and ‘border tax adjustment’.

This new approach is the brainchild of Alan Auerbach, a distinguished fiscal policy economist at Berkeley (eg. Auerbach et al. 2017). The idea moved from the academy to Washington when it was proposed by the House leadership (Tax Reform Task Force 2016) – although at the time of this writing it is not on the Republican agenda for tax reform. It would have a major impact on trade and finance, so we need to weigh it carefully³.

The technical name of this proposal is a ‘destination-based cash flow tax’, or DBCFT. It has two parts, one relating to cash flow and the other because it is destination-based. The first part is a move from the current corporation income tax to a cash flow tax. This would involve principally removing the tax preference that allows deductibility of interest and allowing investment to be completely deducted in the current year (‘expensing’).

The US Treasury estimated that the tax base would be about the same as today’s tax system, so a straight change with unchanged tax rates would be roughly revenue-neutral (Patel and McClelland 2017). Many economists would

favour this kind of reform (if it were revenue-neutral and distribution-neutral) because of the distortions caused by interest deductibility.

The second feature of the DBCFT is to change the cash flow definition to be destination-based. This is designed to correct for the international 'race to the bottom' in which companies minimise their taxes by moving their assets (such as intellectual property) to low-tax countries such as Ireland.

Companies race to the bottom because some elements of the current US corporate tax involve mobile factors. While it is hard to move my house or Wyoming's coal mines out of the US, and out of the US tax system, it is easy to move the ownership of Apple's intellectual property (IP). Suppose that Apple moved its IP from the US to Ireland. In the US, this would be taxed at the federal rate of 35%, but it was apparently taxed at only 0.005% in Ireland in 2014 (Taylor 2016).

DBCFT would move the tax base to where a good is consumed (ie. the destination) rather than on where it is produced (ie. the origin) because consumption is relatively immobile. We can move the production of running shoes to Vietnam, but I consume (ie. wear) my running shoes in Connecticut. In its focus on taxing consumption, the DBCFT is like a sales tax or a value-added tax. From an international perspective, if Apple is taxed only on its domestic cash flow (US sales less US costs), then the location of ownership of its IP no longer enters into the calculation of US taxes. So the race is over because there is no reward for winning it.

Here is where the border tax adjustment comes in. The previous paragraph pointed to cash flow equalling "*US sales less US costs*". This means that imports are not part of costs, and exports are not part of revenues. So if the DBCFT rate is 20%, then there is a tax of 20% on imports and a 20% subsidy on exports. Therefore, companies such as Walmart who are net importers are screaming foul, while major exporters are quiet.

This plan is devilishly complicated, and a few overview comments must suffice at this point. First, there is no country in the world that has the DBCFT... not a single one. As a result, there are huge obstacles to its implementation, such as because there is no experience with it, it does not comply with WTO rules, and it may violate tax treaties (for an explanation of some of the problems, see Graetz 2017).

A second point just mentioned is that many of the advantages would arise only if the DBCFT were universally adopted. However, it would make tax life more complicated and create new tax havens if the US adopted it and other countries did not. For example, the advantage of removing the tax arbitrage from locating intellectual property (IP) in a low-tax country would look quite different with partial adoption. Since imports are taxed and exports are subsidised under a DBCFT, there would be tax arbitrage possibilities from moving all IP (and other footloose costs) to the US. To put this in perspective, the WTO estimates that trade in IP was more than \$300 billion in 2013⁴.

Moving to a DBCFT system from an income tax system would involve tens of billions of dollars in tax reductions and reallocations. This is perhaps the most dramatic example of the distortions that would arise from unilateral adoption of this proposal.

Third, an important facet of the plan is that it would (in its pure form as applying only to goods) raise substantial revenues for the US. At a 20% tax rate, the import taxes would at last year's trade levels be \$440 billion, while the export subsidies would be \$290 billion. So this would lead to \$150 billion in additional US federal revenues at current trade levels.

The total would be lower if services were included (because the US has a surplus there). Revenues would also be lower if the border tax adjustment reduces the trade deficit (as seems likely). Revenues would be further lower if

other countries retaliate with their own border taxes. It is hard to imagine all the corporate finagling that would occur with those hundreds of billions of dollars at stake.

Some defenders of the plan argue that it will have little trade impact because the dollar exchange rate will adjust to offset the tax. To illustrate, if the dollar appreciates by 20%, then this will exactly offset the 20% import tax and export subsidy. While this is true as a matter of logic, there are at least two problems with this defence. First, several countries are actually or effectively pegged to the dollar (Hong Kong being an example).

Unless these countries specifically devalue by 20%, the offset will not occur. A second concern is the imbalance in the US financial account. At the end of 2016, the US owed \$32 trillion to foreigners. If the dollar were to appreciate by 20%, this would comprise a \$6.4 trillion capital gain to foreigners. The US owns \$24 trillion of foreign assets, and US owners would suffer a huge capital loss with dollar appreciation. So if the defenders are right that dollar depreciation would offset the tax-and-subsidy aspect of the DBCFT, they need to defend the major wealth redistribution from Americans to foreigners.

Given all these problems, you might ask why Congressional Republicans are so enamoured with this plan. Conservative economists have for many years advocated a cash flow corporate tax. However, the 'destination-based' element, implying border tax adjustment, is a new feature of the tax landscape. The obvious reason is that Republicans need revenues to finance their 2017 version of a supply-side tax cut, and border tax adjustment could provide \$1 trillion or more of revenues over the next decade. This feature is pure 'America first' in which taxes are collected to benefit the rich at the expense of trading partners.

The verdict on this new corporate tax proposal is that it has many attractive features, but it also has many disadvantages. It is mightily complicated, both domestically as a matter of tax law, and internationally in meshing with other

countries' tax systems. While it has been shelved by the administration and Congressional leadership as of the summer of 2017, it seems a safe bet that the DBCFT will return. ■

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Endnotes

1. For a discussion of the history of 'facts' and the role of the scientific revolution, see Wooton (2015). The quotation on "look it up" was Marco Rubio criticising Donald Trump for hiring Polish workers.
2. A useful history is found at https://en.wikipedia.org/wiki/History_of_mobile_phones. The number of smart phone users is an estimate that comes from <https://www.statista.com/statistics/330695/number-of-smartphone-users-worldwide/>
3. For an illuminating critique, see Graetz (2017).
4. For data on intellectual property trade, see https://www.wto.org/english/res_e/statis_e/its2014_e/its14_toc_e.htm

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World Commerce Review is pleased to announce that TPC Management (UK) Limited has been awarded the Best Professional Services Provider 2018.

The selection panel took into account service innovation, on-going customer support and best practice criteria.

In addition, forward planning and CSR were seen as key areas for the award committee.

The World Commerce Review awards are recognised as the principal indications of professional conduct and excellence.



Best Professional Services Provider



The Trump doctrine on international trade: Part two

Trump risks destroying the fruits of almost 100 years of
global trade cooperation, William Nordhaus argues

The change in the structure of global supply has important implications for US President Donald Trump as he contemplates tearing up existing international trade deals. This column argues that he risks destroying the fruits of almost 100 years of global trade cooperation, the benefits of which to citizens in the US far outweigh the costs. This spirit of cooperation is also the basis for coordinated global action on issues such as climate change.

In my [previous column](#), I examined the Trump Doctrine on trade and some of its key fallacies, along with the allure of the Auerbach-Ryan plan on business tax reform. In this column, I provide a further analysis of the economics of trade, including the potential losers and the broader role of trade policy in international cooperation.

The tail of finance wags the dog of trade

The modern theory of the trade balance, described here, will help explain why President Trump's focus on the trade balance is so misguided. International economic history exhibits a fundamental divide in 1973. Before 1973, the major economies of the world had fixed exchange rates. The gold or silver standards, used by the US from the time of the first US treasury secretary, Alexander Hamilton, until 1935, was such a system. After World War II, nations were on a dollar standard. In 1970 about 95% of world GDP was produced by countries operating with fixed exchange rates.

In 1973, the US and most other countries abandoned gold and fixed exchange rates. By 1975, more than 80% of the world's GDP was produced by countries operating with flexible exchange rates. The era of flexible exchange rates had arrived. A parallel trend has been the opening, or globalisation, of financial markets. Aside from China, virtually all countries today are open to financial inflows and outflows.

Once countries operate with flexible exchange rates and open financial markets, the trade balance marches to a different drum. US trade deficits (or more correctly, the current account balance, which includes services and transfers)

are the accounting counterpart of low US national saving and high foreign saving. Economists believe, indeed, that the causality runs from national saving to trade. In other words, because the US has such a low domestic savings rate, US investment in research, equipment, and structures is partly funded by foreign saving. This foreign saving is registered as a balance of payments surplus, which is the exact counterpart of the deficit on trade and service account.

To put this in a homey way, we can say that the tail of finance wags the dog of trade. The dog of trade looms larger in terms of employment and output, but we must look at the tail to understand the movements in the dog.

Cooperation is not altruism in which 'stupid' negotiators allow countries to exploit the US. Rather, it is the expression of far-sighted self-interest that requires brains and grit and stamina

To illustrate, the US is a low-saving country, and China is a high-saving country. Over the last quarter-century, China saved 44% of its national income, while the US saved 18%. The result was that China put its excess saving abroad through its trade surpluses, while the US did the opposite. More precisely, China ran a current account surplus amounting to 4% of income, while the US ran a deficit of 3% of national income. Other high-saving countries with trade surpluses were Japan, Hong Kong, and Germany, while low-saving countries with trade deficits included Mexico, South Africa, and the UK.

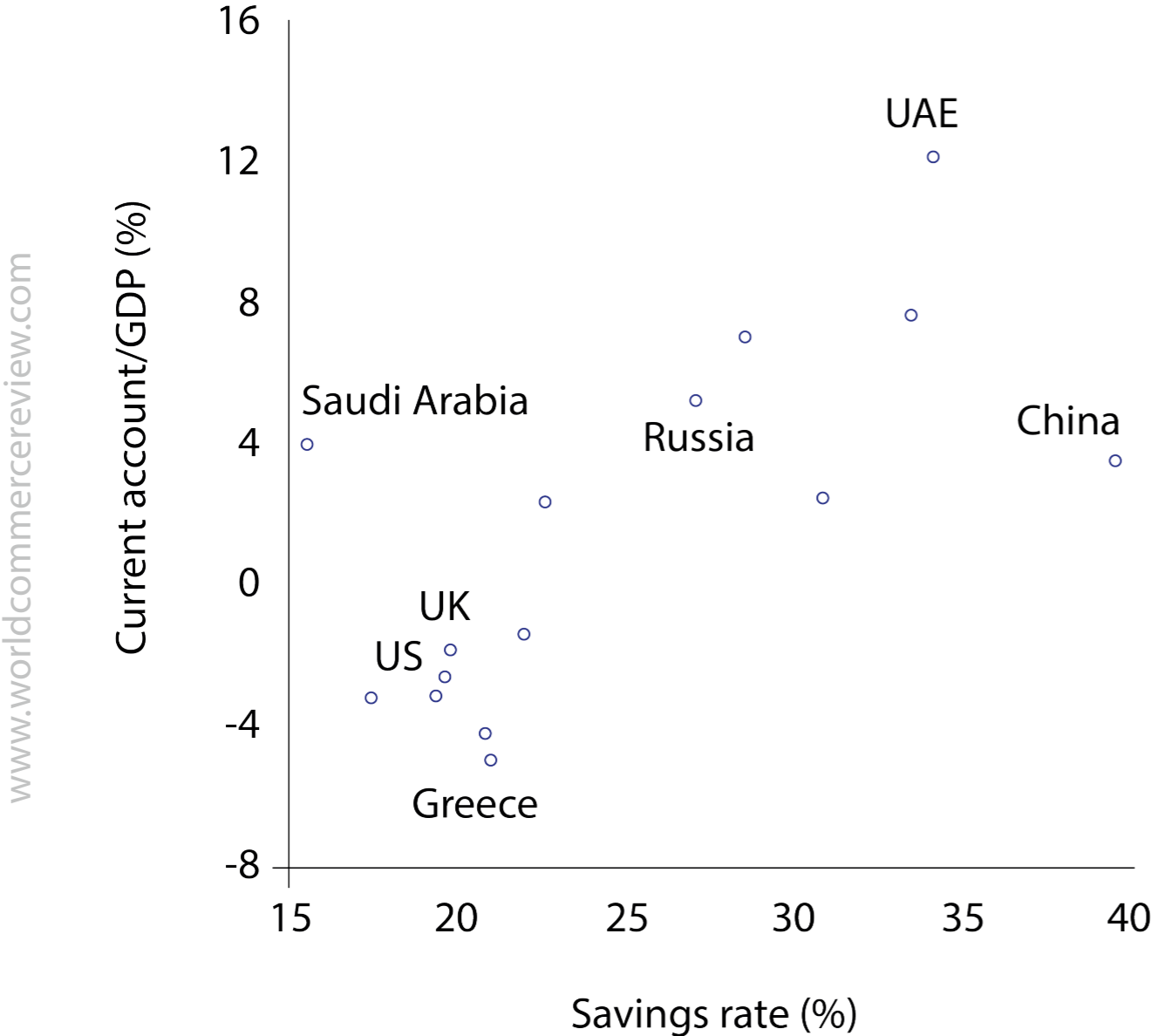
Figure 1 shows a more systematic picture. This displays the national saving rate on the horizontal axis and the current account as a ratio of GDP on the vertical axis. For the current account ratio, a positive number is a surplus and a negative one is a deficit. We can see here that the US fits in nicely with the low saving countries. By contrast, oil producers, who have high savings rates, put their funds abroad and run surpluses.

An interesting example of the way foreigners save in the US is the accumulation of dollar reserves by foreign central banks. These nest eggs (totalling \$6 trillion owed by the US to foreign official agencies) are held by foreigners to protect against speculative attacks on their currencies. But the result of this accumulation of dollars by foreigners is that the exchange value of the dollar is higher and the US tends to run a larger trade deficit.

Another source of financial flows into the US is a portfolio effect. Foreigners own about \$10 trillion of US debt securities. Just for simplicity of exposition, suppose this is a constant 10% of foreign portfolios. If the portfolios are growing at 3% a year, then foreigners will need to buy \$300 billion of US debt each year to maintain the 10% share. This would have to be offset by a trade deficit.

Hence, the paradox is that the US trade deficit is big because its financial markets are so attractive, not because of lousy trade deals.

Figure 1. National saving and the current account



The changing nature of trade

If you listen to Trump, you might think that air conditioners are made either in Mexico or US, or that cars are made in the US or Japan, or that airplanes are made either by Boeing or Airbus. At the [speech](#) on the unveiling of Boeing 787, Trump said, *“This plane, as you know, was built right here in the great state of South Carolina”*.²

Two hundred years ago, in the days of David Ricardo, it was largely true that goods were ‘made’ in one place. Such was standard during the ‘first wave of globalisation’, as has been described in the remarkable book on globalisation by Richard Baldwin (2016). Today, we have moved to the second wave. As with the iPhone or iPod described in my previous column, the production processes for cars, air conditioners, and airplanes have been sliced up very finely among different producers thanks to revolutionary declines in transport and communications costs. We live in the era of highly specialised global supply chains, which involve the increasingly intensive cross-border flows of goods, technology, investment, services, and workers.

Take the example of the Boeing 787. This is assembled in the US. But the central fuselages are made in Italy, the landing gears in Japan, the wingtips in Korea, the batteries in Japan, the engines in the US and UK, the cargo doors in Sweden, the passenger doors in France, the trailing wing edges in Canada and Australia, and the rear fuselages in the US. The key role of Boeing is actually the research, design, and coordination. American ‘manufacturing’ today is largely conceptual, not manual.

Take a step back to review the growth of international trade since World War II. According to the US Bureau of Economic Analysis, in 1945, total trade in goods and services (the sum of exports and imports) was 6% of US GDP. By 2016, total trade was 27% of GDP. This growth was paralleled in most other countries, and indeed other countries generally have larger trade openness than the US.

What were the reasons behind this phenomenal growth? The first spurt came from the opening up of markets after the lifting of controls imposed during the Depression and World War II. This was accomplished through several rounds of international agreements lowering barriers to trade and finance along with the formation of the EU.

The most recent trade expansion was driven by changes in communications and transport costs. Almost everyone appreciates the role of the internet, which permits costless information transfers and thereby allows home countries to coordinate and control the vast supply chains that make possible low-cost production.

A less appreciated ingredient in the growth of trade has been containerised shipping ('the box'). Here is the way Marc Levinson (2016) describes it:

"On April 26, 1956, a crane lifted fifty-eight aluminum truck bodies aboard an aging tanker ship moored in Newark, New Jersey.... In 1956, the world was full of small manufacturers selling locally; by the end of the twentieth century, purely local markets for goods of any sort were few and far between.... By one careful study, the United States imported four times as many varieties of goods in 2002 as in 1972, generating a consumer benefit of 3% of GDP [amounting to \$600 billion at today's level of income]."

Containers represented an invention that was tailor-made for low-cost, high-volume international trade. The major beneficiary of the container revolution has been China. Whereas in 1990, China was barely on the container map, by 2014 six of the ten largest container ports were Chinese (or eight if we include Hong Kong and Singapore). In 2014, China's major ports shipped 126 million containers.

Containers did not just lower transportation costs; they allowed companies to reorganise their production processes. It would not be possible to ship all the different components of an iPhone around the world if they were taken

on and off of ships and trucks and boxcars by hand, as in the earlier era of *On the Waterfront*. One study concluded that containerisation had an impact on a country's trade flows that was four times as important as joining the WTO (Bernhofen et al. 2016).

The structure of the global supply change has an important implication for Trump as he contemplates tearing up existing trade deals. Other countries are critical links in the value chain. Suppose he imposes a 45% tariff on China, as he has threatened (*New York Times* 2016). China might retaliate by slowing the assembly of iPhones and other American products. For want of a screw, the Apple kingdom would be lost. Similar concerns apply to every complex global production process. No country is an isolated and protected island in the great value chain.

Qualifications and the losses from trade

People are of two minds on trade. They love their inexpensive running shoes and smart phones, but they worry about the dislocations caused by trade. So consider the losses from trade, perceived and real.

International trade improves the lot of the vast majority of Americans and others around the world, but some are economically harmed along the way. Not just by international trade, but also by domestic trade – by the impersonal market forces that create new products and jobs, but destroy old ones. Markets are cool-headed but cold-hearted. As Arthur Okun said in his book on inequality, we should award two cheers for the market but not three (Okun 1975).

Begin with inequality. It seems likely that global inequality has been reduced by trade. The rapid growth in many low-income countries such as China and India has been spurred by export-led growth as well as technologies embodied in investments by cutting-edge companies from advanced countries. The growth in these large countries means that global inequality has been stable or declined slightly in recent years (Milanovic 2015).

The sources of inequality in the US are more complicated. The rising inequality has been concentrated at the top. From 1980 to 2015, the share of the top 1% rose from 11% to 20%, while the share of the bottom 80% fell from 56% to 49% (Milanovic 2015). Scholars who have studied the reasons have found many sources. Studies point to forces such as the decline of labour unions, lower taxes on top earners, the labour-saving nature of technological change, the emergence of the superstar economy, immigration of low-skilled workers, the growing share of finance, as well as displacement of high-wage jobs in import-competing industries. While all these took place in the context of increased globalisation, it is hard to see trade imbalances as the major cause of rising inequality.

While globalisation has probably had a small effect on domestic inequality, a more important concern is the impact on employment. There is no doubt that trade has affected the composition of jobs. The major domestic impact of trade was on manufacturing employment. According to the Bureau of Economic Research, in the last three decades, employment in manufacturing declined from 16% to 9% of the US total. The largest percentage losses were in textiles, apparel, and printing. The reason is straightforward: foreign products have become relatively inexpensive, and domestic manufacturing output and employment have declined as a result.

While changes in trade patterns have had large effects on manufacturing, according to the Job Openings and Labor Turnover Survey (JOLTS) by the US Bureau of Labor Statistics, the total number of jobs increased by 10% over the 1998-2015 period. The losses in manufacturing were more than offset by gains in professional, health, and educational services. Roughly a half-million manufacturing jobs were 'lost' to other industrial countries (outside of China and India), but over this period the US economy gained 16 million jobs.

International trade shares an interesting asymmetry that is common to many intractable political problems, such as environmental policies. They tend to have widespread benefits but narrowly targeted and large losses. Virtually all

of us benefit from the low prices and greater variety provided by international trade, but the job losses – in sectors like textiles and apparel, steel, and autos – are concentrated in a few sectors and communities.

A humane society would devise policies to compensate the losers from income losses from trade and technological shocks, but such policies run afoul of market fundamentalism. Indeed, conservatives undermine their own causes when they fail to enact policies to soften the blows of the market system that they, the conservatives, so admire.

The gains from international cooperation

A final flaw in Trump's conception is to think that trade deals are a zero-sum game – that when Mexico hires a worker to produce air conditioners, this robs America of a job. Perhaps, the president learned this lesson in a lifetime of bidding on real-estate deals, where one side wins and the other side loses. Or in running casinos, where the little people are literally losers, but a bad deal can bankrupt even the smartest.

In reality, international trade deals are completely different from casinos or real-estate transactions. Trade bargains are a game in which there are multiple outcomes. At one extreme, countries can fall into a harmful high-tariff, non-cooperative outcome, like the one envisioned in the prisoners' dilemma, where each country pursues its own nationalistic self-interest. Or they can pursue a cooperative free-trade strategy, in which countries agree to self-restraint and allow international competition, specialisation, and the division of labour to lower costs and raise living standards.

Returning to our example of the iPhone made around the world, we might ask, how did this happen? Why do we enjoy the free trade in electronic goods that produced the iPhone? What has provided us with the inexpensive running shoes, or the safer and less expensive cars? Today's free and open trading system was not only a product of the market. It was equally the result of a near-century of difficult and complicated negotiations among countries.

Historically, the US was a high-tariff country; For the period from 1820 to 1930, the average US tariff rate was almost 40% (Carter et al. 2006) The last major tariff-raising legislation was the Smoot-Hawley Tariff of 1930, at which point the average tariff rate peaked at 59%. Along with retaliation and military conflict, this led to serious disruptions to international trade in the Depression and beyond.

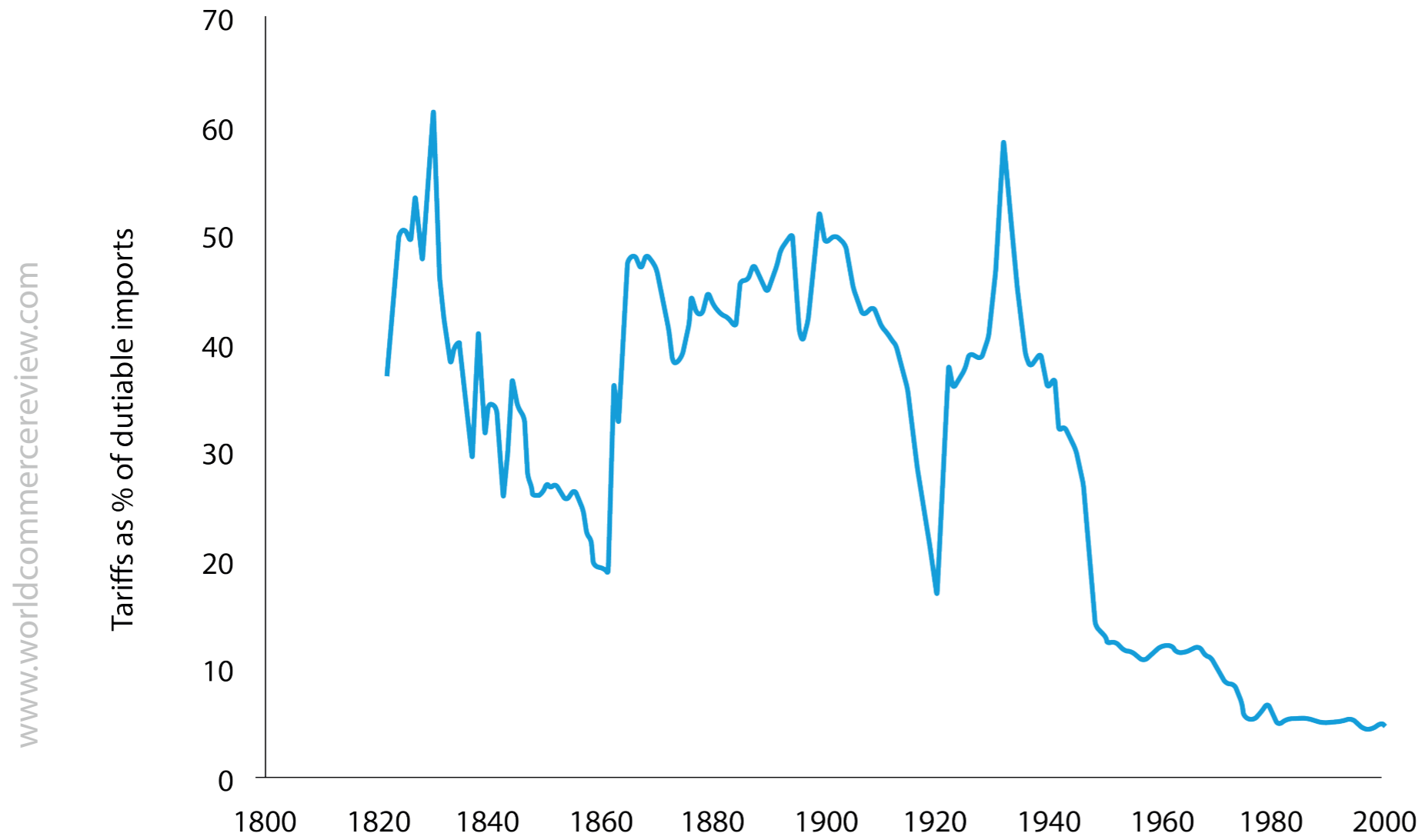
Starting with the Reciprocal Trade Agreements Act of 1934, and going through several rounds of negotiations, nations progressively dismantled their tariff and non-tariff protectionist structures. The average global tariff rate declined from 10% in 1985 to 2% today. (Figure 2 shows the history of US tariffs, while Figure 3 shows global tariff rates.)

The important point here is that an open trading system is a victory won by the peaceful armies of trade negotiators. Open borders plus containers plus the internet plus innovation are the engines that have produced the cornucopia that American and other consumers enjoy. This is the cooperative regime of game theory, which required tireless efforts to escape a non-cooperative regime of high tariffs.

Trump's administration has already torn up the latest negotiated pact, the Trans-Pacific Partnership, and in May 2017 formally notified Congress of its intent to renegotiate the North American Free Trade Agreement (NAFTA). It has launched protectionist measures in lumber (CNN Money 2017) and threatens ones on steel (Reuters 2017). Up to now, there have been no countermeasures, but European Commission President Jean-Claude Juncker warned, *"We are prepared to take up arms if need be"* (New York Times 2017). Presumably, he means a trade war, not a ground invasion.

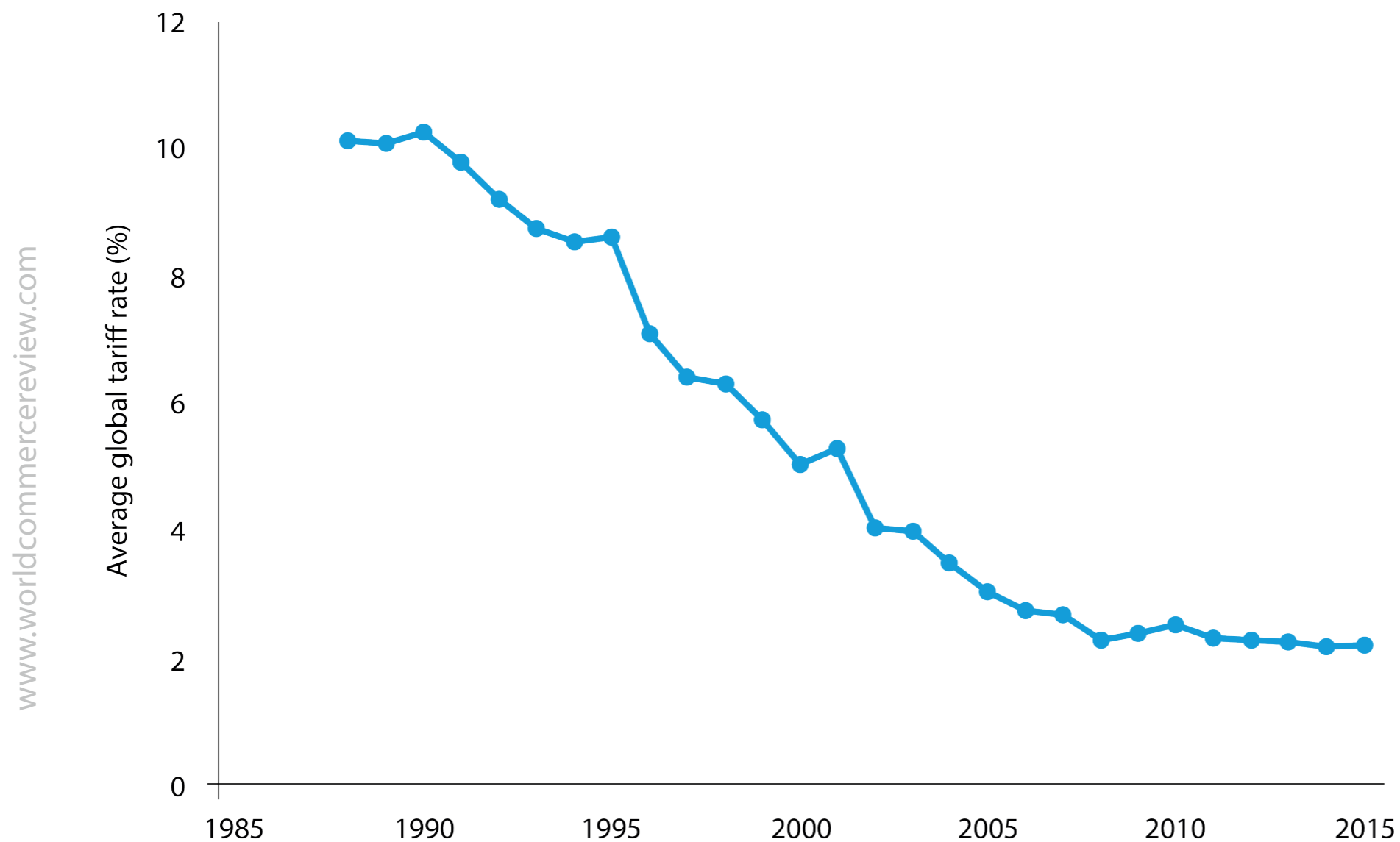
The threats to the international trading system illustrate the danger of Trump's world view. 'America first' is a non-cooperative ideology in which the US would pursue its narrow self-interest in trade, military policy, climate

Figure 2. Average US tariff rate, 1820–2000



Source: Carter et al. (2006), Table Ee430

Figure 3. Average global tariff rate, 1988-2015



*Note: Averages of 64 countries representing 91% of world trade in 2010, weighted by 2010 shares of imports.
Source: World Bank.*

change, and nuclear policy. By pursuing the non-cooperative strategy, we forego the opportunities that can only be achieved when nations work together to solve global problems.

Cooperation is not altruism in which 'stupid' negotiators allow countries to exploit the US. Rather, it is the expression of farsighted self-interest that requires brains and grit and stamina. We have seen the results of a near-century of cooperation in international trade as well as in the declining deaths in war (Pinker 2011). The US and other nations should reject the economic nationalism of Trump et al. and continue on the path to open our borders to trade, reverse nuclear proliferation, and slow climate change. Market forces can work miracles, but they cannot overcome the problems of pollution and war and human-imposed barriers to trade. ■

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Navigating the legal risk

In a wide-ranging interview with World
Commerce Review Hanno Tolhurst provides an
overview of the ASW advantage

Please describe the history of the firm

ASW Law Limited (formerly Attride-Stirling Woloniecki Barristers & Attorneys) was established over 18 years ago, primarily as a commercial litigation firm with a focus on reinsurance disputes. Since then, ASW has built on these foundations to become the premier commercial litigation and arbitration practice in Bermuda and has grown its corporate practice such that our corporate team is recognised as among the best in Bermuda.

What key areas of expertise exist within the firm?

The firm's practice is divided into three principal areas: Corporate, Insolvency and Litigation.

Our barristers and attorneys have extensive legal experience in both Bermuda and a number of foreign jurisdictions. Many of our lawyers have practiced at the Bar in England or at leading law firms in London, New York, Frankfurt, Argentina, Canada and the Cayman Islands.

A number of our partners and senior counsel hold or have held senior positions within the Bermuda Government and the Bermuda regulator, the Bermuda Monetary Authority, or sit on a number of Bermuda Government advisory committees.

Our thriving corporate and insolvency groups are internationally recognised by clients and peers. We also have the premier commercial litigation and arbitration practice in Bermuda and are widely considered to be pre-eminent in insurance and reinsurance law. We also have detailed knowledge and extensive expertise in the areas of corporate,

aircraft registration and finance, banking and hedge fund litigation, fraud litigation, shipping and admiralty disputes, telecommunications disputes, trusts disputes and international arbitration.

The firm is ranked highly in all of the major legal research directories, including Chambers & Partners, Legal 500, Who's Who Legal, IFLR 1000, Euromoney's Legal Media Guide to the World's Leading Lawyers and Practical Law Company. Of the firm's lawyers, Rod Attride-Stirling, Jan Woloniecki, Neil Horner and Kehinde George are listed as leaders in their respective areas of practice.

We also have the premier commercial litigation and arbitration practice in Bermuda and are widely considered to be pre-eminent in insurance and reinsurance law

What benefits are conferred by a Bermuda base?

Bermuda is a politically and economically stable offshore jurisdiction, with many international businesses and their advisers based in Bermuda, specifically in the (re)insurance sector. A sophisticated business environment exists in Bermuda that benefits from a legal framework based on English common law and a regulatory regime that is recognised as Solvency II equivalent by the EU, one of only three jurisdictions worldwide to be so. Bermuda's reinsurance market is the world's third largest, the captive insurance industry was first developed in Bermuda and the domicile is a leader in this field, and Bermuda's insurance linked securities (ILS) market is the largest globally.

How has the captive industry developed in Bermuda?

The Bermuda insurance industry has its origins in the late 1940s but rapid development only started to take place with the advent of the captive insurance company, the first truly Bermudian insurance product, developed by Fred Reiss, the creator of the captive concept, in the early 1960s. Bermuda has since developed and grown into the world's leading captive domicile.

How does the global ASW network benefit the client?

ASW has developed informal and formal relationships with a number of legal firms around the world, particularly in the US, UK, Asia and reputable offshore jurisdictions, which our clients can draw upon. We also have a network of contacts at other key advisers and service providers in Bermuda and globally, which our clients benefit from.

How do you develop relationships with the client?

ASW has developed client relationships in Bermuda and globally by providing first rate, responsive legal advice. We see our clients as partners, with whom we seek to help develop their business interests. ASW also has an excellent network of contacts within Bermuda's international business sector, such that clients benefit from our relationships with other key advisers and service providers in Bermuda.

In conclusion, what is the ASW advantage?

ASW harnesses the collective wealth of knowledge and experience of its lawyers to provide expert legal advice in a timely and responsive manner. ASW has a particular focus on international clients and matters requiring Bermuda legal advice, whilst also servicing the local Bermuda market. Many of our lawyers have previous experience working for large, international law firms based in key jurisdictions such as New York and London, which makes ASW particularly adept at understanding the needs of our international clients and their onshore counsel. Clients benefit from a best in class service unrivalled by any other legal firm in Bermuda. ■

Hanno Tolhurst is a Corporate Counsel at ASW Law Limited, a leading, specialist corporate and commercial law firm based in Bermuda. Hanno's practice focuses on corporate insurance and reinsurance and general Bermuda law corporate advice.



Inclusive growth and prosperity – for whom?

Instead of prosperity the last decade has delivered inequality, insecurity, and the rise of nationalism and populism. Simon Caulkin argues that this is a secular challenge that business, and especially managers, must face head on

Inclusive growth and prosperity, the theme for this year's Global Peter Drucker Forum in November¹, sounds like the ultimate motherhood and apple pie. Who could be against it, and where's the problem? We just reboot the processes that have fuelled 200 years of capitalist progress which has sucked billions of the world's population out of poverty and into the cycle of expanding economic and social wellbeing.

If only it were so simple. To make *"the economy work for everyone"*, to quote UK premier Theresa May, will require everything but business as usual. As the technology scholar and historian Carlota Perez reminds us, to fulfil its potential, each major technological advance needs to take a different direction, based on a new synergy of technological, social and political choices.

Nearly 10 years after the global financial crisis, much of the world remains mired in the last paradigm, which has delivered the opposite of inclusion – inequality, insecurity, and the feeling of being excluded from global and technological advance – and thence Trump, Brexit and the rise of nationalism and populism. This puts business and management squarely in the front line. Managers can no longer shrug off wider responsibilities in the cause of maximising returns within the law. Inclusive growth and prosperity have to be what business is for.

As Drucker insisted: *"Free enterprise cannot be justified as being good for business. It can only be justified as being good for society"*. Corporate responsibility is to deliver growth and prosperity for everyone, period. And that changes almost everything.

In previous growth cycles, jobs and wages were at the heart of what can now be seen as a virtuous circle in which wage growth led demand which fuelled investment, employment and higher productivity, feeding back into higher wages. Not only that: by redistributing the wealth created, employment was also a powerful vehicle of social mobility and inclusion.

But in the ideological shifts of the 1970s, this virtuous circle broke down. Economists promised that concentrating on the supply side and leaving the rest to the market would generate better economic outcomes. Economic policy shifted from full employment to inflation targeting; the pursuit of 'flexibility', often through deliberate weakening of worker organisations, became the watchword for labour markets.

A new emphasis on shareholder value triggered a move from retention and reinvestment of earnings to cost-cutting and distribution in corporate allocation strategies; and these combined with technological advance to launch a wave of global outsourcing that activated a very different cycle, its consequences starkly evident in the crash of 2008 and the subsequent still incomplete economic recovery.

The proper social responsibility of business is to tame the dragon, that is, to turn a social problem into economic opportunity and economic benefit, into productive capacity, into human competence, into well-paid jobs, and into wealth

A decade on, we are left with a 'human capacity-capability gap' that is structural, not cyclical. On one side seethes a sea of humanity that, as Stanford's Jeff Pfeffer reminded the 2016 Drucker Forum, more than anything in the world wants a regular job with a pay cheque. Yet good jobs are a minority: the world needs 1.9 billion more of them, according to Gallup. Good jobs are also a source of meaning and engagement which, as Richard Straub and Julia Kirby note in their opening HBR blog for the Forum, are essential to the good life – *"and no elite minority should have a monopoly on that"*.

On the other side there is no lack of needs for this army to meet, while the range and sophistication of technological aids grow every day. In short, there is more than enough human and technological potential to power a new Golden Age of development based on the ICT-based revolution that began, just as the post-war virtuous circle was going into reverse, in the 1970s.

Yet that seems a long way off. In 2017 growth is stuttering. Productivity is static, innovation rates falling and new business formation modest. Average wages in the US have barely moved since the 1990s. In the US and UK, publicly-quoted companies are on the decline, their numbers having halved in the last 15 years.

Meanwhile, in the same economies the link between corporate growth and jobs has been severed, even, or especially, among tech start-ups. Michigan University's Gerald Davis spells it out: *"The shifts from outsourcing to Uberization have been largely driven by the corporate imperative to create shareholder value, and under our current conditions, creating shareholder value and creating good jobs are largely incompatible. Corporations are 'job creators' only as a last resort"*.

Small wonder that some leading economists hold that the era of growth is over and that we face a period of prolonged secular stagnation. Bluntly, on present trends, the pessimists will likely be right. But that is not inevitable.

Technology is not destiny; nor is globalisation. Their direction is not random but shaped by decisions made by firms, governments and individuals.

In other words, there is a choice, and it is up to leaders of governments, corporations and civil institutions to shape it in ways that will benefit ordinary citizens as well as themselves – or, as we have seen, ordinary citizens will do it for them. As gatekeepers of the investment decisions that determine how the larger trends play out both macroeconomically and where it counts for individuals, in jobs and pay, managers bear the major responsibility here. They cannot rely on an ‘invisible hand’ to bring about a new growth momentum or create demand for their offerings when (as must be close) consumers’ ability to take on debt runs out. If the cost of shareholder (and executive) enrichment is the jobs of those who can no longer afford to buy the products created, the process becomes self-defeating. The engine of capitalism will grind itself to a halt.

Yet tantalisingly, the outlines of a new collective balance are discernible through the fog. New times will require big changes on all sides. For too long, acknowledges Salesforce chairman and CEO Marc Benioff, *“we have done our work in isolation, unaware of the effects our innovations have on societies and environment as a whole.”* For Perez, *“We are in a crucial moment in history similar to the 1930s, requiring thinking and measures as bold as those of Keynes, Roosevelt and Beveridge.”* Measures envisaged will have to go far beyond conventional supply-side adaptation, such as investment in education and infrastructures, to include the much-neglected demand side of the labour market equation and what drives it: the incentives which have fuelled short-termism, financialisation of the real economy and the race to the bottom in pay and conditions that have done so much to fuel insecurity and inequality.

Corporate governance can no longer be played as a private sport between directors and shareholders. It has macroeconomic consequences – and today it is clear that what is good for shareholders no longer works for the economy and wider society.

As many suspected, 'corporate social responsibility' was a diversion that served to evade management's defining challenge: to plot a path to inclusive growth and prosperity, recreating a virtuous circle which builds on rather than fights the distinctive properties of markets and companies. Just as flawed economic theory has caused managers to damage their companies through the pursuit of shareholder value, these too are due for fundamental review.

Growth and development are powered by innovation and its diffusion, in which companies and markets play different but interdependent roles. Consider the semiconductor industry cycle. First, the leader, typically Intel, creates a new generation microprocessor that gains a temporary market advantage for which it can charge high prices. As rivals catch up prices fall until the chip is a commodity. Thus, Intel's advantage is competed away by the wider market, handing the benefit to society as a new constellation of resources, and the cycle begins again.

This is business as a positive-sum game – value creation rather than appropriation – and reframes companies, in the late Sumantra Ghoshal's words, as *"society's main engine of discovery and progress"*. In like vein, businesses can be seen as society's problem-solvers and growth as a measure of the rate new solutions to problems become available. The genius of capitalism, in this view, is not allocation or efficiency but creation and effectiveness – evolutionary processes in which companies that fail to innovate eventually succumb to the rising tide of the market.

Conversely, the secret of the 'positive deviants' that stand out from rivals in many industries is their adoption of (in effect) innovation as a business model that keeps them constantly one step ahead of the market. Think Apple and Dyson in products and services, Toyota and Handelsbanken in management, WL Gore and Haier in both. The 'hidden champions' of the German Mittelstand are another less conspicuous example.

As the gig economy demonstrates, technology makes labour a commodity that can be contracted for in the market as easily as any other. But we still need companies, precisely as temporary protection from market forces allowing

them to carry out their proper, but inherently messy and uncertain, vocation of innovation and exploration. Innovation in the sense of new solutions to human needs clearly demands renewed focus on the customer of the kind we are already seeing in the design thinking movement and in the emerging theory of 'jobs to be done'. The first should help to sharpen the focus of innovation in existing markets; the latter may point the way to solutions that create whole new markets.

While the major responsibility for corporate renewal rests with management, other actors also have important parts to play. Dawning recognition that governance changes are needed to support a longer-term corporate orientation and discourage free-riding is welcome – consider, if proof were needed, the price Unilever has had to pay for the privilege of upholding its model of long-term growth and sustainability. Among a flurry of international initiatives, it is significant that some of the biggest global investors are joining governments and civil institutions in exhorting companies to look to the longer term. These need to lead to action, not just talk.

As part of the new synergy, reassessment of the role of the public sector in innovation is overdue. The creation of economic value is a collective process. No business can operate without basic legal, physical and education infrastructures provided by the state. But as UCL's Mariana Mazzucato has stressed, innovation also needs strong publicly-funded research programmes like DARPA and the US National Institutes of Health that have yielded a deep seam of technologies such as biotechnology, the internet, voice recognition and others that countless companies continue to mine. *"The private sector does not 'create wealth' while taxpayer funded public services 'consume' it,"* notes Mazzucato. *"Rather, economic output is co-produced by the interaction of public and private actors – and both are shaped by, and in turn help to shape, wider social and environmental conditions."*

The final component of a broad new innovation wave is a direction for the collective forces of society and business to pull in. The current mode of deploying technology primarily to cut costs, or for the sake of it, does not fit the bill.

Far from spreading prosperity, too much does the reverse, redistributing existing rather than creating new value, and sharing it in ways that are more unequal than before. There is no shortage of compelling alternatives for clusters of research, technologies and industries to cohere around. Obvious examples are the biosciences and genomics to underpin healthier lifestyles, green growth and new approaches to disease and ageing populations.

What all such 'meta' orientations have in common is their potential to align business and society by turning urgent human problems into meaningful economic opportunity. This perfectly chimes with Peter Drucker's 1984 definition of the corporation's real social responsibility: *"The proper social responsibility of business,"* he wrote, *"is to tame the dragon, that is, to turn a social problem into economic opportunity and economic benefit, into productive capacity, into human competence, into well-paid jobs, and into wealth"*. As a statement of management's own 'job to be done', that could not be bettered. ■

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1. 9th [Global Peter Drucker Forum 2017](#) to be held in Vienna, Austria, on November 15, 16 and 17

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EPAAs: good for Africa?

William Gumede asks if the European Union's Economic Partnership Agreements with Africa are undermining or promoting Africa's development?

Introduction

The European Union (EU) in 2000 agreed in principle with African, Caribbean and Pacific (ACP) countries, its former colonies, to establish new trade agreements with them, which became the Economic Partnership Agreements (EPAs). The EPAs negotiations followed changes in global trade rules, which was sparked by the Uruguay Round of trade negotiations, finalised in 1994, which required regional trade agreements to cut restrictive regulations and duties on 'substantially all the trade' among trading partners (GATT 1994).

The EPAs were meant to be WTO-compatible. The EPAs are not conventional free trade agreements, but also pledges development cooperation. The EU's EPAs with former African, Caribbean and Pacific colonies replaces preferential trade arrangements between the ACP states which operated for three decades prior. The EU negotiated with regional blocs within Africa. These African regional blocs were 'created' for the purposes of the EPAs by the EU. The African EPAs are only with sub-Saharan African countries and exclude North Africa.

In the European Partnership Agreement (EPA), African countries have to open their markets to EU products, in some cases up to 82.6%, and gradually eliminate tariffs over 5 to 25 years. The EU agreed to African countries protecting around 20% of domestic products. In return, African countries will have duty and quota free access for some African products to the EU market (EU Bulletin 2014).

EPAs negotiations have hurt EU-Africa relations

The EPAs negotiations have damaged EU-Africa relations. The EPAs negotiations have brought tension between the EU and African countries. It has also brought divisions between individual African countries, especially the demand by the EU that every country in the African region constructed by the EU for the EPAs, must sign the agreement, before it is ratified. This has caused divisions between African countries who agreed to sign and others who refused. For example, Tanzania last year refused to sign the EPAs causing tension in the East African Community, with the members, such as Rwanda, who agreed to sign.

The EU has punished or threatened to punish African countries who did not sign the EPA deal on the EU's terms (EU Parliament 2014). For example, Namibia initially refused to sign-up, but was forced to back down as the EU threatened to bar market access to Namibian beef, grapes and fresh fish annually worth €30 million. The European Commission declared through a delegated act that if Kenya did not ratify the EPA by October 2016, it will lose its tariff-free access to EU markets. Rwanda signed the EPAs because it desperately wanted to access EU development funding, which it would not have been able to tap into if it did not sign, causing tensions with the members of the EAC who did not sign (Esiara 2016).

In November last year, the Tanzanian parliament unanimously rejected the EPAs, saying it would deindustrialize the country. Tanzania feared that signing the EPAs will undermine its own industrialisation plan with China. In July last year, Uganda President Yoweri Museveni said his country would not sign the EPAs because the EU had not ad-

The EU should allow African countries to strike competitive deals with other industrial and developing countries, such as China, Brazil and India

equately consulted with EAC governments. African countries have little recourse for trade, economic and political disputes with the EU, specifically regarding disputes over EPAs.

The EU's EPAs threaten Africa's development

The United Nations' Andrew Mold said: *"The African countries cannot compete with an economy like Germany's. As a result, free trade and EU imports endanger existing industries, and future industries do not even materialise because they are exposed to competition from the EU"* (EU Bulletin 2014).

The EPAs threatens African farmers and infant industries, as EPAs promote EU products and services entering African markets without any quotas or duties. EPAs undermine African attempts to build local manufacturing capacities – as often heavily subsidized European products flood African economies. As a case in point, the EU's Sustainability Impact Assessment of EPAs warned: *"While liberalisation might encourage (consumers to buy products at affordable prices), it might also accelerate the collapse of the modern [sic] West African manufacturing sector"* (PWC & EU 2003).

African countries are heavily dependent on import taxes for revenue – often around 7-10% of revenue. A study by the Common Market for East and Southern Africa (2002), calculated that countries in the region could lose as much as 25% of trade tax income if EU products enter the region duty-free.

Import tariffs for raw materials such as oil are typically low in the EU but they increase dramatically with each stage of processing. The International Trade Union Council (ITUC) stated: *"As the market tariffs came down on African raw materials, they went up for manufactures (tariff escalation). Also, non-tariff barriers including unreasonable sanitary and phyto-sanitary measures replaced the tariffs. In addition, European exporters continued to benefit from huge levels of subsidies that enabled them to out-compete their African counterparts"* (ITUC 2016).

The EPA's also undermine Africa's attempts to pool their individual country markets, trading more with each other and to create a continent-wide free trade area from Cape to Cairo. This approach is integral to Africa's future prosperity. The EU's decision to create its own African regions to struck EPA deals with undermines Africa's own regional integration project.

The EPAs undermine African regional integration. In implementing EPAs, the EU has divided Africa into its own regions, completely undermining African efforts at integration. According to the EPAs, if an individual country default on any part of the EPA in its 'region', the EU has the power to act against all SADC countries. Yet SADC is expected to reach a consensus if there is a trade dispute with the EU.

The EPAs undermine Africa's efforts to diversify trading partners. The EPAs demand that African countries declare the EU as 'most favoured nation' whose products should not be subjected to higher levies than those of developing countries. In addition, EPAs demand that African countries extend all the benefits of any future trade agreements that an African country may enter into with other countries. This is seen by African countries as a way to prevent African countries from striking more competitive deals with new emerging economies such as India, Brazil and China.

What can the EU do?

The EU has been much more generous in its preferential trade agreements with Western Balkan countries. The EU for example had asked the WTO to continuing its preferential trade agreements with Western Balkan countries, which the EU argued that *"terminating the trade preferences would have a negative impact on the overall economic performance of the Western Balkans, with consequent negative repercussions on their domestic reform and transition processes. Moreover, given the current worldwide economic slowdown, the Western Balkans' economic recovery could be seriously jeopardized"* (WTO 2012). African countries should be given similar treatment by the EU.

Even with an EPA, African countries continue to face stringent rules-of-origin, tough sanitary and phyto-sanitary standards (SPS), and tariff-escalation on important (to Africa) value chains, whereby taxes increase the more processed or value-add products. African exporters also face highly subsidised EU producers. The EU must reverse these policies which undermine African development. The EU has insisted that its controversial agricultural subsidies should be discussed at the level of the WTO, and not the EPAs (Irumba 2014).

The EU needs to explore how best to support Africa produce value-add products and open-up EU markets to such value-added African products. If, for example, an African country wants to export a tree to an EU country, the trade barriers are relatively low.

However, if it turns the wood into a form that can be used to make furniture – which will create more jobs and increase economic growth for the African country, tariff barriers of up to 40 per cent come into force in the EU.

The EPAs contains rendezvous clauses, which are not part of the WTO trade provisions, but which demands protection for EU investments, no restriction to competition by heavily subsidized EU products, insistence that African governments give include EU companies as part of preferential procurement regimes, no minimum labour and environment rights, no African tax regimes which prevents tax avoidance schemes and higher than WTO levels of protection for EU intellectual property (EU Parliament 2014).

The EU should allow African countries to strike competitive deals with other industrial and developing countries, such as China, Brazil and India, without having to give the EU the same level of deals. The WTO, under its Enabling Clause (1979) allows for developing countries to offer preferential deals with peers, without having to extent the same treatment to developed countries.

Africans require the 'policy space' to make their own independent policies and decisions. The restrictiveness of the EPAs means that African countries will have difficulty coming up with their own national and evidence based development policies, appropriate to their own specific circumstances – because it may clash with provisions in the EPAs.

The EU has comprehensive laws allowing employees representation and to be consulted in the workplace. For example, the European Works Council Directive, which mandates large EU firms to have works councils, elected by employees who management should consult regularly on major issues affecting a company. EU companies must follow the same standards on employee involvement as prescribed by the EU when they invest in Africa. The EU must give African countries fair mechanisms to resolve disputes between the EU and African countries. ■

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Revitalising connectivity through inland waterways

Bipul Chatterjee and Saurabh Kumar discuss how India can become a responsible partner in its neighbours' development through fostering cooperation in regional infrastructure projects



Introduction

A major concern about South Asia's economic development and its limited share in the global economy through trade and investment has been the lack of investment in infrastructure, including that of a regional nature. Lately the imperative of addressing such an infrastructure deficit has resulted in a boost in connectivity projects in the region, which have long-term geopolitical implications. For instance: the Bangladesh-Bhutan-India-Nepal Motor Vehicles Agreement (BBIN MVA) or the Bangladesh-China-India-Myanmar Economic Corridor (BCIM-EC).

A study by the Asian Development Bank (ADB) estimated that Asia as a whole needs US\$8.4 trillion between 2016-2030 for the improvement and development of transport infrastructure *just* to maintain its current status of economic growth. South Asia alone will require 24 per cent of this share amounting to an investment worth 8.8 per cent of their gross domestic product¹.

Although India is yet to articulate a clear long-term official policy for regional connectivity initiatives, sub-regional connectivity through road, rail and inland/coastal waterways involving Bangladesh, Bhutan, India and Nepal presents a sustainable as well as economically viable case for it. It is the right moment for India to show that it can become a responsible partner in its neighbours' development.

These infrastructure projects present huge business opportunities for firms engaged in infrastructure development and offer opportunities for large-scale employment generation as well. This could immensely benefit India and its immediate neighbours suffering from inadequate infrastructure for their economic development. Apart from this, they will help smaller countries to get better access to the markets of large countries. To a large extent this will address the issue of under-utilisation of abundant natural resources of smaller countries in India's neighbourhood.

Connectivity through inland waterways

The South Asian region in general, and Bangladesh, Bhutan, India and Nepal in particular, have not yet been able to take full advantage of their historical and extensive network of naturally navigable waterways to meet their needs for goods and passenger movements.

This is despite the fact that India has inland waterways of around 14,544 km, while Bangladesh has 5,923 km of navigable inland waterways, and the mountain terrain of Nepal provide waters to some of the major rivers and river tributaries of these two countries.

These infrastructure projects are a possible game changer for fostering cooperation in Eastern South Asia

These deficiencies in utilising existing natural advantages result in reduced economic returns. For example, the World Bank's Logistics Performance Index (LPI), a prominent benchmark to identify challenges and opportunities in trade-related activities which takes in to account six major indicators (customs, infrastructure, ease of arranging shipments, quality of logistics services, tracking and tracing, and timeliness) ranks Bangladesh as 87th, Bhutan as 135th, India 35th and Nepal 124th, which are much lower than many other developing countries such as Malaysia². It was also estimated that a 10 per cent increase in overall infrastructure can produce an overall economic return of around 17 per cent in the long run³.

Goods transported via inland waterways can be an environmentally friendly and cost-effective way of cargo movements in this sub-region. For example, the comparative operating cost of freight in per tonne-kilometre (TKM) is 1.41 Indian Rupees by railways, 2.48 Indian Rupees by highways and 1.06 Indian Rupees by inland waterways transport. Transportation-related inter-modal connectivity (including inland waterways, road and railways) to the seaport can reduce shipping container costs by 20-50 per cent according to a study conducted in 2015 for this region⁴.

Nevertheless, the share of commercial goods transportation through inland waterways in overall internal cargo transportation is much less in this region, which is mainly in India (0.4 per cent of total cargo movements) in comparison to 8.7 per cent in China, 8 per cent in the USA, 42 per cent in the Netherlands⁵.

A major hurdle in the development of this sector in India is that it is not organised. States such as Assam and West Bengal, who have fully functional waterways departments, are gaining from the use of waterways, but other large states such as Bihar and Uttar Pradesh, despite having large rivers and waterways, are left behind due to policy inertia vis-à-vis this sector and the non-existence of a separate waterways department.

Figure 1. Inter-country cargo transported under PIWT&T routes

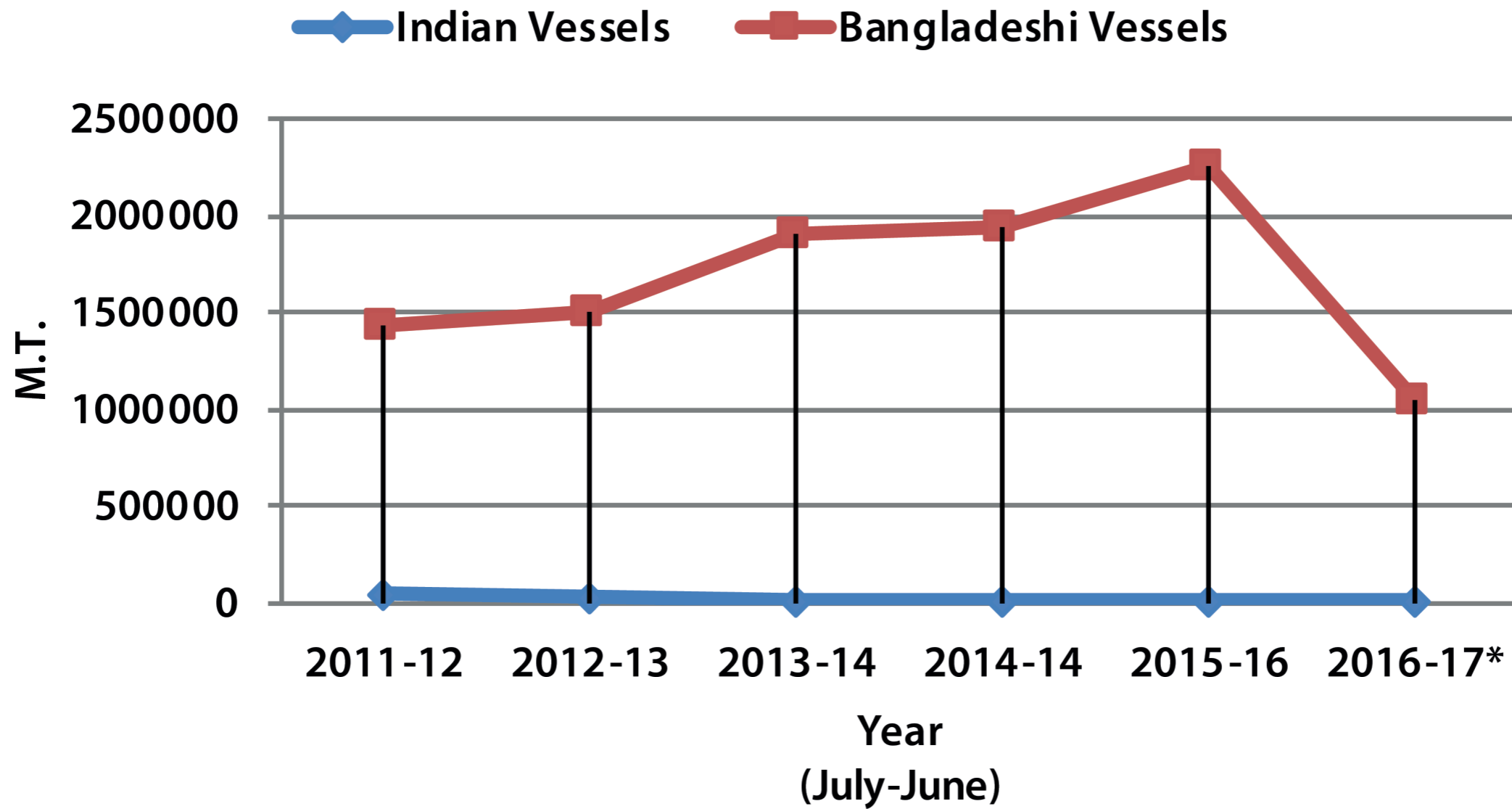
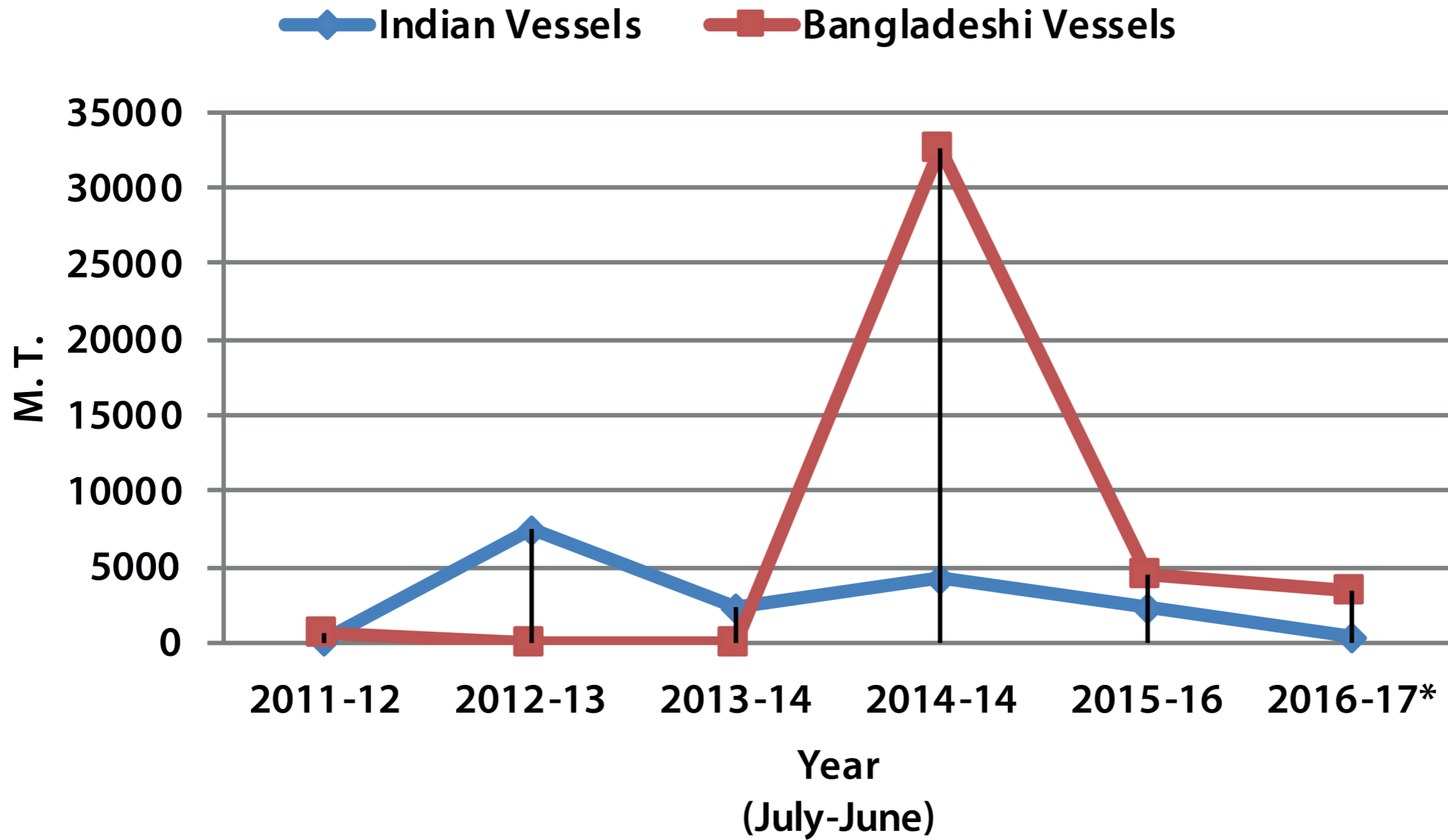


Figure 2. Transit cargo transported under PIWT&T routes

www.worldcommercereview.com



Source: Bangladesh Inland Water Transport Authority (2017), "BIWTA Statistics",
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Note: *Data till December 2016

However, in recent years there has been a significant growth in the cargo movements on National Waterways 1 (NW-1), which is on river Ganga. Cargo movements have gone up to 2.69 billion tonne-kilometres (BTKM) in 2015-16 in comparison to its 2009-10 level of 1.05 BTKM. It is also projected that by the year 2031-32 cargo movements from Varanasi terminal in Uttar Pradesh will be around 2.57 MT, while from Haldia terminal in West Bengal it is expected to reach 17.85 MT, which will include food and agricultural products, coal, fly ash, cement, fertilisers and building materials⁶.

Although these figures show a good potential for the inland waterways sector within the country, when it comes to regional connectivity through inland waterways there is a much less than optimal picture about the cross-border movement of cargo. For example, inter-country cargo movement on Bangladesh-India routes as per their Protocol on Inland Water Transit and Trade (PIWT&T) by Indian vessels was 11,636 MT in 2016-17, in comparison to 1,051,262 MT of Bangladeshi vessels. (See Figure 1)

Not only this, transit cargo movement was only 352 MT by Indian vessels in comparison to 3,334 MT by Bangladeshi vessels in the same duration (see Figure 2). Indian vessels made only 17 trips but Bangladeshi vessels made 2,632 trips in 2016⁷. This clearly demonstrates reluctance in utilising the protocol routes to enhance regional connectivity through inland waterways.

Impact on sub-regional trade

These regional connectivity initiatives have two primary objectives:

- trade facilitation in the form of speedy visa and customs clearances, fewer documentations at border points and storage facilities at required places etc, and

- reduction in transportation cost so as to reduce overall trade costs.

Furthermore, in the long-run these initiatives also have the potential to expand into digital, currency and people to people connectivity. In other words, they will not only affect the volume of trade but can also make a significant change in its composition.

Another major area where a tectonic shift in these regional connectivity initiatives will bring is existing trade routes. These will be in favour of new pathways instead of existing ones as those are already under severe stress and have become economically expensive.

Such a change in trade routes will also change the nature and pattern of current trade, probably a shift in favour of smaller countries such as Bhutan and Nepal, which, despite having large reserves of natural resources, are struggling to do trade due to sub-optimal nature of their connectivity options.

Therefore, new regional connectivity initiatives will have trade creation effects as prices for various products will go down after reduction in transport and transit costs. Apart from that, the demand for those products, which are used in infrastructure creation, will also go up.

Another major impact will be seen through an economic spill-over effect, which is generally not discussed while discussing the economic benefits of infrastructure investment and trade policy. Massive investment in connectivity projects will create more and better jobs leading to increasing income and demand for other products.

As far as impacts on big companies and micro, small and medium enterprises (MSME) are concerned, there can be contrasting results from these large-scale regional connectivity initiatives. Big companies engaged in construction

business, logistics firms and export trading houses are likely to get more benefits as these initiatives can attract more opportunities in trade and investment.

In contrast, long-term results for the MSME sector can be negative as cheaper products from labour abundant countries may overflow in to smaller countries facing labour shortage.

Conclusions

In an era when trade deals are being renegotiated or are scrapped (for example, North American Free Trade Agreement, Trans-Pacific Partnership), trade facilitation and regional connectivity initiatives offers a breath of fresh air to the global trading system.

Together these two can present a combination of policies that can reduce transaction costs and make procedures and standards more sufficient.

Therefore, the development of economically viable regional connectivity initiatives will, among other, require:

- harmonisation of standards and procedures (for example, compatible custom and visa rules; allocation of tax/revenue, vehicle/vessel related regulations);
- construction and management of storage facilities and mechanised amenities for loading/unloading at terminals/ports and at border points;
- digital security and up-to-date state of the art technology-based transportation system; and

- ability to fight illegal trafficking through smart management of trade routes, etc.

While at a macro level it needs to be coordinated through inter-governmental panels/bodies representing the views of diverse stakeholders, there is the imperative of having a clear long-term operational strategy with analysis of costs, benefits and risks. Financing part of such initiatives also needs to be made more transparent and based on a participatory approach. Incremental multilateralism and involvement of international organisations will give credibility to these initiatives and would also lend easy access to the private sector.

Given the complex nature of these initiatives, policy approach should go beyond the contour of an individual project or mere focus only on one or another aspect of transportation and connectivity. Lessons should also be taken from other regional organizations and agreements for successful implementation of connectivity initiatives in this region. For example, Trans-European Transport Network (TEN-T) – a joint rail, road, water and air transport web within in the European system or the Amazon Cooperation Treaty Organization (ACTO) – an organisation for the sustainable development of the Amazon region. ■

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Note: This article is based on the findings from CUTS International's project titled 'Expanding Tradable Benefits of Trans-boundary Water: Promoting Navigational Usage of Inland Waterways in Ganga and Brahmaputra Basins'. Views are personal.

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Fraud on the rise: can technology save us?

With the global cost of chargebacks mounting for consumers, banks and merchants alike, Alice Bonasio argues that we need innovation to fight back

Online fraud is now the most commonly experienced crime in England and Wales, according to a [report](#) published by the UK National Audit Office (NAO). Up to 1.9 million cyber-related fraud incidents were estimated to have taken place last year alone, with the cost likely to run into billions of pounds.

The report also outlined that the NAO faces a significant challenge in influencing partners, such as banks and law enforcement bodies, to take on the responsibility of preventing and reducing fraud. As a “*low-value but high-volume crime*”, fraud is often overlooked by governments, law enforcement, and industry alike, says Amyas Morse, Head of the NAO. Acknowledging that the landscape for tackling online fraud is extremely complex, the report calls for an urgent response to address it.

The report further cites that online fraud is under-reported; even where data is available there is a lack in the sharing of information between government, industry, and law enforcement agencies. In fact, there is no formal requirement for banks to report fraud or share reports with government, yet we see consistent evidence of fraud recurring all over the world. This is an enduring and global problem, one that takes a heavy toll on merchants and service providers of all sizes, as well as banks, issuers, and ultimately customers.

The growing scale of online fraud also suggests that many people are still not aware of the risks, and that there is much to be done to change behaviour. This is also evidenced in [separate figures](#) from Citizens Advice showing a 17% rise in consumers being caught out buying ‘phantom’ goods online. This type of cybercrime occurs when fraudsters advertise items at cut prices on social media sites like Facebook and Instagram—as well as online marketplaces such as Gumtree and eBay—and con buyers into spending on average £1,100 on products ranging from cars to flights and even insurance, which simply do not exist. In only a few months, January to March this year, Citizens Advice logged over 3,600 complaints about such phantom goods.

These scams can have a lasting financial and emotional impact on consumer confidence and their relationship to merchants. While educating consumers is both sensible and necessary, the NAO report stresses that government and industry still have a responsibility to protect citizens and businesses. The report also found that the protection banks provide varies, with some investing more than others in educating customers and improving their anti-fraud technology.

Given that [organized attacks](#) of online fraud is likely to increase, this investment is absolutely essential—yet keeping up with the latest techniques employed by fraudsters can put tremendous strain on a company's logistics. While few would argue that fraud detection and prevention is a priority for businesses, the fact is most businesses lack the necessary resources to build and maintain such solutions. It is the industry's responsibility, however, to keep up—and ideally get ahead—of these fraudsters in order to protect both themselves and consumers.

*By 2020... card fraud worldwide is expected to reach
\$31.67 billion*

The adoption of such technologies has indeed been shown to have a significant positive impact on fraud prevention. Take, for example, [EMV](#)—the technical standard for smart payment cards and terminals that have allowed the rollout of payment solutions, such as Chip and Pin and Contactless. In the UK, its implementation led to a dramatic [reduction of 32% in the levels of overall card fraud](#) in the seven years following their introduction in 2004, according to [official figures](#) from the UK Card Association.

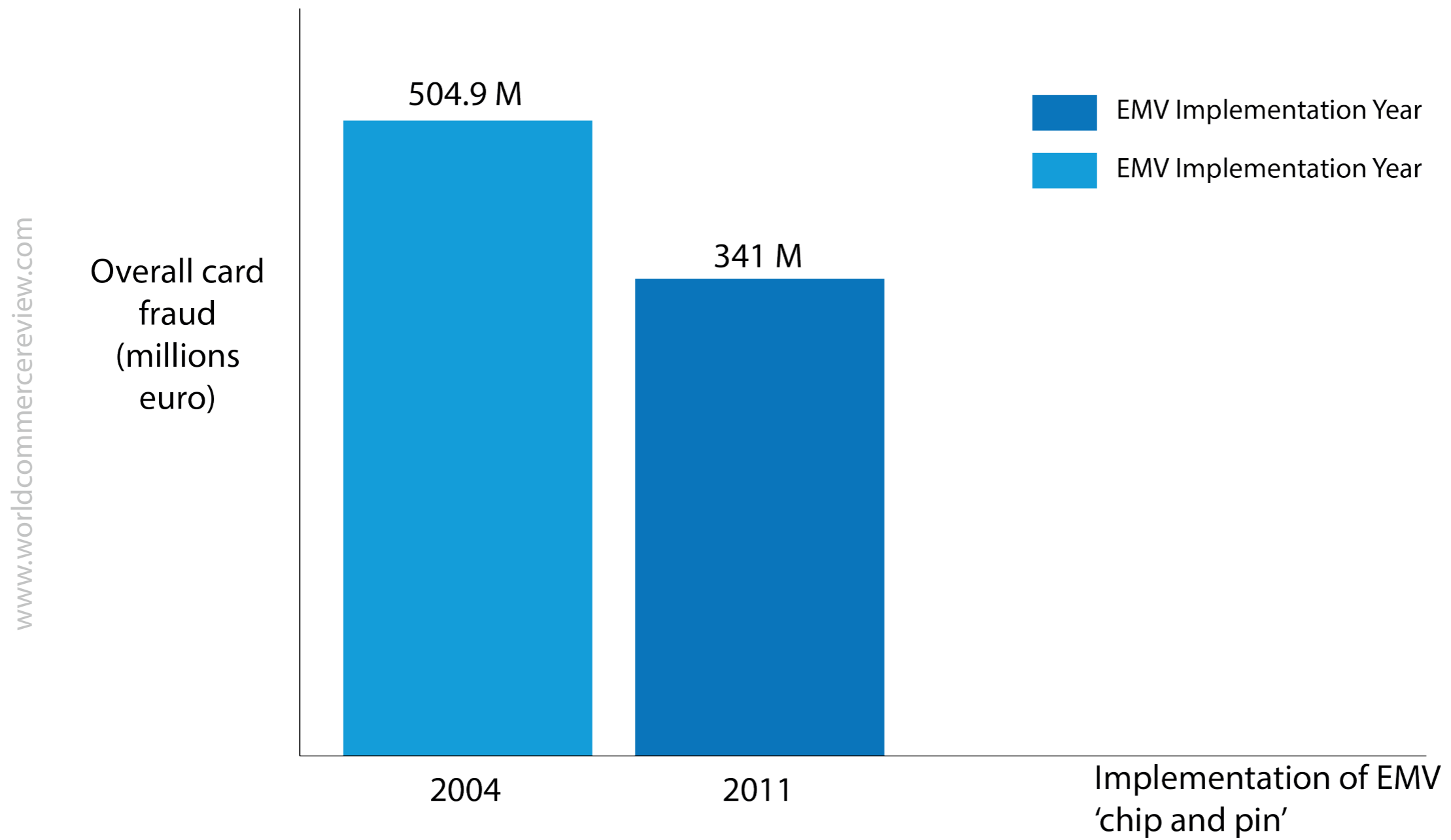
Such measures have undoubtedly made fraud much more difficult to perpetrate in ‘card present’ payment scenarios, yet the shift to online retail has brought with it an entirely new set of challenges relating to fraud prevention and mitigation. There is no getting away from the fact that individual shopping habits have fundamentally changed over the past decade, and that the shift towards online and mobile shopping is not going to be reversed. PricewaterhouseCoopers’ (PwC) [Total Retail 2016 Survey](#) found that the popularity of mobile shopping continues to rise, stating that *“46% of our global sample buys products via mobile at least a few times a year, compared to 40% last year”*.

While this might be good news for consumers in terms of better prices, more choice, and added convenience, it leaves the bulk of ‘card-not-present’ transactions—which are the norm in online shopping and vulnerable to problems such as chargebacks. These chargebacks happen when customers dispute a transaction in their statement and request a refund—often going directly to their card issuer or bank and bypassing the merchant altogether.

According to [The Nilson Report](#), gross card fraud losses for 2015 reached \$21.84 billion, not including the costs incurred by issuers, merchants, and acquirers for their operations, call centres, and chargeback management. By 2020, the report concludes, card fraud worldwide is expected to reach \$31.67 billion, and that measures such as improving methods of reducing fraud on card-not-present transactions are critical to keeping those losses in check.

This is a complex issue, since there are many factors which can trigger a chargeback in the first place, and a blunt approach can cause a merchant more harm than good. One of these factors is known as ‘buyer’s remorse’—where

Figure 1. EMV implementation has reduced card fraud



a customer finds a product at a cheaper price elsewhere and uses the system as an alternative returns and refund mechanism. This is one of the forms that so-called 'friendly fraud' takes. Another common scenario is where a person requesting the refund is not entirely sure they haven't made the transaction, but will 'try their luck' anyway. Since the cost of investigating such claims is often much higher than the value of the refund itself, banks will mostly opt to issue the refund without dispute, and some customers have learned to take advantage of this to manipulate the system. According to industry research firm [Aite Group](#) in their *Impact Note* of August 2016, 60% to 70% of chargebacks are the result of first-party or friendly fraud.

Business can minimise vulnerability to chargebacks in various ways. These include ensuring that they build a good relationship with their customers, by providing accurate product information and keeping the lines of communication open, so customers are more inclined to approach merchants with queries than to go directly to the issuing banks to initiate a dispute. Having a clear and efficient refunds policy also minimises the chance of experiencing so-called buyer's remorse, where a customer is tempted to use chargebacks as a backup refund mechanism. However, many customers still get confused when seeing an unfamiliar name appear on their statement, as often merchants will be listed under names which differ significantly from their brand or trade name.

"When a customer sees a charge they don't immediately recognise on their card, they often ask the bank to remove that charge from their statement", explains Matthew Katz, CEO of [Verifi](#), a provider of end-to-end payment protection and management solutions. "This is done by calling the bank directly to raise a dispute, leaving out the merchant who could potentially provide further information to clarify what the charge relates to. In fact, our research has found that up to 86% of cardholders bypass the merchant and contact their issuing bank directly to dispute or question a charge on their bill".

While banks generally issue a refund to the customers, the process often has a very negative impact on overall customer experience, causing confusion and lingering trust issues which can lead to future sales being lost. This has

an added impact on the merchant's bottom line, on top of the fees, fines, and operational expenses of handling the chargeback in the first place.

These costs quickly snowball, ranging from administrative resources needed to investigate claims and process refunds, to fielding customer queries and potential loss of legitimate sales, present and future. Add this to the operational expense of preparing and shipping merchandise, as well as the value of the goods themselves which often must be written off, and the cost for merchants quickly adds up. Ultimately, this is also very bad news for consumers, as these costs will eventually trickle down the supply chain and translate into higher prices. The true price of these chargebacks is not reflected in the refund amounts alone, significant as these may be. In their September 2015 report, *The Impact of Fraud and Chargeback Management on Operations*, [Javelin Research](#) found that organizations typically spent between 13% and 20% of their operational budget on fraud and chargeback management.

"Globally, chargebacks continue to grow and represent a significant challenge", agrees Katz, "To address this problem, we need solutions that better align the interests of cardholders, merchants, and issuing banks on a global scale, focusing on continual innovation and refinements that are essential to effectively combat this problem", he believes.

This is what [Cardholder Dispute Resolution Network](#) (CDRN) does, according to Katz. Verifi's solution—which covers approximately 50% of the US market and boasts a 90% resolution rate—was named for the fifth year in a row as ['Best Chargeback Management Program'](#) by CNP Expo. It is now continuing to expand in international markets such as the United Kingdom, Verifi having opened an office in London in 2016, and now announcing a key [strategic partnership](#) with payments processor MegaCharge.

One of the problems that CDRN addresses, according to Katz, is the fact that by the time merchants learn of the issue, it's often too late to stop the chargeback. *"Our patented closed-loop technology integrates directly with the top*

issuing banks. This pauses the chargeback process for up to 72 hours and redirects cardholder disputes from the bank to the merchant in near real-time. The merchant will have more time to assess and resolve the dispute before it ever becomes a [chargeback](#). To date, we are supporting more than 25,000 accounts globally and handling over 200,000 individual chargebacks each month—amounting to an estimated \$195 million in chargebacks prevented.

“The problem of chargebacks and friendly fraud are not only impacting businesses’ bottom line, but hindering future growth and jeopardizing customer retention, trust, and satisfaction rates. For merchants to strengthen their risk management and counter friendly fraud, the ideal line of defense would permit merchants to provide insights into the cardholder’s order as shopping cart-level data. This would feature merchant details and even the device used to make the purchase through the financial institution’s platform—all at the time the dispute arises. This deeper level of data can help cardholders better understand their purchases and avoid filing false cases of fraud that result in lost sales, higher labour costs and more”, Katz concludes.

Since the bulk of consumer purchases will be made online, it stands to reason that to tackle online fraud we must leverage data and technology in increasingly sophisticated ways. As the recent reports on the growing scale of this global problem show, gone are the days when the tools to do so could be considered an optional extra. They have, quite simply, become business essentials for every merchant looking to conduct business in the digital age. ■

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Delivering effective 21st century trademarking

Even with the advance of artificial intelligence human analysts will remain a vital part of the trademark landscape for years to come, Rob Davey argues

Trademarking has always been an important point of consideration for brands, but it is more vital than ever today. With an incredible number of brands across all kinds of industries vying to make a name for themselves, intellectual property (IP) professionals must be able to work faster and more effectively in searching, clearing and registering the relevant trademarks for their clients.

In order to meet this challenge in today's landscape, however, human trademark experts must work together with advanced technology solutions, many of which are driven by artificial intelligence (AI). AI has already proved its worth in other industries, but it holds particular value in the legal sphere; according to [Thomson Reuters](#), *"the next few years will likely favour lawyers who can use partial states of automation to outperform their peers."*

Even more recently, Thomson Reuters [described AI](#) as one of the top three emerging trends in 2017, saying *"the advancement of machine learning and other techniques in artificial intelligence are giving businesses and their development teams the opportunities to design data-driven applications that can recognize patterns to become sufficiently 'cognitive' to reduce and even automate repetitive manual work."*

When implemented in the right way, AI has so much to offer the trademark industry. It can be used to automate complex cognitive tasks and increase the effectiveness of search and watch results, while also dramatically improving overall speed and efficiency. However, while many have tried to reap the rewards of AI, only a few have managed to combine it effectively with human expertise for the very best results.

Human and machine intelligence at work

This is where the majority of trademark specialists have room to improve. Of course, AI technology on its own has a role to play in improving operations, but its full benefits cannot be fully enjoyed without it being used alongside human experts that can offer their own unique perspective on things. Researching trademarks is about getting all

of the details right, which is why solutions providers must have years of experience and specialised knowledge that goes beyond technology.

To achieve this necessary knowledge, the best providers will work closely with the industry's most experienced trademark analysts and linguists to learn what they do, why they are doing something in a particular way and why they choose certain results over others, for example. After collaborating this closely over a long period of time, businesses can begin to really think like trademark analysts.

No matter how sophisticated an AI-enabled technology might be, it is of no use without accurate and reliable data behind it, and this is always best delivered by humans

One of the commonly-used variations of AI in trademarking is what's known as neural network technology. It has been employed for years by the most forward-thinking trademark specialists, mostly for trademark watching solutions, and is designed to work in much the same way as the human brain works, determining and creating connections among related concepts. The neural network technology being used is 'trained' using vast amounts of specifically pre-processed trademark data to accurately perform semantic equivalence, which then determines the 'relatedness' of words, helping providers make even more accurate decisions.

More recently, providers have been using AI to deliver self-service clearance solutions that make it easier to help clients looking to trademark brand names, while sophisticated image recognition technology can simplify the process for those registering slogans and logos.

These solutions employ neural networks and other AI technologies to automate and accelerate complex trademark search and analysis processes. Deep learning techniques are also often used to identify semantically related terms, while helps to further improve recall to minimize the risk of missing relevant marks. These kind of advanced processing technologies can deliver thorough results in just seconds.

Considering how advanced these AI-enabled solutions are, it could theoretically be fairly simple for these to take the place of human analysts, but relying on technology on its own will likely lead to issues down the road. Instead, these technological systems must complement trademark experts instead of replacing them.

The value of experience

Simply put, the best human analysts possess a wealth of experience that allows them to make the kind of nuanced judgements that machines cannot. They also have deep, developed relationships with customers that gives them a clear understanding of their requirements — something that currently cannot be matched by technology.

This means they have the ability to look at search or watch results and rank them in a way that's most meaningful to the customer, which is far more difficult than it might sound at first due to the number of factors that play a part in determining what makes a mark relevant to that customer.

No matter how sophisticated an AI-enabled technology might be, it is of no use without accurate and reliable data behind it, and this is always best delivered by humans. The best trademark solutions providers will have a dedicated team of quality analysts whose responsibility it is to review and correct data from the trademark offices before adding it all to their own proprietary trademark database. This work involves reviewing hundreds of trademark records daily and finding errors such as a word mark that doesn't match the image — the kind of critical error that could be missed by an online searching tool.

Human analysts are also able to work with a level of proactivity that cannot be achieved through current AI technology. For example, a quality analyst would enhance the records to help ensure the relevant results are not missed, perhaps by looking at a multi-word mark or slogan and attaching strength to the most important parts of that mark. Once this is done, AI-enabled technology can be used to display all relevant results in a format that makes sense — a perfect marriage of human experience and technological sophistication.

Advanced in future technology

By now we have a clear idea of how human analysts will remain a vital part of the trademark landscape for years to come, but what's looming over the horizon in terms of future technological innovations?

Most importantly, next-generation trademark watching solution will deliver even greater speed and precision than that available today. Using AI to further refine semantics, the goal will be to catch even more relevant, targeted re-

sults in a bid to reduce risk and save trademark professionals valuable time — something that is important to any and every business.

Some providers are continuing their tireless work to bring AI technology towards an even more sophisticated and human level. Some are working on machines that can observe how a customer works and automatically fine-tune the findings to deliver results according to the unique needs of that customer, providing targeted insights that helps IP practitioners work even more efficiently.

Conclusion

The real-world needs of trademark professionals will always be the primary driving force behind any technological innovations in this industry. The potential of technology to make it easier for experts to digest massive amounts of information and make right decisions in fast-paced scenarios is extraordinary, but only if developed and implemented correctly. ■

Rob Davey is a Senior Director at CompuMark, a brand of Clarivate Analytics



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A photograph of three polar bears in a snowy, arctic landscape. The bears are white and fluffy, standing on a snow-covered ground. The background shows a sunset or sunrise with a gradient of colors from orange to purple. The text is overlaid on the image in a white, sans-serif font.

Al Gore's claims to climate truth make no sense: no one knows

Tom Harris argues that what are seen as science facts
are merely the current opinions of some experts and
should not be seen as absolute truth

The central premise of former US Vice President Al Gore's climate change films is impossible. Not merely wrong or exaggerated, as many of his opponents claim, but, literally, impossible. Gore is supposedly telling us 'truth' about climate science. After all, his 2006 movie was entitled *An Inconvenient Truth*. And his film released in August of this year is called, *An Inconvenient Sequel: Truth to Power*.

But Gore does not really know the truth about the causes and consequences of climate change. Indeed no one does, not even the world's leading experts.

This is not just because the science is enormously complicated. It is also because scientific hypotheses, and even scientific theories, are not absolute truth; they can be, and often are, wrong. Science 'facts' are merely the current opinions of experts and, especially in the case of climate change, different experts often have very different points of view.

Voltaire once said, *"If you wish to converse with me, define your terms."* He understood how definitions direct and limit debates and ultimately control outcomes. So, we should start by clarifying what we mean by truth.

Plato defined truth as something that is *universal, necessary, and certain*. In the climate change case, this is easy to remember: universal, necessary, and certain or UNC, which could stand for 'United Nations Climate.'

Truth is universal in the sense that it applies everywhere. Whether you are in Athens, Sparta or on another planet, it is true. It also applies 'everywhen,' now, in five minutes or in a billion years.

Truth is also necessary. It must be the way it is; there is no other explanation possible. It is unequivocal.

And truth is certain. It is not a matter of probability. It is in the bank.

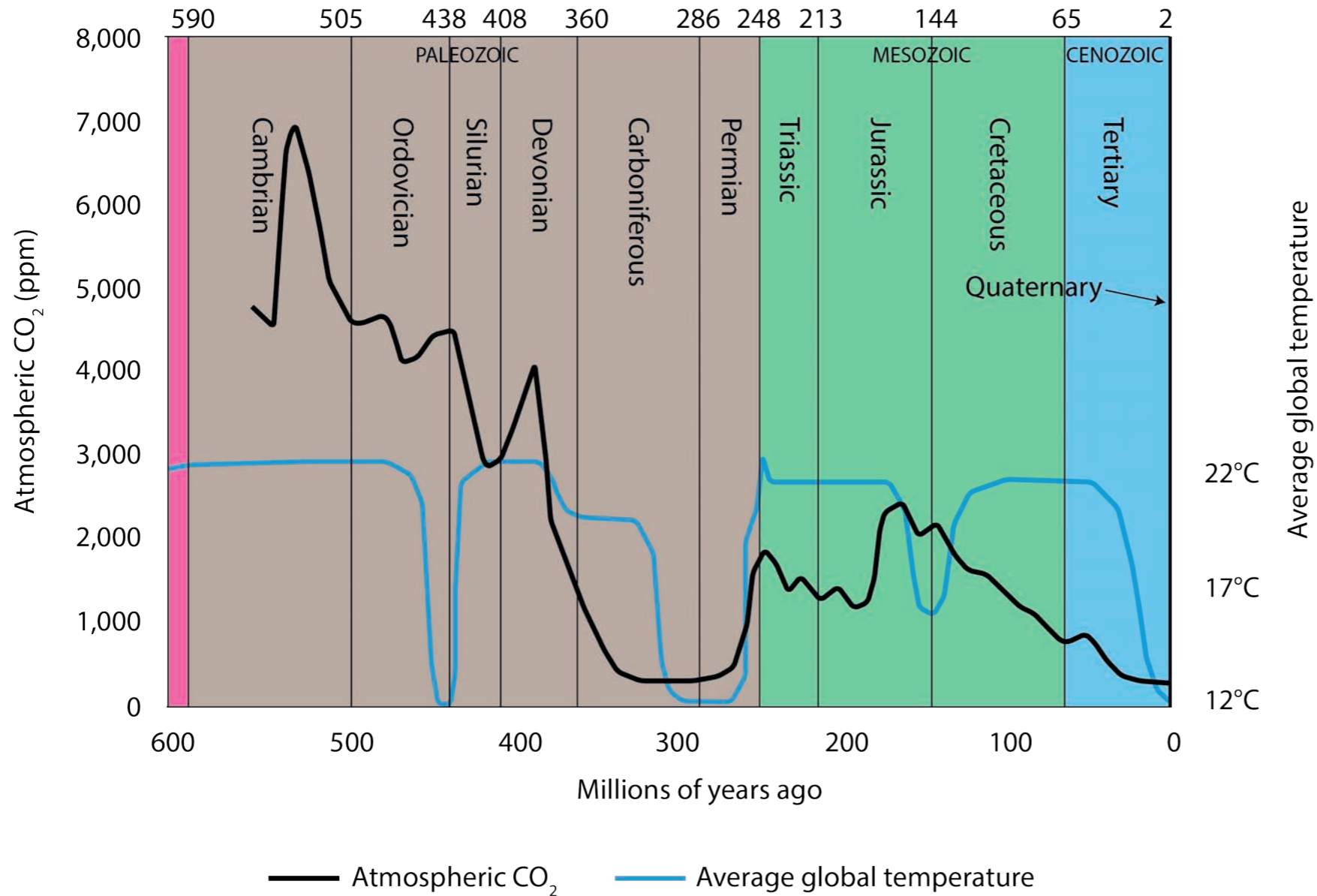
Truth applies to things like mathematics or chess in which we write the rules. Two plus two equals four. That is true. The Queen can move vertically, horizontally or diagonally in a straight line around the chess board, as long as no pieces are obscuring her path. That is true.

But truth never applies to our findings about nature, which are educated *opinions* based on scientists' interpretations of observations. And philosophers since ancient times have recognized that observations cannot prove anything to be true. In contrast to being universal, necessary, and certain, empirical evidence is *particular, contingent, and has some degree of probability*. So, contrary to the confident pronouncements of climate activists, observational

It's time to open up the debate about climate change, one of the most complex and costly issues of our age

Figure 1. Past temperatures and carbon dioxide levels show no consistent correlation in deep geologic time

www.worldcommercereview.com



Late Carboniferous to Early Permian time (315-270 million years ago) is the only time period in the last 600 million years when both atmospheric CO₂ and temperatures were as low as they are today

Temperature after CR Scotese <http://www.scotese.com/climate.htm>

CO₂ after RA Berner, 2001 (GEOCARB III)

evidence cannot be used to prove truth. Not only are our methods of observing imperfect but we all have biases that affect how we interpret what we see.

This is not a new idea. In the 17th century, English philosopher Sir Francis Bacon identified what he called four "*Idols of the Mind*," ways in which our thinking is misled by inherent traits and social influences.

First, Bacon had the "*Idols of the Tribe*," a bias that affects everyone. This concerns our natural tendency to put more importance on positive evidence—observations that support our point of view—than on negative evidence. We also tend to look for attractive patterns in our experience, patterns that are not necessarily consistent, significant or even real.

A good example in the climate change case is the conclusion that, because there is a correlation between increasing carbon dioxide (CO₂) and increasing temperature in some time intervals, this supposedly proves that CO₂ rise causes temperature rise. That the correlation does not apply in other time intervals is considered inconsequential by the true believer in man-made climate change.

Next, Bacon spoke about the "*Idols of the Cave*," specific biases that affect each of us as individuals due to our personalities, likes, and dislikes. For example, some people are convinced that industrialization is bad, so, in support of this personal hobbyhorse, they frequently see evidence that industrialization causes serious problems, even if the significance of this evidence is questionable. That the problems may have entirely different causes is often overlooked by people who are overly influenced by the Idols of the Cave.

Similarly, people who are dedicated to some specific branch of learning may also fall prey to the Idols of the Cave to the extent that they interpret much of what they see in the light of their own field only. Like the chemist who sees

chemistry in all things, the expert who focusses on human causes of climate change may see human causation even in environmental changes other experts regard as natural.

Bacon also identified the *"Idols of the Marketplace,"* prejudices that come through social interactions, particularly those that are mediated through the use of language that is equivocal. Such ambiguities result in people talking past each other since they do not really understand their opponents and may use the same terms for quite different ideas.

For instance, activists and the UN are often criticized for saying 'climate change is real,' as this statement seems so self-evident as to be useless. Climate has been changing since the origin of the atmosphere and it will continue to do so no matter what we do. So, of course, climate change is real, critics say; so is sunrise and gravity. This does not mean humanity causes them.

But the United Nations Framework Convention on Climate Change defines the term 'climate change' to mean *"a change of climate which is attributed directly or indirectly to human activity that alters the composition of the global atmosphere and which is in addition to natural climate variability observed over considerable time periods."*

So, to the promoters of the hypothesis of man-made climate change, 'climate change is real' is indeed meaningful. Such confusion in the use of language is one of the reasons discussions between people of differing positions on climate change often degenerate into angry arguments that accomplish nothing.

Finally, Bacon identified the *"Idols of the Theatre,"* a tendency of people to think erroneously because of what they were taught in school. This is very prominent in the case of climate change science. Most high school, college, and university climate change courses start from a premise that science proves that human industrial activity is the primary cause of the past century's warming and that catastrophe lies ahead if we do not change our ways.

Graduates from these institutions are therefore strongly conditioned to accept academic dogma about climate change and not ask the questions that need to be asked if we are to come to a balanced understanding of the issue.

Al Gore is not alone in making a serious mistake about climate 'truths.' Climate activists often present their opinions as truth based on settled science. In fact, the United Nations leads the way in this mistake, often labeling its science conclusions 'unequivocal,' in other words, statements that cannot be wrong.

For example, the Intergovernmental Panel on Climate Change [Fourth Assessment Report Synthesis Report](#), one of the most important climate change documents of the United Nations, starts, *"Warming of the climate system is unequivocal, as is now evident from observations of increases in global average air and ocean temperatures, widespread melting of snow and ice and rising global average sea level."*

Besides the fact that it is a mistake to refer to *"global average air and ocean temperatures...and global average sea level"* as *"observations"* (they are the results of statistical manipulations of thousands of observations in different places and at different times), the UN statement makes no sense philosophically.

Although he supports the dangerous human-caused global warming hypothesis, Lehigh University philosophy professor Steven Goldman explained in a personal communication that the IPCC statement is flawed. It is *"an attempt to persuade extra-logically,"* said Goldman. *"Strictly logically, no observations can lead to an 'unequivocal' interpretation."*

David Wojick, a Virginia-based Ph.D. in the logic and philosophy of science, disagrees with Goldman about the climatic impact of human activity but agrees that the IPCC made a serious mistake in the Synthesis Report. *"Reasoning from evidence is inductive logic,"* said Wojick. *"As for unequivocal, that is never the case in inductive logic."*

Yet, in speaking about the IPCC *Fifth Assessment Report*, Working Group I co-chair Dr Thomas Stocker **asserted** essentially the same again. “*Warming in the climate system is unequivocal*,” said Stocker. Canadian historical climatologist Dr Tim Ball calls Stocker’s statement “*nonsense*.”

So why do more philosophers not speak out about these problems, errors that are diverting the public from properly considering the arguments presented?

It may be that academics judge that acceptance of climate concerns will encourage pollution reduction, alternative energy development, conservation, increased foreign aid, and social justice, things many regard as beneficial. So they keep their opinions to themselves rather than risk impeding progressive policies.

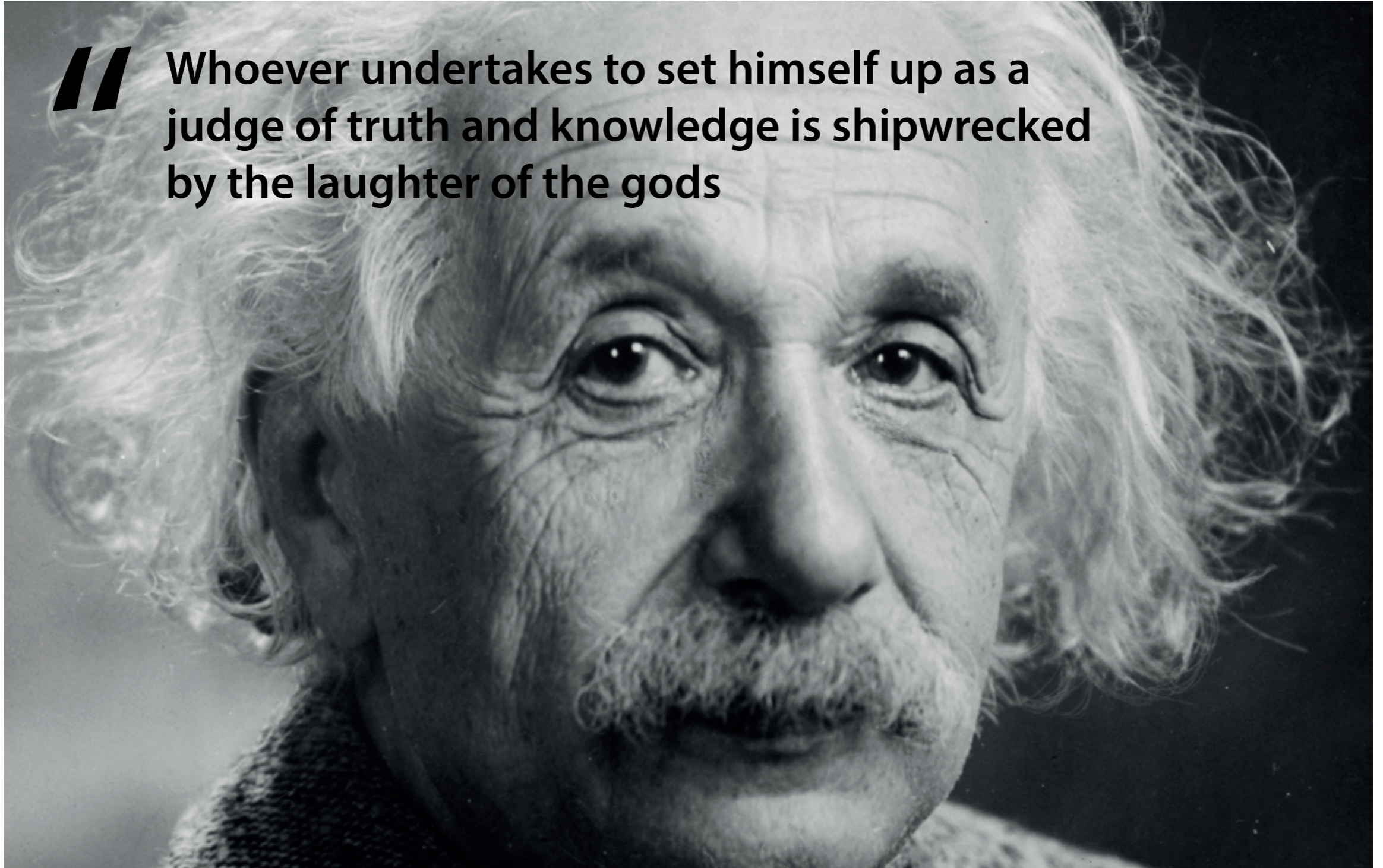
It may also be due to the fact that the overwhelming majority of philosophy professors are politically left of center and ‘stopping climate change’ is a cause liberals are expected to support.

But, traditionally, liberals have usually supported skepticism and relativism. Indeed, it was the German Left who promoted Albert Einstein’s Relativity and the Right who opposed it, believing (in hindsight, correctly) that it threatened their world view.

But this approach has been turned upside down in the global warming debate. While many conservatives promote open discussion about the causes of climate change, most of the Left consider this unacceptable. Like an excerpt out of George Orwell’s novel *Nineteen Eighty-Four*, sponsors of the California Climate Science Truth and Accountability Act of 2016 even wanted some kinds of climate change skepticism made into a criminal offense.

Similarly, in December 2015, activists in Canada attempted to use the federal Competition Act to curtail three groups—Friends of Science Society (Calgary), International Climate Science Coalition (Ottawa), and The Heartland

// **Whoever undertakes to set himself up as a judge of truth and knowledge is shipwrecked by the laughter of the gods**



Institute (Illinois)—from presenting what the complainants considered “*materially false or misleading representations about climate science for the purpose of promoting business interests.*”

After more than a year of investigation, the Canadian federal government [discontinued their inquiry](#). Ecojustice [complained](#), “*Now is the time we need our cops on the climate beat to be stepping up. The Competition Bureau took an encouraging first step but did not follow through.*”

Use of official bodies to enforce one perspective or another in science is a slippery slope. Indeed, such an approach has impeded human progress throughout history. For example, when the Greco-Egyptian writer Claudius Ptolemy proposed his Earth-centered system, he did not say it was physical astronomy, a *true* description of how the universe actually worked. He promoted it as mathematical astronomy, a model that worked well for astrology, astronomical observations, and creating calendars.

It was the ultra-conservative Catholic Church that, relying on a literal interpretation of the *Bible*, promoted the Ptolemaic system as *truth* to be questioned at one’s peril. This was why Nicolaus Copernicus, a Canon in the Church, waited until he was on his death bed before he allowed his revolutionary book showing the Sun to be the center of the universe to be published, even though the text was completed 30 years earlier.

This is also why Galileo ran into so much trouble when he claimed that the Church was wrong and that Copernicanism was the truth, a position that Galileo could not really know either. The Church eventually banned Copernicus’ book and it remained on the list of prohibited books for over two centuries.

Similarly, the assumed, unquestionable truth of Sir Isaac Newton’s laws eventually acted to slow the advancement of science until Einstein showed that there were important exceptions to the laws. When authorities preach truth about science, progress stops.

Climate Change Reconsidered II

Physical Science

NIPCC

NONGOVERNMENTAL INTERNATIONAL PANEL
ON CLIMATE CHANGE

The greatest misinformation in the global warming debate is that we currently know, or, perhaps, even *can* know, the future of a natural phenomenon as complicated as climate change. University of Western Ontario professor Dr Chris Essex, an expert in climate models, lays it out clearly:

“Climate is one of the most challenging open problems in modern science. Some knowledgeable scientists believe that the climate problem can never be solved.”

Regardless, as demonstrated by thousands of peer-reviewed papers in leading science journals highlighted by the [Nongovernmental International Panel on Climate Change](#), there is a broad range of scientific opinion on this issue. Indeed, much of what we thought we knew about climate is now regarded as wrong or highly debatable.

Albert Einstein once said, *“Whoever undertakes to set himself up as a judge of truth and knowledge is shipwrecked by the laughter of the gods.”* It might be humorous to the gods, but the belief that we know the truth about climate change has resulted in at least one billion US dollars a day being spent on climate change mitigation. Imagine what could be done with a billion more dollars a day dedicated to education, health care, cleaning up our rivers, or adapting to the inevitable natural environmental changes that lay ahead.

It’s time to open up the debate about climate change, one of the most complex and costly issues of our age. ■

Tom Harris is executive director of the Ottawa, Canada-based International Climate Science Coalition



World class aviation services

The Cayman Maritime & Aviation Services Park will create the largest transportation services group in the region, the CAACI write

The Cayman Islands Government has recently granted legislation allowing the addition of offshore aviation services to the Cayman Enterprise City (CEC) special economic zone. Aviation services joins the maritime sector within CEC to create the Cayman Maritime & Aviation Services Park (CMASP). It is envisioned that CMASP will create the largest transportation services group in the region, which will attract international maritime and aviation service businesses to set up a physical presence in the islands.

This expansion, the CMASP, can now include aircraft owners and brokers, technology companies and startups focused on aviation research and development, aircraft manufacturing and repair businesses, head offices of aviation industry businesses, businesses that provide management consultancy and any other specialized services relating to the aviation industry.

The CEC Special Economic Zone consists of six business parks each complimenting the other to create a dynamic and innovative environment based on the best special economic zones in the world. The addition of the aviation park is expected to be instrumental in further diversifying Cayman's economy and will assist to grow their client base.

The CAACI has a well-established reputation as a credible aviation regulator and custodian of a world-class aircraft register. The creation of the CMASP further enhances opportunities for commercial air transport operations to be established in the Cayman Islands, as it provides alternative means for Air Operator's Certificate (AOC) holders to have their principal place of business in the territory.

With aircraft registration and services becoming increasingly competitive around the globe, the opportunity for aviation service providers to be licensed into the CEC Special Economic Zone allows the Cayman Islands to offer additional services to quality clientele that operate globally.

Director-General of Civil Aviation, PH Richard Smith remarked, *“This is a very positive development for the Cayman Islands, as it presents the opportunity for multifaceted international aviation industries to be established here. It is envisioned that the aviation park will host a dynamic international community of maritime and aviation services businesses. Additionally, it also presents a basis for operators of Cayman Islands registered aircraft to establish their principle place of business within the jurisdiction to obtain an Air Operator Certificate for offshore commercial air transport.”*

“The creation of the CMASP is an example of how a Government Authority and private enterprise can collaborate and innovate for the benefit of the jurisdiction. This will bring the Cayman Islands opportunities that didn’t previously exist, and CEC will put the weight of our marketing and business development team behind the effort to promote the Registry, the CMASP and the country generally,” said Charlie Kirkconnell, CEO of CEC. ■



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A photograph of a private jet on a tarmac. The jet is white with a blue stripe and has its cabin door open. In the foreground, there is a dark-colored luxury car. The background shows a clear sky.

Welcome to NBAA-BACE

The international business aviation community is
invited to Las Vegas for NBAA-BACE

Business aviation is a productivity multiplier that makes companies of all sizes more efficient, productive and successful. Tens of thousands of companies and organizations worldwide utilize this vital industry to travel safely, efficiently, and securely to conduct business in today's fast-paced and highly competitive global environment.

For 70 years, the National Business Aviation Association (NBAA) has represented the interests and concerns of this diverse industry throughout the United States. Even though NBAA's annual convention focuses primarily on matters affecting business aviation users in the United States and across North America, the event has increasingly served as a focal point for the international business aviation community as well.

Matters of interest and concern to operators from all corners of the globe will be at the forefront at NBAA's 2017 Business Aviation Convention & Exhibition (NBAA-BACE.) More than 27,000 industry professionals will come to Las Vegas, NV from October 10-12, where they will find more than 1,100 exhibits displayed across 1 million square feet of floor space at the Las Vegas Convention Center (LVCC).

NBAA-BACE will also feature a comprehensive lineup of fixed-wing business aircraft, of all types and for all missions, on display at nearby Henderson Executive Airport (HND) from storied manufacturers including Dassault Falcon, Embraer, Textron Aviation, and Gulfstream.

Additionally, more than a dozen light business aircraft and rotorcraft will be displayed at the indoor static display on the LVCC exhibit floor. NBAA-BACE will also feature an expanded selection of rotorcraft highlighting the many diverse applications for helicopters within business aviation.

Of course, NBAA-BACE will also feature an impressive roster of featured speakers. Several distinguished aviation leaders will participate in the event's Opening General Session on Tuesday, October 10 to discuss the current state

of the industry, while astronauts Scott and Mark Kelly will be among the featured presenters during the Second Day General Session on October 11 that will also include presentation of the National Aviation Hall of Fame's annual Combs-Gates Award recognizing efforts to preserve aviation history.

Educational sessions address global concerns

NBAA-BACE will also serve as a premier informational forum, with a comprehensive array of topical and timely education sessions addressing topics of interest to business aviation operations across the globe.

For example, the NBAA International Operations Committee will host two sessions at NBAA-BACE, including an interactive panel addressing the committee's Top 10 hot topics for 2018 and strategies operators may use to minimize their exposure to global threats and challenges. A new session will address a thorny issue when operating in some countries where local customs directly contradict established anti-corruption laws and policies.

Business aviation is a global industry, and issues affecting one country or region often reverberate far beyond international borders

This year, a session addressing the International Standard for Business Aviation Operators (IS-BAO) and the recently-introduced International Standard for Business Aircraft Handling (IS-BAH) will provide operators with the opportunity to discuss implementation challenges with staff members from the International Business Aviation Council (IBAC) and explore possibilities to make the standard more accessible while not giving up any of its credibility and value.

Additional sessions topics will include the emerging market for supersonic business aircraft; the expansion of unmanned aircraft systems (UAS) operations in business aviation; preserving access to local airports; and methods for the industry to meet ongoing personnel challenges.

Session attendees will also discover expanded interactivity options allowing presenters to ask questions of the audience through the NBAA-BACE app, and modify their presentations in real-time based on attendee feedback and knowledge levels. People may also use the app to ask questions during presentations, and “vote up” questions to assign higher priority for a response.

Safety and innovation in spotlight

Safety will also be a top focus area during the event. Returning to NBAA-BACE this year will be the Single-Pilot Safety Standdown, showcasing the most effective safety strategies for single-pilot operators. This year’s theme is *Building a Culture of Safety for Single Pilot Operations*, featuring presentations that provide practical tools and information to enhance the safety of their operations.

Also returning to NBAA-BACE is the National Safety Forum, addressing a variety of perspectives on today’s most pressing safety issues. Now in its third year, this important forum will focus on three of the 2017 NBAA Top Safety Focus Areas – Fitness for Duty, Airport & Ground Handling Safety, and Loss of Control-Inflight – and will include in-

vited representatives from the US Federal Aviation Administration (FAA) and National Transportation Safety Board (NTSB).

NBAA-BACE is always at the forefront of bringing new approaches for engagement with industry representatives, and this year will be no exception. One example of this fresh perspective is NBAA's Innovation Zone, which offers a unique venue for attendees to learn about new topics in business aviation.

Located on the Exhibit Floor, the Innovation Zone will feature a number of education sessions focusing on the latest forward-thinking topics of interest to those in business aviation, and new technologies available throughout the industry. Innovation Zone presentations will focus on topics such as enhanced data and facility security technologies; tech trends in business aviation and using new apps to increase operational efficiency; and taking a detailed look at future business aircraft now under development.

Educating future generations about possible career paths in business aviation is another key mission for NBAA-BACE, and college and university students are invited to sit down with industry professionals at Careers in Business Aviation Day on Thursday, October 12.

Business aviation is a global industry, and issues affecting one country or region often reverberate far beyond international borders. On behalf of the more than 11,000 members of NBAA, readers of *World Commerce Review* are invited to join us in Las Vegas this October, where the size and scope of our vital international industry will be on proud display. ■

