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The Politics of Globalisation

Peter Mandelson
Susan Schwab
Kamal Nath

The Giants' Advance
Indian Trade
Easy Money
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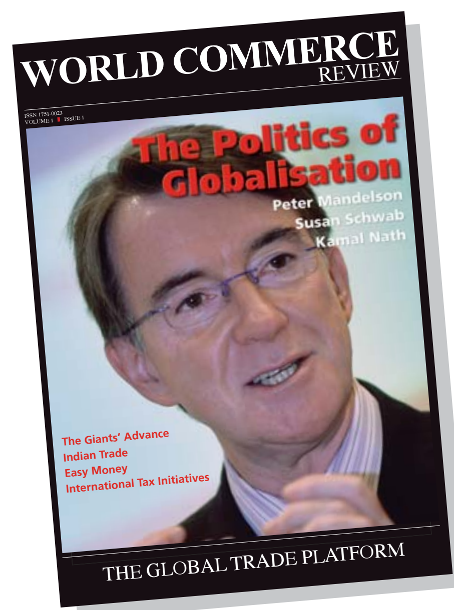

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The Politics of Globalisation

Peter Mandelson is the European Commissioner for External Trade

Here are some numbers from a new world. Everyday, 1000 new cars appear on the streets of Beijing; every week, the Chinese government builds a new power station. In 2004, Infosys in India advertised 9000 software engineer jobs: they got 1 million applicants. One in every two cranes standing in the world today is standing on a building site in China. The population of Egypt increases by a million people every nine months.

We all know we live in a world of rapid change - it has become a cliché to say it. We all know that a global economic and political order that has shaped the world since the middle of the nineteenth century is ending. But sometimes it takes the image of those cranes and power stations - or the fact that in the time it will take you to read this article 10 new cars will roll onto Beijing streets and immediately get stuck in Beijing traffic - to really bring home the world just over the horizon and how fast it is changing.

Our economic and political lives in the global age are interconnected in a deep and often subtle ways. So that President Bush can announce a US push to grow more biofuels last February in Washington and the rise in the price of corn can have poor people in the streets in Mexico City four days later protesting the rise in the cost of tortilla flour - their basic food. Making sense of such a world, and Europe's place in it, has never been more important. I am a politician; what follows is a politician's perspective on the challenges of globalisation.

There is a tendency – not among economists but among politicians and journalists - to see the economics of globalisation as a zero sum game. Our jobs shipped off to their countries. Our livelihoods undermined by their cheap labour costs. Our prosperity traded for theirs. It has often been said that the political problem in a liberalizing economy can be summed up very simply: the beneficial effects of economic change are generalized; the costs are localized. The dismantling of the Multi-Fibre Agreement at the start of 2005 will save almost every person in the developed world hundreds, if not thousands of euros over their lifetime in the cost of clothes. Yet almost no-one in the developed world lobbied their local politician to end the MFA.

However, if you have a friend or a relative in the textile industry - which if you come from certain parts of Spain or Italy or North or South Carolina would just about be a certainty – then the likelihood is that the last 5 years of their life have been spent in political activity defending barriers to trade in textiles. Because China and other parts of the developing world are putting those parts of our textile industry that compete on labour costs out of business.

But China is not stealing our jobs, not in any meaningful sense. In fact, for every job that Europe has lost to economic change in the last two decades it has created a new one in more competitive parts of the economy. In Europe we are still the world's biggest exporter, the world's biggest investor and the world's biggest market for foreign investment. We still dominate global markets for high-value goods. They wear Italian shoes in Japan. They don't wear Japanese shoes in Italy.

So the economic cake has got bigger, as economists have always argued that it can and does. A hundred million new jobs in the developing world have not cost Europe jobs or hurt Europe economically on aggregate. In fact the opposite is true - they've made us more competitive, they've lowered our input costs and they've reduced prices for consumers. They've depressed interest rates and lowered inflation. And a hundred million jobs in the developing world - the biggest ever shift of a portion of humanity out of poverty - is hard to argue against. Not least because, as the Egyptian trade minister once put it to me: it's fine to congratulate the developing world for growing at 8 or 9% a year, but when you are adding a million new people to your population every nine months, you have to grow that fast just to create the jobs they need. So those jobs are also part of a wider picture of security and stability.

Nevertheless, a hundred million new jobs in the developing world means painful competition and restructuring for some parts of our economy. And a lot of old certainties have been eroded and some industries have already changed beyond recognition. And if you think that the textile industry's challenges are not applicable to the wider economy, then I would refer you to the 1 million Indian software engineers I mentioned. Addressing that change is a genuine social justice issue in Europe. The dislocations can mean human tragedies - painful and traumatic - and all the macroeconomics in the world do not change that.

Governments have to be ready to help with adjustment and to equip people for change. And if we don't want a politics of retreat, and national chauvinism and protectionism in Europe, we will have to build a credible - and practical - politics of openness.

Yes, we need to acknowledge that globalization is not, automatically, a benefit for all. We need to recognize and address the adjustment costs involved while making the strongest possible case for the overall benefits of openness. We should champion economic reform and greater dynamism because those things are the means of creating stronger and more prosperous societies. But we should argue that the benefits have to be sustainable and the benefits have to be shared by all.

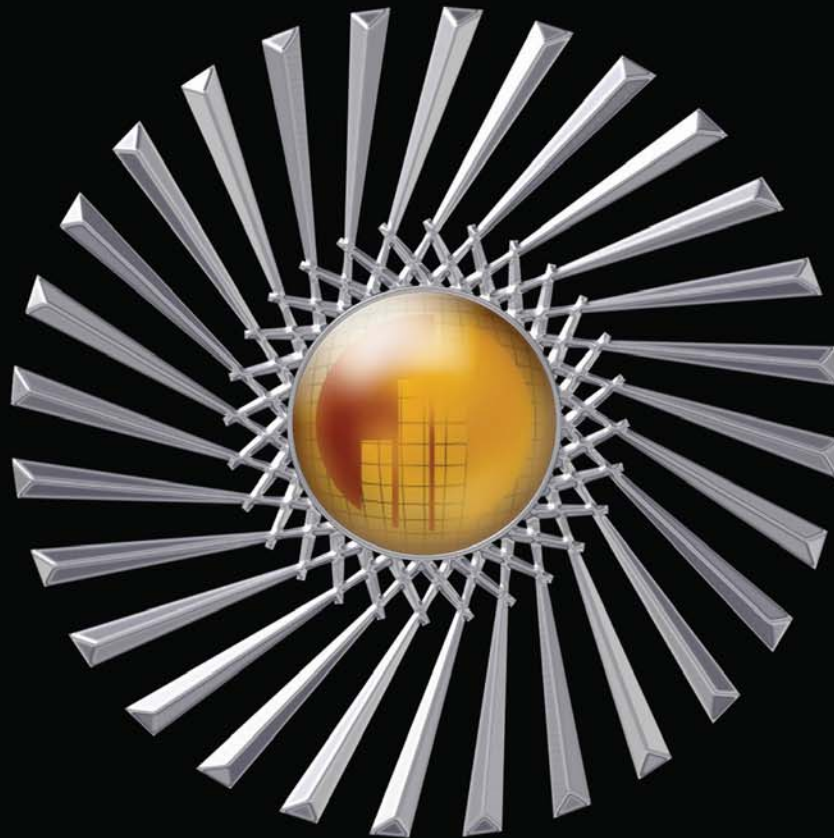
The debate on the future of the European Union and its institutions which has been transfixing Brussels and the EU's member state governments for the last two years presents us with competing visions of how the European Union can respond to these challenges in a global age. Some in Europe would like to see the Europe Union act as a bulwark against globalization: a wall and a gate we can pull closed in the face of change. This position makes a powerful appeal to our anxiety about change and our sense of social solidarity. But its picture of a static European society should worry us because everything we know about the global age suggests that nothing is standing still. It risks becoming a political fantasy about resisting change, holding back the tide, when we should be seeking ways to shape change and distribute its benefits more equally.

A much more compelling case for the European Union as it begins its second half century sees the EU not as Europe's fortress against globalisation but as something that gives us the power to shape globalisation. For example, the EU is the only way that European member states will have sufficient collective weight to shape the global debate on climate change or energy security or development or trade. The alternative for European member states in dealing with powerful partners like the US, or Russia or China is diminished influence, or no influence at all.

By enlarging the European Union we can help secure the economies of scale and the human resources that will continue to make us internationally competitive. The EU is how we project Europe's collective interests in a globalised world, and how we equip Europeans for the economic and social challenges that it brings.

The way we channel the dynamic power of trade is arguably the single most important impact we will have in shaping economic development in the global age. By progressively investing in export growth and opening their borders, Brazil, China, India and the other emerging economies have grown fast enough to double per capita income every ten years - which has no historical precedent. While all of these countries continue to face massive challenges of poverty reduction, and while new prosperity exists alongside old deprivation, each of them has taken an undeniable and irreversible step out of the developing world.

But here's another set of facts: despite having almost complete duty and quota free access to EU markets, Sub Saharan Africa actually trades less with the EU than it did 10 years ago. Over 50% of Sub



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Saharan Africa's exports to the EU are now just two products - oil and diamonds. Africa exports its capital rather than investing in itself.

The twin challenges of the WTO and the global trading system are to manage these two - unfortunately divergent - trends. China and the other large emerging economies need to be fully integrated into the global trading system, and their contribution to the system in the form of reciprocal openness needs to reflect their growing strength. For poorer countries we need to recognize that open markets are not a magic wand. In part because a lot of agricultural trade in least developed countries is actually protected from more competitive agricultural exporters like Brazil only by preferential tariff rates - which is why anyone who thinks that just liberalizing farm trade is a panacea for development has failed to understand the problem. Liberalisation in these areas must be gradual and carefully assisted.

In part it is simply because these countries still lack the capacity to take advantage of open markets. They need the aid for trade and development assistance that will build the infrastructure and the capacity to get goods to market. It is necessary to tackle the complex and sometimes corrupt management of Africa's borders. It takes twenty days to get a container through a port in Eritrea. It takes two hours in Liverpool. We also need to work to improve the conditions in Africa that will encourage people to invest there.

That is why we must complete the Doha Round of WTO talks, which at the time of writing are struggling in Geneva. Unlike the Uruguay Round, which had too much smoke and too many mirrors, Doha will impose serious tariff cuts for all farm goods, and restructure farm support for good. And it will make big inroads into protection in other areas - in the developed world but also in the emerging economies. If we let it slip away the economic costs, and the lasting damage to the multilateral trading system, will be severe.

Doha is conceptually a different kind of trade deal - one that self-consciously accepts the imperatives of development and in which the voice of the developing world has been and will be decisive. One that will be accompanied by huge new packages of capacity-building aid and special and differential treatment for developing countries. Doha can mark a pivot point in the history of the WTO in which it turns away from simple mercantilism towards an agenda that sees trade as a means to an equitable globalization. Completing Doha would send a vital signal that we can act collectively, through global institutions to shape globalization and global economic change; that we can harness the huge potential benefits of globalisation while acting to limit the costs.

As I noted, this economic agenda is only part of a much wider political challenge. The Doha round must have its equivalents across the rest of the global governance agenda. Our management of climate change; our collective response to global energy security; our collective response to migration and global demographic change - a world in which more Egyptians are being born than ever before, and Europe faces a steep population decline.

It is vital to remember that however central economic change is to what is happening around us, globalization is a deeply political phenomenon - the politics of globalization are the politics of the environment, climate change, migration, energy security and poverty alleviation. Our responses to globalisation will be conditioned by politics as much as anything else. Finding the right political solutions to the challenges of globalization first means asking the right questions and understanding the right problems. The challenge in Europe is to take back globalization from the pessimists. Not for its own abstract sake, but because it can be and should be shaped for the general good. ■

New Challenges and New Opportunities in a Diverse Global Marketplace

Susan C Schwab is the United States Trade Representative

The challenges World Trade Organization (WTO) members have faced in concluding the Doha Development Round negotiations make it clear that fundamental changes have occurred in the global trading system. It is clearer now than ever that nations at all stages of development are vital players in today's dynamic global trading system. And for the first time, the most advanced emerging markets are grappling with their new responsibility to step up to a leadership role and join the developed nations to fortify the system from which they have benefited and from which they stand the most to gain.

With the end of the Cold War and China's decision to engage commercially with the rest of the world, billions of people have joined the global economy in the last 20 years. This changing landscape tracks closely with the evolution of the rules-based trading system as we moved from the General Agreement on Tariffs and Trade (GATT) to the WTO. In previous rounds, the major players consisted almost exclusively of developed countries. But over the years, developing countries have come to play larger and more productive roles. There were 57 so-called developing countries participating in the GATT in 1979. The number grew to 68 in 1988, then to 98 in 1994. Today, the World Trade Organization has 150 members, the majority of which are considered developing countries, with some 30 more looking to accede. This is an exciting and welcome development. It is a strong affirmation of the fact that trade is among the most effective economic development tools we have.

Even as trading nations coalesce around this reality, the global trading system has become more complex. The North-South divide no longer adequately describes a world with a broad spectrum of countries at different levels of development. We have seen groups of countries form blocs based more on their aspirations and less on their actual stage of development. Alliances formed that share one set of objectives find themselves at odds over another set. The global South is no longer a monolith. Countries such as Malaysia, Thailand, Costa Rica, Chile, and Mexico have all been pushing for a robust market-opening outcome for the Doha Round and share many of the goals

of pro-trade developed countries. Each of these has a unique story to tell - a different economic path that leads to the same goal of expanding trade liberalization worldwide. Most see trade negotiations as a unique forum for countries to exchange so-called concessions that are, in fact, improving reforms.

In the meantime, there are some countries less willing to embrace the opportunities before us. Instead, they cling to the mercantilist notion

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that a trade concession means a loss. They try to embrace outdated and inaccurate notions of the South as a singular, uniform entity that should refuse to "pay" for greater market access in the developed world with reductions in trade barriers to their own countries. They remain sceptical about the gains from opening themselves to trade and investment. In still other cases, visionary leaders are struggling with domestic political constituencies resistant to trade liberalization. These are political realities we must come to terms with but which we cannot allow to sink the Doha Round.

As we move forward in our efforts to succeed in the Doha Round, individual WTO members must ask themselves what they want for the round and for themselves and what they are prepared to do to achieve the development goals we set for ourselves in 2001. These objections should generally reflect the level of development each has achieved and aspirations going forward. The least developed WTO member countries, for example, are not being asked to adjust their tariffs and subsidies. The United States recognizes that it and other developed countries must shoulder most of the burden for a successful outcome.

But the time has come for the rapidly emerging economies to step up to the challenge of helping to make Doha succeed. As we look ahead, WTO members must reflect on the compelling record of trade's role in expanding economic opportunities and contributing to development.

Among the best examples of the benefits of expanding free and fair trade is the success of the US economy. According to the Peterson Institute for International Economics, in the period since World War II, trade liberalization helped raise US annual incomes by $1 trillion, or $9,000 per household. The United States is the most open major economy in the world. According to the International Monetary Fund, developing countries accounted for 57 percent of US imports in 2006. The high per capita income, low unemployment, and solid economic growth the United States has enjoyed, with few exceptions, in the last 60 years provides compelling testimony to the fact that opening markets, embracing the rule of law, and encouraging trade spurs innovation and bolsters competitiveness. This experience stands in sharp contrast to the 1930s, when protectionist sentiments prevailed in the United States and resulted in tariff hikes that choked off trade flows and deepened the Great Depression.

As more nations have embraced trade and entered the global trading system in the years since World War II, they have also raised their standards of living. Over the five-year period from 2000 to 2005, for example, developing country economies have grown more than twice as fast (5.3% per year) as high income countries (2.2%) and the World Bank now classifies Singapore as a high-income country. Developing countries that adopted trade liberalizing strategies in the 1990s have grown three times the rate of those that liberalized less or not at all. Some 400 million people in China alone have been lifted out of poverty since China's leaders began to integrate into the global economy a quarter century ago. Trade's potential role in raising living standards in the future is equally compelling. Tens of millions more people could be lifted out of poverty by opening new trade flows.

The imperative at this moment in the economic transformation that has taken hold is to more broadly spread the benefits of trade within nations and to encourage more nations to shape their futures by adopting market principles. This is the responsibility of all trading nations.

As we graduate from the outdated North-South perceptions and rhetoric, we realize that countries of the "South" themselves must deepen and strengthen trade and investment ties with each other. There is at least as much potential benefit for developing countries from barrier reductions by other developing countries in a successful multilateral trade agreement than from the benefits derived from developed country actions. In fact, seventy percent of tariffs imposed on the exports of developing countries are imposed by other developing countries.

The Blair Commission on Africa concluded that increasing sub-Saharan Africa's share of global trade just one percent – from two to three percent – could boost incomes in that region by $70 billion. That is roughly three times the amount of development aid donor countries currently provide. The World Bank estimates that roughly half the benefits of global free trade in goods would flow to developing countries. Under such a scenario, by 2015, there could be income gains of $142 billion for developing countries. Measuring it dynamically, these gains could be as much as $259 billion. That also dwarfs the aid that wealthy countries provide. Moreover, fifty percent of the income gains to developing countries from free trade in goods would come from the removal of barriers in the developing countries themselves.

Of course, trade in services is also shaping economic development more than ever. Once again, developing countries and larger emerging markets have more to gain from services liberalization than developed countries. From infrastructure development in finance, telecommunications and transportation to job creation, services now account for more than half of the GDP in developing countries and it is increasing rapidly. Services are providing over half of the new jobs in the Caribbean, Latin American, and Asia. The key to growth is attracting new investment in the services sector, where recent studies have clearly established that the open markets attracting the highest levels of foreign direct investment are also experiencing the highest levels of growth.

In addition to the benefits of additional trade and investment flows, developing countries – the economies of the future - will ultimately be the greatest beneficiaries of a strong, rules-based global trading system. Many emerging economies already make frequent use of dispute resolution procedures, trade remedies and other sophisticated WTO machinery. WTO members at all stages of development have a stake in a strong WTO that can give coherence to the complex new economic relationships.

The United States has aspired to a comprehensive, ambitious, and balanced outcome from the very launch of the Doha Round in 2001 and pursued the round's ambitious goals through each meeting and ministerial to the present. President Bush, before the United Nations General Assembly, reaffirmed US determination to stand up to the forces of economic isolationism and encourage countries to take bold steps to open their markets to the free flow of goods and services.

The opening of multilateral trade liberalization to new voices may perhaps be the best way forward to success in the Doha negotiations, particularly as they increasingly enunciate their own interests rather than echo outdated and irrelevant mantras about North-South conflict. WTO members should welcome a frank discussion with these new voices that focus on the core principles of the WTO's role in eliminating global barriers, expanding trade and encouraging prosperity in developing and developed countries alike.

If we allow the forces of economic isolationism and neo-mercantilism to prevail, whether in developed or developing countries, we risk more than the chance to move forward with trade liberalization. More importantly, we risk hardening the barriers and distortions already in place in the global trading system and encourage individual countries to erect additional barriers and employ tactics that undermine the benefits of free and fair trade for all.

As trading nations grapple with internal economic transformations and new relationships with each other, we should seize this opportunity to embrace further trade liberalization, trade capacity building in developing nations, and the rule of law so as to generate new trade and investment flows for the next 20 years.

Students and practitioners of trade are familiar with the bicycle theory: To stop is to fall over. Doha is the best mechanism for keeping the bicycle moving. The fact that there are more riders on the bicycle in this round requires more coordination and balance than in previous rounds. Fortunately, there is general recognition on the direction in which we need to go. I remain hopeful that the new riders will work together and sustain the forward momentum to open new trade flows and broaden the reach of prosperity to the people of the world. ■

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India's Trade Policy

Kamal Nath is the Indian Minister for Commerce and Industry

With more than a billion people, India is the world's second most populous country, and also the largest democracy. Following more than a decade of reforms, India is now fully integrated into the global economy – in fact, its rate of integration into the global value chain, capital flows and manpower mobility has been far greater in the last decade than ever before. With its vast pool of technical skills, a significant base of English-speaking people with an increasing disposable income and a fast-expanding domestic market, India has truly emerged as a viable partner to global industry and services.

India's foreign trade policy is, however, a response not only to the dynamics of the fast moving global economy but also to our domestic sensitivities and imperatives of eradication of poverty, employment and income generation. Its trade policy needs to be seen from a perspective that is three-fold: (i) policy initiatives on market access at the multilateral level; (ii) the new trade agenda covering regional and bilateral trade agreements; and (iii) the traditional trade agenda of export promotion and import regulation through our foreign trade policy.

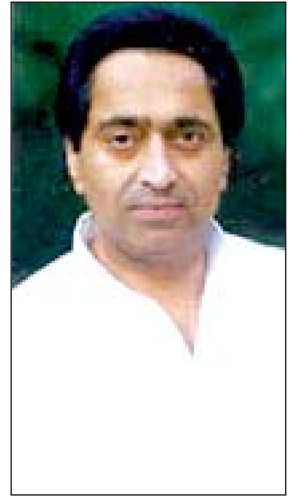
The Doha Round is a development round, as enshrined in the Doha Ministerial Declaration, the July 2004 Framework and the Hong Kong Ministerial Declaration. India strongly believes that the success of the round is predicated on its development agenda – an outcome that is to be gauged against deliverables achieved for developing countries in the key negotiating areas of agriculture, non-agricultural market access (NAMA) and services. The round must address the real problems of unemployment, low purchasing power and poverty in a large number of countries, and thereby, re-balance its outcome vis-à-vis the asymmetric of the Uruguay Round.

In agriculture, India's main concerns are reduction of trade-distorting subsidies in the developed world, greater market access for the agro goods of developing countries and defending the interests of farmers of developing countries for whom food security, livelihood and rural development are a question of survival. Non-tariff barriers to agricultural trade, including phyto-sanitary conditions, are a matter of serious concern for developing countries like ours.

In NAMA, India's manufacturing sector is vibrant and would be the basis of economic resurgence and for becoming an important global player. Hence, Non-Agricultural Market Access (NAMA) in the World Trade Organisation (WTO) negotiations is important for India, as we seek to balance our offensive export interests with the sensitivities of our vulnerable sectors. We would like to see the elimination or drastic reduction of tariff peaks – that is, high tariffs maintained by developed countries on products of export interest to developing countries – so that developing countries are able to use trade as a critical policy instrument for garnering an equitious share of global trade.

We must constantly remind ourselves that the Doha Round is the first development round in the history of trade negotiations. Consequently, reduction commitments must be calibrated in terms of the capacities of the developed and developing WTO members. That is why Less Than Full Reciprocity (LTFR), which is an integral part of the Doha mandate, is so important, as it provides for lower reduction commitments for developing countries compared to the developed countries. But, some of the proposals by the developed country members, far from respecting the LTFR mandate, have sought to demolish it completely. This is clearly unacceptable as it will only perpetuate the present asymmetry in the world trading order. Of equal concern is a move now afoot to skyrocket the ambitions in the avatar of sectoral initiative looking at elimination of tariffs in specific sectors. These are just means of looking at modalities that clearly go beyond the mandate!

Let me now turn to services. Revolutionary changes in telecommunications and transportation have empowered individuals and corporates to collaborate and compete globally, and a number of services that were non-tradeable earlier can now be traded. The services sector has thus emerged as an engine of growth of the global economy. The telecommunications 'revolution' has led to the success of the global delivery model where the internet has made it possible to reorganize production. Compelling pressures on businesses to cut costs and the change in world demography are other factors that have propelled this growth. The phenomena of outsourcing and offshoring are direct outcomes of these forces.



The recent study by Goldman Sachs identified Brazil, Russia, India and China (BRIC) as the large emerging market countries projected to grow rapidly over the next thirty years. Within the group, India's potential growth rate was projected to be the fastest – around 8 percent annually – faster even than China which is currently, and has been for many years, the fastest growing economy!

In fact, the services sector in India is playing an important role in the economy and is growing faster than other sectors, accounting for about 54% of our GDP.

India has also emerged as an attractive destination for establishing Business Process Outsourcing (BPO) and back office operations. Cross-border trade in the support and BPO services has assumed great significance, given the availability of technology, skilled labour and the cost differentials between developed and developing countries. In fact, US and European firms are now offshoring increasingly complex services such as advanced software design, R&D and software product development to countries like India.

India has, therefore, an aggressive interest in the services negotiations, especially in Mode 1 (cross-border trade), and Mode 4 (movement of natural persons) – the two modes of particular interest to India. On Mode 1, India would like locking in the current open international trade regime. On Mode 4, India seeks unhindered access for the strictly temporary (for one year at the most) movement of skilled professionals – in other words, non-immigration services – to fulfil service contracts without linking Mode 3 (commercial presence) with it. India is also pursuing the issue of Domestic Regulation to have clarity of regime in the post-Doha Round phase so that market access is not restricted or denied on account of domestic laws by the service receiving country.

I firmly believe that for globalization to entail win-win scenarios, comparative advantages of developing countries should not be stifled by protectionism in the developed world.

The development dimension has to be borne in mind in other areas as well, such as TRIPs (Trade Related Intellectual Property Rights), rules, environment etc., and a balanced package has to be worked out for the success of the Doha Round. Issues relating to removal of the gap between Convention on Bio-Diversity (CBD) and TRIPs need to be bridged. India, along with other developing countries, has been demanding the inclusion of "disclosure requirements" in the patent applications to prevent bio-piracy and misappropriation of traditional knowledge. Also, the area of rules requires a lot of effort by way of bringing in transparency and reducing the time and costs involved in seeking redress, which as of now is heavily tilted in favour of developed countries.

Turning to RTAs, since the mid-1990s, we have seen the emergence of many trading blocks, so much so that trade flows among these trading blocks today account for more than 50% of world trade! We believe that Regional Trading Arrangements should be 'building blocks' towards the overall objective of trade liberalisation and should complement the multilateral trading system. In the past, India had adopted a very cautious and guarded approach to regionalism and was initially engaged in only a few bilateral/regional initiatives, mainly through PTAs like the Bangkok Agreement (signed in 1975) to

exchange tariff concessions in the ESCAP region, the Global System of Trade Preferences (GSTP - signed in 1988) to exchange tariff concessions among G-77 member countries, and the SAARC Preferential Trading Arrangement (SAPTA - signed in 1993) to liberalise trade in South Asia. However, these engagements achieved limited results in terms of increasing trade volumes with the member countries.

Recognizing that RTAs would continue to feature permanently in world trade, India is engaging more with its trading partners now with a view to expanding its export trade share. Since the early part of this decade India has concluded in principle agreements to move towards Comprehensive Economic Cooperation Agreements (CECA) which cover FTA in goods, services, investment and identified areas of economic cooperation.

We have embarked on several bilateral and trading arrangements which include India Sri Lanka FTA, India Singapore CECA, the South Asian Free Trade Agreement (SAFTA), India Mercosur PTA and so on. Some of the agreements which are at an advanced stage of negotiations are those with the ASEAN and Korea. These apart, we are engaging with the Gulf Cooperation Council (GCC), Japan and the European Union (EU) for Comprehensive Trade and Investment Agreements.

One measure of India's economic openness and engagement with the world economy is her trade. Surprising as it may seem, share of trade in goods and services as a percentage of GDP is higher in India than in the US or Japan. We have more than doubled our merchandise exports within three years. Coupled with our expanding imports, our total merchandise trade is of the order of $300 billion annually. With our export and import of services each at $75 billion, our engagement with the global economy is 450 billion dollars. Foreign Direct Investment last year was $19 billion, and our foreign exchange reserves exceed $200 billion (up from less than a billion 16 years ago). Our GDP is more than a trillion dollars in real terms – in PPP terms it is four times as much.

But, there are many realities that co-exist in India. Just because Indian industry has matured to the extent of aggressively pursuing acquisitions abroad, and we are witnessing an outward flow of FDI, does not mean that we have reached first-world status. Sixty percent of India's people are dependent upon agriculture for their livelihoods. Indian agriculture is characterized by small holdings of less than five acres. Ninety percent of landowners are also tillers. Indian agriculture is predominantly 'subsistence' agriculture, not 'corporate-for-profit' agriculture. In spite of this, the Indian farmer is willing to compete with the American farmer. But he cannot compete with the US Treasury. We cannot allow what has happened to West Africa to happen to our farmers.

I believe that the mandate and the principles of a development round hold the promise of the most ambitious interface between national economies and the international environment ever undertaken by governments across the globe. We have engaged in this round in the belief that it is a development round. And we shall continue to proceed on that premise. The need for delivering on the development dimension rests not merely on fairness and equity and justice – though that would be reason enough. But healthy economics itself demands it. Where would Europe and America sell their goods if Asia and Latin America and Africa were sick and poor and floundering? An economically healthy developing world is important to the continued prosperity of the north, as it is also the only guarantor of international peace.

Over three billion people on this planet continue in the clutches of poverty. Yet they are imbued with a vision of hope. They do not know what international economics is, they have not heard of the WTO or the Doha Round. But what they do know is that there is a world out there in which a privileged few consume twenty times more oil, fifty times more energy and a hundred times more electricity than they do. To address this inequity is indeed the biggest challenge before mankind. ■

Indian Economic Growth

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Sustained economic growth in India is not a matter of debate anymore, it is accepted that given the current indicators the country will continue to clock good growth rates in the coming years. But the main issue of deliberation today is making this growth inclusive. It was not, therefore, surprising that the focus of the union budget presented by the Finance Minister Mr Palaniaapan Chidambaram in February this year was on the agriculture sector (where 65 per cent of the population is dependent) along with emphasis on social development, since about 800 million in the country live under $2 a day.

What is important to note is that India has witnessed pretty remarkable growth takeoff since the liberalization measures adopted in the early nineties got stabilized. Over the last decade or so, growth has been at about 6 percent per annum. At that rate, you would see per capita income double every 16 years or so. This is well above the so-called "Hindu rate of growth," for example, in the 1970s when it was ranging around 3 percent.

This has been made possible due to a widespread reform that was launched in the early 1990s, which undertook all reforms from slashing tariffs on imports to disinvesting in public sector and removing the need for licences to set up industry in the country. Reforms have also impacted the states in the country and they have all, barring one, moved towards a single VAT regime.

The services sector, which accounts for about 52% of the economy today has seen tremendous growth and has been an engine of exports. There has been a 54% growth in service exports from the country and if the present trend continues then service exports from India will surpass merchandise exports in the next few years.

Challenges

Infrastructure: this is a big challenge to overcome for India. Industry in the country today is primarily focusing to bring down overhead costs due to lack of adequate infrastructure and has been seeking large investments in this important sector.

For instance, in some big metros, water is on some days only available for a few hours a day. The average manufacturer loses about 8 percent of output to power outages. That is much more than what you see in other developing countries like China or Brazil. Most small manufacturers own generators and large plants have set up captive power generation units. Most greenfield projects include the cost of captive power plants thereby increasing the cost of the project. In other comparable developing countries the number of units keeping captive generators is far less.

This issue needs immediate attention and the government is now paying attention to this very important sector in a concerted fashion. But still the pace of growth in infrastructure availability remains an issue of concern for industry.

But despite the lack of infrastructure, the manufacturing sector has been witnessing good growth rates of well over 10 per cent in the recent past. It is also becoming an aggressive player in the global market place by taking over some large companies. Some recent examples are the Tatas and the Aditya Birla Group, which have made some large investments abroad totalling about $20 billion of investments. But it is not just the large companies that are acquiring global footprints. Even the small and medium sector is looking at investing over US$400-500 million in the last couple of years.

The government is aware that if the disadvantage of bad infrastructure is addressed properly then Indian industry can turn far more competitive in global markets.

Skill development

Skill development becomes the next big challenge for India, given the demographic advantage that it enjoys now. If the advantage has to

yield results then there is a need to look at skill development.

It is a fact that India will remain for some time one of the youngest countries in the world. A third of India's population was below 15 years of age in 2000 and close to 20 per cent were young people in the age group of 15-24.

The population in the 15-24 age group grew from around 175 million in 1995 to 190 million in 2000 and 210 million in 2005, increasing by an average of 3.1 million a year between 1995 and 2000 and 5 million between 2000 and 2005. In 2020, the average Indian will be only 29 years old, compared with 37 in China and the US, 45 in West Europe and 48 in Japan.

Despite the fact that a very large number of people graduate from colleges and finish technical education, the biggest challenge today for India is providing skill education to the school dropouts. It is believed that nearly 90 per cent of the students who join school leave before they reach the 10th grade and a very small population actually goes for higher education.

One big way of ensuring skill development is increasing the number of Industrial Training Institutes (ITIs) and the government is working to adopt a two-pronged strategy to increase the number of these institutes. One model is to develop it with partnership with the state governments and the second is to adopt a public-private partnership model that has been welcomed by industry associations such as the Confederation of Indian Industry (CII). CII has in fact laid great emphasis on skill development since industry, which has been growing, is suddenly feeling that there is a shortfall in the number of skilled personnel on the shop floor and in the service industry.

Agricultural growth

Palaniaapan Chidambaram began his budget's focus on agriculture by quoting the first prime minister of India Mr Jawaharlal Nehru, who said "Everything else can wait, but not agriculture". This is important since for India to sustain 9-10 per cent growth agriculture, analysts will argue, has to grow at between 3.5 to 4 per cent per annum.

Farm credit

The biggest challenge for India is farm credit since land holdings are very small. But Mr Chidambaram pointed that credit in this sector has continued to grow at a satisfactory pace. Until December 2006, over half a million new farmers were brought into the institutional credit system. For 2007-08, an addition of another half million 50 new farmers will be brought into the banking system.

Another challenge is helping the distressed districts in various states. The government to help these districts is working on water related schemes as well as a special plan for induction of high yielding milch animals and related activities.

Agricultural indebtedness

One problem that ails rural India is agricultural indebtedness. The government appointed a committee to examine all aspects of agricultural indebtedness and is in the process of finalising solution to tackle this situation based on the recommendations of that committee.

Productivity

A challenge for agriculture in India is improving productivity. Most products in India are faced with very low yields compared to the land they cover. This year's union budget has expressed governmental concern about the stagnation in the production and productivity of pulses.

This, as in other crops, is due to a critical deficiency is the availability and quality of certified seeds. The government has therefore proposed to expand the "integrated oilseeds, oil palm, pulses and maize development programme". Under this programme there will be a sharper focus on scaling up the production of breeder, foundation and certified seeds. The Indian Institute of Pulses Research (IIPR), the national and state level seeds corporations, agricultural universities, Indian Council for Agricultural Research (ICAR) centres, fertilizer cooperative companies - KRIBHCO, IFFCO - and the farm cooperative NAFED as well as large private sector companies will be invited to submit plans to scale up the production of seeds. With all these efforts the government hopes to double the production of certified seeds within a period of three years.

Plantation sector

After addressing the issue of productivity the next logically is to help farmers grow crops that will provide higher earnings and the focus on the plantation sector is expected to deliver that result. A special purpose tea fund has been launched for re-plantation and rejuvenation of tea and the government will soon put in place similar financial mechanisms for coffee, rubber, spices, cashew and coconut. This is expected to help a large number of farmers in the country.

Accelerated Irrigation Benefit Programme

Availability of water for irrigation is another problem in a country, which is so heavily rain dependent. The Accelerated Irrigation Benefit Programme (AIBP) has been revamped by the government to complete more irrigation projects providing an additional irrigation potential of 900,000 hectares. Along with this the National Rainfed Area Authority was established to coordinate all schemes relating to watershed development and other aspects of land use.

The other important issues in agriculture which the government is focusing on includes training for farmers in the area of water management and providing a safety net through insurance for agricultural commodities.

Integrating with global markets

The union budgets since the nineties have had one important component - the regular cut in customs duties on most products. From very high levels in the early nineties the country has now brought down peak tariffs on most products to about 10 per cent.

Finance ministers in India have over the years have said in their budget speech that India will bring down tariffs to the ASEAN levels.

Along with bringing down tariffs India is also engaged in intensive negotiations with almost all major trading partners, except the US, for a free trade agreement covering goods, services and investment.

India's FTA model, called the Comprehensive Economic Cooperation Agreement (CECA) goes beyond the normal FTA model adopted by other countries. If all the negotiations fructify then India will have FTAs have a zero duty regime for most products, except a small negative list, with over 50 countries since negotiations are also on with regional groupings like the ASEAN, European Union and the Gulf Cooperation Council.

The move towards integrating with world markets has also meant that India's trade to GDP ratio has been increasing over the years and today stands at over 40 per cent. While India's total merchandise exports crossed the $125 billion mark last year, service exports too have been growing. However, due to good growth rates India has a trade deficit due to large energy imports.

Conclusion

India's focus today is inclusive growth. This is important to also ensure that economic growth does not lead to large scale imbalance between the urban and rural population.

The second challenge for India is to ensure that there is no imbalance created between the different regions and equal opportunities are created across the whole country. As of now there are glaring disparities in growth rates among the different states.

The union budget and the five year plan (2007-12) is also focussed on this issue. The best way forward is to ensure that the public-private partnership is followed to build physical infrastructure and greater emphasis is provided to social issues like health and education so that the growth is balanced and is sustained for a longer period. ■

ICC Recommendations for Completing the Doha Round

Prepared by the Commission on Trade and Investment Policy

ICC welcomed the agreement among trade ministers in January 2007 to re-start the negotiations following initiatives at the highest political level. A final and very narrow window of opportunity appears to have opened up to forge agreement on an historic, global package of trade-enhancing measures.

ICC believes that a successful conclusion of the Doha Round is a vital interest for world business and encourages fellow business leaders to work closely with their governments to achieve that end as a matter of great urgency. Although national differences over a deal on agriculture have taken centre stage, the Doha Round is – and should be – about much more than that one sector. Considerable progress has been made in all areas of the negotiations over the past five years and there is much already on the table which would make it easier to do business across frontiers.

The Doha trade round represents a historic opportunity to generate economic growth, raise living standards and create potential for development across the world that should not be squandered. As an indication of the magnitude of the contribution that an ambitious Doha Round agreement could make to the world economy, a World Bank publication estimated that the global welfare impact from liberalization of merchandise trade including the elimination of domestic support and export subsidies is 287 billion US dollars.[1]

World leaders need to urgently devote their personal attention to reaching an agreement so that rapid progress can be made on the contours of a balanced package of measures to substantially improve market access in agriculture, industrial products and services, facilitate trade and update WTO rules.

If the Doha Round fails, the gains already on the table will be lost. The considerable advances already made towards achieving the most trade-enhancing global agreement ever will be wasted. And the multilateral trading system that has played such a critical role in raising world living standards will be seriously damaged – paving the way for already resurgent protectionist forces and an ever more complicated and costly patchwork of bilateral and regional trade arrangements, which are not alternatives to the multilateral system.

Political leaders at the very highest level must continue to engage themselves to ensure that WTO governments collectively, at this very late hour, find the political will to realize the great promise of Doha. They – and we – have a final chance. We must all invest the time and effort to get a deal done.

As a strong supporter of the rules-based multilateral trading system, the International Chamber of Commerce (ICC) which represents thousands of enterprises of all sizes and sectors in 130 countries calls upon all members of the World Trade Organization (WTO) to redouble their efforts to bring the Doha Round of multilateral trade negotiations to a successful conclusion as soon as possible.

ICC believes that the objective of completing the Doha Round remains achievable. The challenge is more political than technical. It requires the commitment of governments to find the political will to make compromises and difficult decisions on opening markets that recognize the common interest in success and the collective cost of failure.

Tariff and non-tariff barriers for non-agricultural products

ICC considers that the negotiations on market access for non-agricultural products are of central importance to the Doha Round because of the benefits for both consumers and producers in all WTO member countries that further liberalization could bring. Therefore, it is strongly in the interest of both developing and developed countries to substantially reduce tariffs and non-tariff barriers with an appropriate sequencing of reductions. A large part of the expected gains from trade liberalization will result from the lowering of tariffs and non-tariff barriers by low and middle income countries from increased trade among these countries.

Agriculture

ICC calls on WTO members to reach agreement on specific modalities with the objective of achieving substantial cuts in domestic support and the dismantlement of market access barriers. These measures severely impede trade in agricultural products, impose a heavy burden on consumers and taxpayers especially in industrialized countries, and have a particularly injurious effect on the export opportunities of many developing countries. Improved market access, especially for products of export interest to developing and least developed countries, should be a key objective of the modalities and an essential outcome of these negotiations. ICC welcomes the decision taken at Hong Kong to eliminate export subsidies by 2013.

Services

ICC welcomes the objectives and approaches set out in annex C of the Hong Kong ministerial declaration and urges WTO members to use these as a guide in making new and improved commitments. All WTO members should engage in the process of exchanging requests and offers, both on a bilateral and plurilateral basis. ICC remains very concerned by the slow progress of the services negotiations. All WTO members should participate actively in these negotiations with the aim of achieving progressively higher levels of liberalization on the broadest possible range of sectors and across all modes of service supply. Services trade liberalization accruing from the Doha Round must go beyond levels currently available through unilateral access.

Trade facilitation

A WTO agreement on trade facilitation, in the form of a set of trade facilitation rights and obligations fully integrated into the corpus of WTO instruments, will be a major step toward the full realization of the benefits of trade liberalization flowing from successive rounds of multilateral negotiations. This will simplify and expedite information/data requirements and the movement, release and clearance of goods – to the advantage, in particular, of developing economies and of small and medium-sized enterprises, and with significant welfare gains for all countries both when exporting and importing. A trade facilitation agreement is therefore a “win-win” proposition for all WTO members that will strengthen especially the capacity of developing countries to increase their share of international trade and investment flows, not least their trade with other developing countries. Furthermore, trade facilitation is of particular significance at a time when security concerns add challenges to cross-border trade management.

Antidumping

ICC supports the aim of the negotiations launched at Doha to clarify and improve disciplines under the agreement on antidumping, while preserving the basic concepts, principles and effectiveness of this agreement and its instruments and objectives. The aim of these negotiations should be to prevent the abusive use of antidumping measures through a more harmonized and disciplined approach to the implementation of the antidumping agreement. ICC urges WTO members to undertake a balanced approach to this important element of the Doha Round.

Preferential trade agreements

ICC shares the deep concern expressed in the report of the Consultative Board to the WTO Director-General over the proliferation of preferential trade agreements, which threatens the integrity of the multilateral trading system and the principle of non-discriminatory trade, given the ineffectiveness of current WTO disciplines. Therefore, ICC attaches great importance to achieving substantive progress on clarifying and improving disciplines and procedures under the existing WTO provisions applying to preferential trade agreements. While ICC welcomes the new provisional transparency mechanism established in December 2006, WTO members should agree on permanent, meaningful review procedures and effective multilateral disciplines. However, ICC also believes that the most effective long-term solution to concerns about the impact of discriminatory trade preferences is to ensure the successful conclusion of the Doha Round by year-end resulting in a ▸▸

- broad and substantial multilateral reduction of tariffs and non-tariff barriers.

Note: ICC commends to WTO members the detailed policy statements prepared by various ICC policy commissions on specific issues in the Doha Round negotiations. These policy statements are available on the ICC website at www.iccwbo.org

About ICC

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. ICC promotes an open international trade and investment system and the market economy, and helps business corporations meet the challenges and opportunities of globalization. Business leaders and experts drawn from ICC's global membership establish the business stance on broad issues of trade and investment policy as well as on vital technical subjects. ICC was founded in 1919 and today it groups thousands of member companies and associations from 130 countries. ■

1 *Dominique van der Mensbrugghe "Estimating the Benefits of Trade Reform: Why Numbers Change" in Trade, Doha, and Development: Window into the Issues, edited by Richard Newfarmer, World Bank, 2005.*

Embracing the Challenge of Free Trade: Competing and Prospering in a Global Economy

Ben Bernanke is Chairman, The Federal Reserve Board

Trade is as old as humanity, or nearly so. Archaeological sites demonstrate that ancient peoples traded objects such as rare stones and shells across fairly long distances even in prehistoric times. Over the centuries, with stops and starts, the volume of trade has expanded exponentially, driven in large part by advances in transportation and communication technologies. Steamships replaced sailing ships; railroads succeeded canal barges; the telegraph supplanted the Pony Express. Today, in a world of container ships, jumbo jets, and the Internet, goods and many services are delivered faster and more cheaply (in inflation-adjusted terms) than ever before.[1]

I will discuss the crucial economic benefits we receive from the ongoing expansion of international trade.[2] I will also address the adverse effects of trade and some possible ways to mitigate them. I will argue that one possible response to the dislocations that may result from trade - a retreat into protectionism and isolationism - would be self-defeating and, in the long run, probably not even feasible. Instead, our continued prosperity depends on our embracing the many opportunities provided by trade, even as we provide a helping hand to individuals and communities that may have suffered adverse consequences.

The benefits of trade

At the most basic level, trade is beneficial because it allows people to specialize in the goods and services they produce best and most efficiently. For example, we could conceivably all grow our own food and provide our own medical care. But because farming and medicine require special knowledge and skills, a far more efficient arrangement is for the farmer to specialize in growing food and for the doctor to specialize in treating patients. Through the specialization made possible by trade, the farmer can benefit from the doctor's medical knowledge and the doctor can enjoy lunch. The opportunity to trade allows everyone to play to his or her own strengths while benefiting from the productive skills of the whole community. Indeed, economists have demonstrated that trade between two people can be beneficial even if one of them is more skilled than the other at every task, so long as the more-skilled person specializes in those tasks at which he or she is relatively more productive.

What applies to individuals applies to nations as well. Two centuries ago the economist David Ricardo famously observed that, if England specialized in making cloth while Portugal specialized in producing wine, international trade would allow both countries to enjoy more of both goods than would be possible if each country produced only for domestic consumption and did not trade. As in the case of individuals, this conclusion applies even if one country can produce both cloth and wine more cheaply than the other, so long as each country specializes in the activity at which it is relatively more productive. A telling confirmation of Ricardo's insight is that, when nations go to war, their first order of business is often to try to block the other's access to trade. In the American Civil War, the North won in large part because its blockade of Southern ports prevented the Confederacy from exporting its cotton. In the twentieth century, the fact that Great Britain and its allies were able to disrupt German trade more successfully than Germany could impede the flow of goods into and out of Great Britain bore importantly on the ultimate outcomes of both world wars.

Patterns of trade are determined by variations in a number of factors, including climate, the location of natural resources, and the skills and knowledge of the population. I suppose that one could grow roses commercially in Montana for Valentine's Day, but it would likely require climate-controlled greenhouses complete with artificial lighting - very expensive. A much less costly solution is for Montanans to grow and sell wheat, then use the proceeds to buy roses from localities where the weather is balmy in February.

This is all standard textbook material, and it may well leave you unconvinced of the importance of international trade. After all, the United States is a big country, and we can certainly achieve many of the benefits of specialization by trading within our own borders. How important is it for the health of our economy to trade actively with other countries? As best we can measure, it is critically important. According to one recent study that used four approaches to measuring the gains from trade, the increase in trade since World War II has boosted US annual incomes on the order of $10,000 per household.[3] The same study found that removing all remaining barriers to trade would raise US incomes anywhere from $4,000 to $12,000 per household. Other research has found similar results. Our willingness to trade freely with the world is indeed an essential source of our prosperity - and I think it is safe to say that the importance of trade for us will continue to grow.

In practice, the benefits of trade flow from a number of sources. By giving domestic firms access to new markets, trade promotes efficient specialization, permits economies of scale, and increases the potential returns to innovation.[4] US firms increasingly seek to expand production and profits through new export opportunities; indeed, US exports grew about 9 percent in real (that is, inflation-adjusted) terms last year. Export-oriented US manufacturing industries include producers of aircraft, construction equipment, plastics, and chemicals. The United States also excels in the manufacture and export of sophisticated capital goods and scientific equipment. Outside of manufacturing, a number of US high-tech companies, including software developers and online service providers, are world leaders in their fields. American films and music attract large worldwide audiences. Montana's exports include wheat, metal ores, and high-tech materials that are critical to the production of semiconductors.

Firms that emphasize exports are among America's most dynamic and productive companies. Relative to firms that produce strictly for the domestic market, exporters tend to be more technologically sophisticated and to create better jobs. Among US manufacturers, for ▶▶

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example, exporters pay higher wages and add jobs more rapidly than non-exporters. A significant portion of US international trade is conducted by multinational firms; studies show that these firms generally pay higher wages than purely domestic firms, both in the United States and in developing countries. US firms with a global reach tend to be better diversified and are better able to respond to new market opportunities wherever they may arise.

Exports are important, but so are imports. Without trade, some goods would be extremely expensive or not available at all, such as the Valentine's Day roses of my earlier example or out-of-season fruits and vegetables. Trade also makes goods available in more brands and varieties; examples include automobiles, consumer electronics, garments and footwear, wines, and cheeses. One of the great attractions of globalization is that it brings to consumers the best of many cultures. And of course, global trade allows many types of goods, especially consumer goods, to be purchased at lower prices. Lower prices help all consumers but may be especially helpful to those with tight budgets. Indeed, a number of the large, import-intensive retail chains in the United States are focused on low- and moderate-income consumers, who benefit from being able to buy a wide variety of lower-priced goods.

Another substantial benefit of trade is the effect it tends to have on the productivity of domestic firms and on the quality of their output.[5] By creating a global market, trade enhances competition, which weeds out the most inefficient firms and induces others to improve their products and to produce more efficiently. The US manufacturing sector, which is perhaps the sector most exposed to international competition, has achieved truly remarkable increases in its productivity in the past decade or so. In addition, international supply chains, made possible by advances in communication and transportation, reduce costs and increase the competitiveness of US firms. Trade also promotes the transfer of technologies, as when multinational firms or transplanted firms bring advanced production methods to new markets.

Trade and finance are closely linked and mutually supporting, and in recent decades international financial flows have grown even more quickly than trade volumes. The globalization of finance plays to the strengths of US financial institutions and financial markets. The United States has a large surplus in trade in financial services, and US firms are leaders in providing banking, investment, and insurance services to the world. Financial openness allows US investors to find new opportunities abroad and makes it possible for foreigners to invest in the United States. The ability to invest globally also permits greater diversification and sharing of risk.

Trade benefits advanced countries like the United States, but open trade is, if anything, even more important for developing nations. Trade and globalization are lifting hundreds of millions of people out of poverty, especially in Asia, but also in parts of Africa and Latin America. As a source of economic growth and development in poor countries, trade is proving far more effective than traditional development aid. The transition economies of central and eastern Europe have also benefited greatly from trade, especially trade with the rest of the European Union. A recent study by the World Bank compared two groups of developing countries, dubbed the "globalizers" and the "non-globalizers." Collectively, the globalizers have doubled the ratio of trade to their gross domestic product (GDP) over the past twenty years, in part because of sharp cuts in tariffs on imports; the non-globalizers, collectively, have seen a decline in their trade-to-GDP ratio over the same period. Among the globalizers, economic growth accelerated from 2.9 percent per year in the 1970s, to 3.5 percent in the 1980s, to 5 percent in the 1990s. In contrast, the non-globalizers have seen their growth decline from 3.3 percent per year in the 1970s to 0.8 percent in the 1980s and 1.4 percent in the 1990s. The study also found that, among the globalizers, absolute poverty declined significantly and the degree of income inequality changed little.[6]

If trade is so beneficial, why do we sometimes see political resistance to freer, more open trade? Notably, negotiations in the so-called Doha Round of trade talks now under way have proceeded very slowly, notwithstanding a consensus among economists that all countries involved would enjoy substantial benefits from further trade liberalization. One important reason is that, although trade increases overall prosperity, the benefits for some people may not exceed the costs, at least not in the short run. Clearly, the expansion of trade helps exporting firms and their workers. As consumers, nearly all of us benefit from trade by gaining access to a broader range of goods and services. But some of us, such as workers in industries facing new competition from imports, are made at least temporarily worse off when trade expands. Because the benefits of trade are widely diffused and often indirect, those who lose from trade are often easier to identify than those who gain, a visibility that may influence public perceptions and the political process. That said, the job losses and worker displacement sometimes associated with expanded trade are a legitimate economic and social issue. In the remainder of my remarks, I will focus on the impact of trade on US jobs - both positive and negative - and discuss some possible policy responses.

Trade and jobs

Does opening US markets to foreign producers destroy jobs at home? The expansion of trade or changes in trading patterns can indeed destroy specific jobs. For example, foreign competition has been an important factor behind declining employment in the US textile industry, including in my home state of South Carolina. Job loss - from any cause - can create hardship for individuals, their families, and their communities. I will return shortly to the question of how we should respond to the problem of worker displacement.

For now, however, I will point out that trade also creates jobs - for example, by expanding the potential market overseas for goods and services produced in the United States. Trade creates jobs indirectly as well, in support of export activities or as the result of increased economic activity associated with trade. For example, gains in disposable income created by lower consumer prices and higher earnings in export industries raise the demand for domestically produced goods and services. Domestic production and employment are also supported by expanded access to raw materials and intermediate goods. The US jobs created by trade also tend to offer higher pay and demand greater skill than the jobs that are destroyed - although a downside is that, in the short run, the greater return to skills created by trade may tend to increase the wage differential between higher-skilled and lower-skilled workers and thus contribute to income inequality.

The effects of trade on employment must also be put in the context of the remarkable dynamism of the US labour market. The amount of "churn" in the labour market - the number of jobs created and destroyed - is enormous and reflects the continuous entry, exit, and resizing of firms in our ever-changing economy. Excluding job layoffs and losses reversed within the year, over the past decade an average of nearly 16 million private-sector jobs have been eliminated each year in the United States, an annual loss equal to nearly 15 percent of the current level of non-farm private employment.[7] The vast majority of these job losses occur for a principal reason other than international trade. Moreover, during the past ten years, the 16 million annual job losses have been more than offset by the creation of about 17 million jobs per year - some of which, of course, are attributable to the direct and indirect effects of trade. Truly, the US labour market exhibits a phenomenal capacity for creative destruction.

If trade both destroys and creates jobs, what is its overall effect on employment? The answer is, essentially none. In the long run, the workings of a competitive labour market ensure that the number of jobs created will be commensurate with the size of the labour force and with the mix of skills that workers bring. Thus, in the long run, factors such as population growth, labour force participation rates, education and training, and labour market institutions determine the level and composition of aggregate employment. To see the irrelevance of trade to total employment, we need only observe that, between 1965 and 2006, the share of imports in the US economy nearly quadrupled, from 4.4 percent of GDP to 16.8 percent. Yet, reflecting growth in the labour force, employment more than doubled during that time, and the unemployment rate was at about 4.5 percent at both the beginning and end of the period. Furthermore, average real compensation per hour in the United States has nearly doubled since 1965.

Although many readily accept that balanced trade does not reduce aggregate employment, some might argue that the United States' current large trade deficit must mean that the number of US jobs has been reduced on net. However, the existence of a trade deficit or surplus, by itself, does not have any evident effect on the level of employment. For example, across countries, trade deficits and unemployment rates show little correlation. Among our six Group of Seven partners (the world's leading industrial countries), three have trade surpluses (Canada, Germany, and Japan). However, based on the figures for February of this year, the unemployment rates in Canada (5.3 percent) and in Germany (9.0 percent) are significantly higher than the 4.5 percent rate in the United States; and Japan's unemployment rate, at 4.0 percent, is only a bit lower.[8] Factors such as the degree of flexibility in the labour market, not trade, are the primary source of these cross-country variations in unemployment.

What about outsourcing abroad?

The debate about the effects of trade on employment has been intensified by the phenomenon of outsourcing abroad, or "offshoring." Offshoring has been driven by several factors, including improvements in international communication, the computerization and digitization of some business services, and the existence of educated, often English-speaking workers abroad who will perform the same services for less pay. A portion, though not all, of these wage differentials reflects differences in skills and productivity; for example, outsourced programming work is usually simpler and more routine than programming done in the United States.

The increase in outsourcing abroad has led to dire predictions about a wholesale "export" of US jobs in coming years. Although globalization and trade will continue to be forces for economic change, concerns about a massive loss of jobs due to offshoring do not seem justified. Companies have found outsourcing abroad profitable primarily for jobs that can be routinized and sharply defined. Certainly, advancing technology will continue to increase the feasibility of providing services from remote locations. For the foreseeable future, however, most high-value work will require creative interaction among employees, interaction which is facilitated by physical proximity and personal contact. Moreover, in many fields, closeness to customers and knowledge of local conditions are also of great importance. These observations suggest that, for some considerable time, outsourcing abroad will be uneconomical for many types of jobs, particularly high-value jobs.[9]

Moreover, a balanced discussion of outsourcing abroad should reflect that, just as US firms use the services of foreigners, foreign firms make considerable use of the services of US residents. Many do not realize that, in contrast to its trade deficit in goods, the United States runs a significant trade surplus in services - particularly in business, professional, and technical services. This country provides many high-value services to users abroad, including financial, legal, engineering, architectural, and software development services, whereas many of the services imported by US companies are less sophisticated and hence of lower value.[10] A recent study of twenty-one occupations that are most likely to be affected by outsourcing found that net job losses were concentrated almost exclusively in the lower-wage occupations and that strong employment gains have occurred in the occupations that pay the highest wages.[11] Further expansion of trade in services will help, not hurt, the US economy and the labour market.

Just as discussions of the outsourcing of business services tend to ignore the services US firms sell to other countries, so do discussions of the movement of jobs offshore ignore the fact that foreign firms also move jobs to the United States. Between 1996 and 2004 (the most recent data available), the employment of US residents by majority-owned non-bank affiliates of foreign companies operating within the United States increased by about 1 million jobs. In 2004, US affiliates of foreign companies accounted for more than $500 billion in value added (about half in manufacturing) and about $180 billion in exports. Globalization and offshoring work both ways.

Responding to job displacement

Although trade has many positive effects in the labour market, nothing I have written is intended to minimize the real costs imposed on workers and communities when new competition from abroad leads to job losses and displacement. What can be done to help workers who lose their jobs as a consequence of expanded trade?

Restricting trade by imposing tariffs, quotas, or other barriers is exactly the wrong thing to do. Such solutions might temporarily slow job loss in affected industries, but the benefits would be outweighed, typically many times over, by the costs, which would include higher prices for consumers and increased costs (and thus reduced competitiveness) for US firms. Indeed, studies of the effects of protectionist policies almost invariably find that the costs to the rest of society far exceed the benefits to the protected industry. In the long run, economic isolationism and retreat from international competition would inexorably lead to lower productivity for US firms and lower living standards for US consumers.

The better approach to mitigating the disruptive effects of trade is to adopt policies and programs aimed at easing the transition of displaced workers into new jobs and increasing the adaptability and skills of the labour force more generally. Many suggestions for such policies have been made. Currently, the government's principal program for helping workers displaced by trade is the Trade Adjustment Assistance program, which is up for renewal before the Congress this year. As now structured, the program offers up to two and a half years of job training, allowances for job search and relocation, income support for eligible workers, and health insurance assistance for some. Elements of other proposals being discussed include job-training tax credits and wage insurance, which would help offset pay cuts that often occur when displaced workers change jobs. Another approach is to focus on establishing policies that reduce the cost to workers of changing jobs, for example, by increasing the portability of pensions or health insurance between employers. As new technologies expand the range of occupations that may be subject to international competition, measures to assist affected workers become all the more important. It would not be appropriate for me to endorse specific programs; that is the prerogative of the Congress. However, I can safely predict that these and other policy proposals to address concerns about worker displacement will be the subject of active debate in coming years.

More generally, investing in education and training would help young people entering the labour force as well as those already in mid-career to better manage the ever-changing demands of the workforce. A substantial body of research demonstrates that investments in education and training pay high rates of return to individuals and to society as a whole. Importantly, workforce skills can be improved not only through K-12 education, college, and graduate work but also through a variety of expeditious, market-based channels such as on-the-job training, coursework at community colleges and vocational schools, extension courses, and online training. An eclectic, market-responsive approach to increasing workforce skills is the most likely to be successful.

Whatever the specific approaches chosen, helping workers who have lost jobs - whether because of trade or other causes - to find new productive work is good for the economy as well as for the affected workers and their families. Moreover, if workers and their families are less fearful of change, political pressure in favour of trade barriers or other measures that would reduce the flexibility and dynamism of the US economy would be reduced.

Conclusion

To sum up, international trade in goods, services, and assets, like other forms of market-based exchange, allows us to transform what we have into what we need or want under increasingly beneficial terms. Trade allows us to enjoy both a more productive economy and higher living standards.

Of course, current trading arrangements are far from perfect. Some features of the world trading regime, such as excessive restrictions on trade in services and the uneven protection of intellectual property rights, are both unfair and economically counterproductive. Working through the World Trade Organization or in other venues, we should continue to advocate the elimination of trade distortions and barriers in our trading partners even as we increase the openness of our own economy. We should also work to ensure that both we and our trading partners live up to existing agreements under the World Trade Organization. When trading partners do not meet their obligations, we should vigorously press our case. Ultimately, a freer and more open trading system is in everyone's best interest.

Although expansion of trade makes the US economy stronger, the broad benefits of trade and the associated economic change may come at a cost to some individuals, firms, and communities. We need to continue to find ways to minimize the pain of dislocation without standing in the way of economic growth and change. Indeed, the willingness to embrace difficult challenges is a defining characteristic of the American people. With our strong institutions, deep capital markets, flexible labour markets, technological leadership, and penchant for entrepreneurship and innovation, no country is better placed than the United States to benefit from increased participation in the global economy. If we resist protectionism and isolationism while working to increase the skills and adaptability of our labour force, the forces of globalization and trade will continue to make our economy stronger and our citizens more prosperous. ■

1 *Hummels, David (2006). "Transportation Costs and Trade over Time," in David Hummels, Anthony Venables, Harry Broadman, and John S. Wilson, rapporteurs, Transport and International Trade: Round Table 130. Organisation for Economic Co-operation and Development and European Conference of Ministers of Transport. Paris: OECD. Bernanke, Ben S (2006) "Trade and Jobs," speech delivered at the Distinguished Speaker Series, Fuqua School of Business, Duke University, March 30, http://www.federalreserve.gov/boarddocs/speeches/2004/20040330/default.htm, provides a brief history of globalization.*

2 *Based on remarks by Chairman Ben S Bernanke at the Montana Economic Development Summit 2007, Butte, Montana, May 1, 2007*

3 *The estimates ranged from $7,000 to $13,000.*

4 *Cox and Alm (2007) discuss the benefits of trade in the modern global economy.*

5 *Bernard and Jensen (1999) find that exporting firms are more productive than non-exporters. Bernard,Jensen, and Schott (2006) document the tendency of trade to reduce production at low-productivity plants and to increase output at high-productivity plants in the United States, a shift that raises average productivity.*

6 *Refer also to Bhagwati (2004). In Defence of Globalization. New York: Oxford University Press.*

7 *According to the Bureau of Labor Statistics (BLS), over the past ten years, gross job losses in the United States have averaged about 7.8 million per quarter. Multiplying 7.8 million by 4 suggests that about 31 million U.S. jobs come to an end each year. This figure includes temporary layoffs, seasonal closings, and other short-term job losses; some research suggests that longer-term job losses amount to about half of the total (Davis, Haltiwanger, and Schuh, 1996). Dividing 31 million gross job losses by 2 yields about 16 million long-term job losses each year.*

8 *February 2007 is the latest month for which these rate comparisons are available. The data are from the Bureau of Labor Statistics, which has adjusted them to approximate the US definition of unemployment.*

9 *The economic importance of physical proximity is the underlying reason that people and businesses are willing to pay high rents and other costs to live in or near major cities, where they can be near large numbers of other people and businesses that have related expertise and interests.*

10 *Another type of service in which the United States has a strong export position is higher education. In 2005-06, US institutions of higher learning trained nearly 600,000 foreign students, of whom about half were studying for graduate and professional degrees. Many foreign students who study in the United States spend at least some time here subsequently, adding their skills to those of the domestic workforce (Institute of International Education, 2006).*

11 *Mann Catherine L (2006, pp. 140-41) Accelerating the Globalization of America: The Role for Information Technology, with Jacob Funk Kirkegaard. Washington: Institute for International Economics, analyzes changes from 1999 to 2004. Updating the analysis with 2005 data from the Bureau of Labor Statistics does not change these results. Some of the low-wage occupations, such as data entry and word processing, may have lost jobs to automation rather than outsourcing.*

The Giants' Advance: China and India in the World Economy

L Alan Winters, Director of the Development Research Group, and Shahid Yusuf, Development Research Group, of The World Bank

China and India account for about 37.5 percent of world population and 6.4 percent of the value of world output at current prices and exchange rates. As their per capita production and consumption approach levels similar to those of today's developed economies - a standard to which both these Giants aspire - major effects on global markets seem inevitable. A recent World Bank publication asks whether the Giants will continue their current rapid growth and how any such expansion will impinge on other countries. This article contributes to the last question by analyzing the Giants' impact on global goods markets. In particular, it asks whether the Giants will leave any room for low-income countries at the bottom of the industrialization ladder, and whether high- and middle-income countries will see their current advantages in more sophisticated fields erode.

Putting Giants in perspective

In terms of gross domestic product (GDP) China is perhaps one-fifth as large as the United States in current dollars (5.0% of world output compared with 28.6% in 2005) and India is one-sixteenth as large (1.8% of world output in 2005). Thus in terms of impact, a given proportionate shock emanating from Germany or Japan would outweigh one from China, let alone one from India.

In terms of growth, however, China accounted for 13 percent of world growth in output over 1995–2004 and India for 3 percent, compared with the United States' 33 percent, its slower growth rate being offset by its much higher starting share in 1995. Looking forward, we assume that the contributions to world growth shares of the three countries will be 16%, 4% and 29%, respectively, over 2005-2020. These will increase China's share of world output to 7.9% in 2020 (at 2001 prices) and India's to 2.4%.

The significance of this contribution to global economic expansion can be better appreciated by comparing China's takeoff from 1979, with previous large industrializations (India's progress is too recent to be analyzed in this way). Table 1 considers the United Kingdom and the United States over the 18th and 19th centuries. Although, the valuation basis differs from the statistics in the previous paragraph, they do suggest that neither the UK nor the USA administered such a large shock to the global economy as China has already. According to these data, China had an initial share of 4.9 percent and grew 4.4 percentage points per year faster than the world as a whole. Historical growth rates were much lower, even for booming countries, and the nearest parallel to China was the United States over the period 1820–70, during which time the differential was 3.3 percentage points a year for 50 years (with a lower starting share). In absolute terms, the Industrial Revolution was a revolution because, for the first time, it was possible that average per capita incomes might double in a couple of generations. In the United States' heyday, incomes more than doubled in a single average lifetime (i.e. 35 years). At the Giants' current growth rates and life expectancies, incomes would rise more than a hundredfold in a lifetime (75 years)!

Table 1 Comparative Industrialization

GDP at PPP prices

Factor for comparison	China 1978-2003	United Kingdom 1700-1820	United States 1820-1870
Industrializer 's initial share (%)	4.9	2.9	1.8
Industrializer 's annual growth (%)	7.5	1.0	4.2
World annual growth (%)	3.1	0.5	0.9
Growth differential	4.4	0.5	3.3
Number of years	25	120	50

Sources: Maddison 2003.

Economic growth

What lies behind these rapid growth rates, both in the past and the future? Neither is driven by strong population growth in aggregate, but China currently and India in its future benefit from a demographic dividend provided by a youthful and expanding workforce and declining dependency ratios. Urbanization is important in China and will fuel Indian growth as workers move out of the countryside to more productive jobs. Both China and India have made significant advances in basic education in the past two decades. In 2000, adult literacy was 84 percent in China and 57 percent in India, and youth (ages 15–24) literacy rates were 98 percent and 73 percent, respectively. Moreover, both countries are accumulating human capital rapidly, with secondary school enrolment rates of 50 percent and 39 percent, respectively, in 1998. By 2005, India was producing 2.5 million new university-level graduates per year, 10 percent of whom were in engineering. China produced 3.4 million graduates, including 151,000 with postgraduate degrees.

These data presage a significant increase in the Giants' shares of world skills and, hence, changes in their comparative advantages. The McKinsey Global Institute suggested, however, that only about 10 percent of Chinese and 25 percent of Indian graduates currently would meet the standards expected by major US companies; hence,

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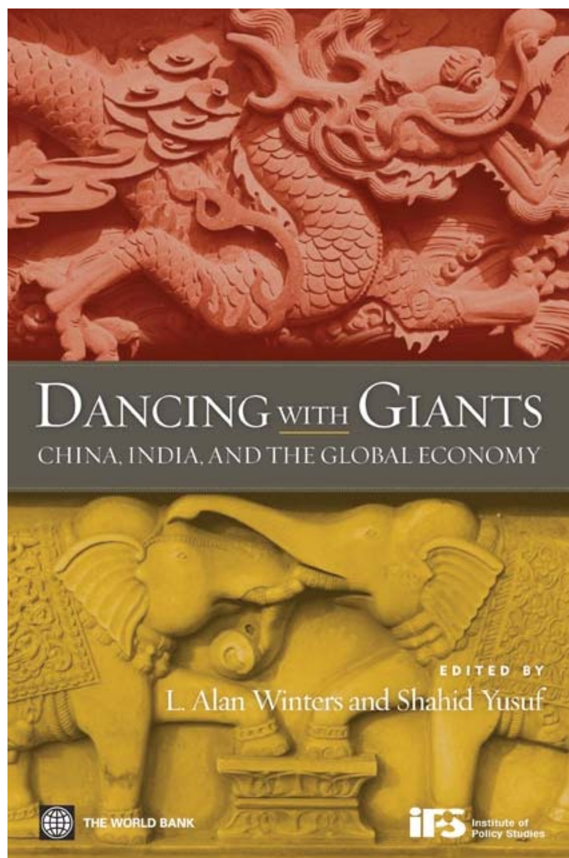
although undoubtedly this will change over time, at present one should not think of the average Chinese or Indian graduate as very highly skilled.

Turning to physical capital, the GDP-weighted average rates of gross capital accumulation were 42 percent and 24 percent for China and India, respectively, over 1990–2003. China's higher rate was largely financed by her prodigious domestic savings rate, and explains somewhat under half of her growth rate. Overall productivity has increased at a highly respectable rate in China and to a lesser degree in India since 1993. The 4% per annum increase in China's factor productivity presumably reflects the reallocation of labour from agriculture and the state sector to market activities, and the entry of highly productive foreign firms, but both economies still have large backward sectors.

China's and India's growth affect other countries through a variety of channels, but international trade is the strongest and most direct. Hence, the remainder of this note considers their trade performance to date (formidable in the case of China), the improvements in the Giants' industrial capabilities, and some numerical projections of the impact of their growth on world trade and their trading partners.



International trade expansion

China's trade expansion since 1978 has been legendary, and since the early 1990s India also has taken off. At 6.3 percent for exports and 5.5 percent for imports, China's shares of world goods and services trade exceed its GDP share. This is extraordinary for such a large economy, although in part it reflects China's integration into Asian production chains. Through this integration, perhaps as much as a third of the recorded value of exports (measured gross) comes from imported inputs rather than from local value added, which is what GDP measures. With annual growth at 15.1 percent per annum over 1995–2004, China provided almost 9 percent of the increase in world exports of goods and services (second only to the United States), and 8 percent of the increase in imports (also second to the United States). Within these aggregates, China is a significant importer and exporter of manufactures, with global market shares of 6.2 percent and 7.7 percent, respectively, in 2004. Manufactured imports comprise mainly parts and components for assembly activities and capital equipment, whereas exports substantially are finished goods.

Part of the increase in China's materials imports is balanced by corresponding declines in the countries from which China has displaced manufacturing. Indeed China has taken to observing that the fruits of her high carbon emissions are substantially reaped by consumers in OECD countries who import Chinese manufactures. Most of the increase, however, represents a net rise in demand: millions of Chinese consumers are starting to buy consumer durables and other goods as they grow richer, and low Chinese export prices are stimulating consumption elsewhere in the world.

The data on the total consumption of various primary products reinforce the importance of China and India in world commodity markets. In metals and coal, China always is ranked first, with shares of 15 to 33 percent of world consumption, and the United States is ranked second or third; in total energy terms, the United States is first (23%) and China second (13%). The Giants also are important consumers of agricultural commodities, and here India figures prominently, leading the world in consumption of sugar and tea, and second to China in rice. Even more striking is China's growth in imports of primary products. Soybean consumption has increased at 15 percent a year recently, and soy and palm oil consumption by 20 percent and 25 percent, respectively. Oil is currently particularly sensitive, but here the roles of China and India are less critical than often imagined. It is true that they account for half of the increase in oil use this century, but their shares of world oil consumption are still modest—9.0 percent and 3.1 percent, respectively, in 2005.

Increasing commodity demand from the Giants obviously supports prices, other things being equal, but prices also depend on supply. Most analysts hold that, in recent years, Chinese demand has increased most metals prices because supply growth has not kept up with demand. The exception that (loosely speaking) proves the rule is aluminum, for which China is a net exporter and produces about 25 percent of the world total. Compared with price increases of 379 percent for copper from January 2002 to June 2006, aluminum prices increased by only 80 percent. Similarly for oil: both through the recent past and in our forward-looking projections, the sensitivity of world oil prices to the Giants' demand is fairly low although in both countries transport and residential demand for energy will be soaring. The recent spike in oil prices owes more to constraints in, and concerns about, supply than to excessive demand increases.

India's trade in goods has not been remarkable to date, but it is starting to increase as barriers come down. The country accounted for about 2 percent in the growth of world exports and imports over the period 1995–2004. India's largest single export is gemstones (one-eighth of visible exports in 2004), but manufacturing is the largest export category and is now starting to grow strongly. The most dynamic export sector in India, however, is information technology (IT)-enabled services for global companies, including call centres and software application, design, and maintenance. Such activities require qualified English-speaking labour, of which India has an abundant, low-cost supply. Despite their dynamism, however, India's overall exports of commercial services ($40 billion in 2004) are less than those of China ($62 billion), and neither country has a large world share (1.8 percent and 2.8 percent of world services exports, respectively).

The IT sector accounts for only 6 percent of services turnover in India, and employs perhaps 3 million people. Moreover, it tends to be focused at the low to middle end of the business. Thus, while the buoyancy of this sector is heartening for India's growth prospects, services trade alone does not look likely to transform Indian economic performance.

Industrial geography: the evolution of comparative advantage

The key question for the future is how China's and India's international trade is likely to develop. Before getting to specific numbers, it is worthwhile to consider some qualitative trends in industrial and service capabilities: both India and China have demonstrated the ability to upgrade their performance in specific sectors. As just noted, although services exports will be important for India, we do not see them presaging a completely new development model; and China's appetite for primary imports seems bound to continue growing. Hence, the future pattern of manufacturing production and exports is likely to be central to development in both countries.

The principal drivers in the Giants are large domestic middle-class markets (currently about $1 trillion per year in China and $250 billion annually in India), and large supplies of labour supplemented, at least in China, by improving industrial capability stimulated by domestic

and foreign investment. The first driver creates a base for industries with large economies of scale, and the second will tend to keep wages down and help maintain labour-intensive industries. These features combine to favour certain mid-tech and high-tech sectors, such as autos, electronics, and domestic appliances and, in the future, pharmaceuticals and engineering. These sectors have seen rapid recent advances in technology and organization, and have strong future prospects.

In China, the continuation of low-skilled, labour-intensive manufacturing seems feasible, but not in the traditional manufacturing centres along the eastern seaboard where production costs are rising. Some adjustment undoubtedly will prompt less-skilled sectors to relocate abroad, including to India, but it also is likely that some will move to inland centres where the large agricultural reserve of labour could be trained and mobilized for industrial work. The increases in outputs and incomes following this movement inland would be part of the payoff for recent huge investments in infrastructure.

Higher education also is booming in China, with a large share of its graduates in science and engineering and, of course, many skilled Chinese citizens who live abroad and could return. A concentration of the best Chinese brains coupled with the rapid increase in spending on R&D, currently almost 1.3% of GDP, could make China a major force in some sophisticated sectors. However, the demand for skills in public service, general management, and education could constrain the emergence of such technological or innovative leadership for some time in many sectors. One consequence of this is that China will continue to import sophisticated goods, including capital goods, from abroad.

China currently sits at the centre of production networks spanning Southeast and East Asia. The policy of offering duty-free access to imports of components for exports while protecting the local producers of both intermediate and final goods for the domestic market undoubtedly encouraged Chinese openness. This policy is beginning to unwind as productivity increases and the domestic market grows, making it more attractive to relocate the manufacture of components from Southeast Asia to China. Thus, the biggest uncertainty probably faces the suppliers of intermediates to Chinese industry, mainly in East and Southeast Asia.

India is smaller and poorer than China and, as argued above, India has not yet proved to be a major force in international manufacturing. So far, India has had export success in textiles and clothing, and, given its abundance of unskilled labour, it seems almost bound to continue to sustain a competitive edge in these industries. It is also a growing player in pharmaceuticals, building on its base of seasoned corporations, its ample supplies of graduates, and its potentially large home market. For the same reasons, India also is acquiring a reputation in some specialized engineering and services sectors. Other major industries show potential for expansion - steel, white goods, electronics - but probably mainly for the home market over the next two decades. Thus, although one may anticipate robust growth in Indian manufacturing over the next decade, there does not appear to be a strong likelihood of “disruptive” exporting occurring.

Despite this catalogue of potential successes, China and India cannot have comparative advantage in everything. What, therefore, does all of this mean for other countries? To answer this question we need an approach that recognizes that other countries must both buy and sell to the Giants.

General equilibrium

Our analysis of the trade consequences of the Giants’ growth addresses uses a simulation model that imposes a firm internal consistency that requires, for example, that imports and exports roughly balance, and that demand equals supply for each good and factor of production. When considering such huge shocks as the more than doubling of the Giants’ economies, this discipline is extremely important.

Our exercise starts by “rolling the world economy” forward from its base in 2001, for which we have a consistent database of millions of pieces of information, to 2005. This entails allowing for the enlargement of the European Union, the final liberalizations mandated by the Uruguay Round, India’s recent liberalization, and Chinese accession to the World Trade Organization. We then postulate a continuation to 2020 of India’s current tariff and trade reforms, and apply exogenously given estimates of the growth of productivity and factor supplies in all countries and regions. From this we project a base view of the world economy in 2020. It projects, for example, a 66% increase in world output, including a more than doubling in the Chinese and India economies, a 72% increase in world trade, significantly rising oil prices relative to 2001 and rising food prices.

From this base we next ask what if India and China grew faster by 1.9 percentage points and 2.1 percentage points a year, respectively, as a result of faster productivity improvements in all industries? This simulation gives a direct indication of the effects of the Giants’ advance, and we analyze it both alone and with an added assumption that the productivity increase results in an increase in the range and quality of China’s and India’s export products. There are three broad effects on other countries: their exports face fiercer competition because the Giants’ costs fall; their imports from the Giants become cheaper; and they benefit from aggregate demand increases, both in the Giants and in other countries as they sell to the Giants and increase their efficiency with the improved Chinese and Indian inputs. The balance of these forces varies from country to country, but because most countries import significant amounts from the Giants and all get a share of the increase in aggregate demand, most countries gain overall from the incremental growth of the Giants. The exceptions are certain countries in Southeast Asia, the rest of South Asia, and Europe, where the effects of increased competition predominate. These countries still record large increases in real income over 2005-2020, however, because of the underlying trends; it is just that their increases are reduced a little by the Giants’ growth, the Philippines and Singapore, being the two hardest hit.

Even for the net gainers, however, painful adjustment is necessary. The Giants achieve major gains in their market shares in manufacturing, so most other countries experience declines in manufacturing output relative to base, especially in clothing and electronics, which are the most sensitive to competition. Thus, even if the Giants’ success is generally good news for other countries as a whole, within those countries there will be gainers and losers.

These results suggest that an important concern for other countries will be the extent to which the Giants, especially China, move up market into their “product space” - in terms of both products and quality within them. This view is reinforced by further simulations that restrict technical progress to the sectors identified above as gaining competitiveness – metals, electronics, machinery, motor vehicles and commercial services. Even though world output increases by less than in the previous simulation (because the productivity gain is restricted in coverage), the growth in world trade is three times larger because China and India receive a boost in their current exporting sectors and they have to sell their extra output abroad. Other countries must correspondingly adjust their output patterns to accommodate these shocks, often halving output in machinery and electronics and nearly doubling it in clothing, leather, and wood (again, relative to the base). This suggests that individual manufacturer's fears about Chinese and Indian competition may be justified. However, only a full analysis such as ours can show that the offsetting benefits from cheaper imports and stronger world growth are generally larger.

Modeling exercises like these are parables, not predictions. The results do show, however, that the consequences of the Giants’ rise could be large in particular sectors, that suitable adjustments to the new circumstances would enable most countries to win, and that no country’s overall growth trajectory is seriously disturbed by the Giants’ growth.

Dance steps: responses to the rise of China and India

The rise of China and India as major trading nations in manufacturing and services will affect world markets substantially. The question that remains is, how should these others respond to these new opportunities and challenges - how should they dance with the Giants? Part of the answer is generic. Any country will be better placed to take advantage of new markets and to weather competitive pressure if it creates a healthy investment climate and invests soundly

in infrastructure and human resources. And, given the impossibility of predicting precisely in which sub-sectors threats and opportunities will arise, there will be a premium on flexibility - creating circumstances in which entrepreneurs are able to experiment, expand on success, and withdraw cleanly from failure.

Beyond this general advice policy responses should depend on country circumstances. Very briefly, resource poor low-income countries need to prepare to move into markets vacated by the Giants as their costs rise. Resource rich countries will receive an income boost from rising primary prices; they need to focus on managing the related volatility, sharing the gains equitably and investing in diversification. The middle-income countries probably face the biggest shocks: they need to create conditions for innovation to cope with China's technologically dynamic companies such as Huawei and Lenovo and for integration into global production chains – especially through investment in human capital. Finally developed countries need to keep calm. At least for another couple of decades their comparative advantage in skills and innovation is not seriously threatened, and they are huge gainers from the supply of cheaper manufactures. ■

Easy Money: Global Liquidity and its Impact on New Zealand

Alan Bollard is the Governor of the Reserve Bank of New Zealand

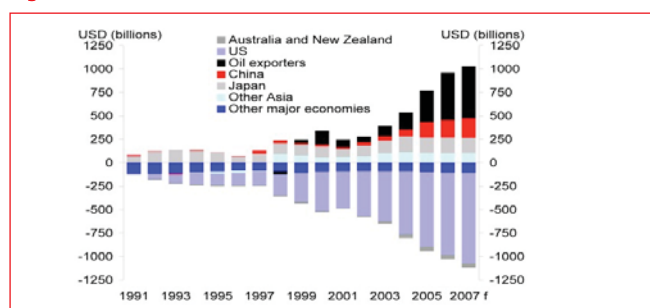
What has been happening to global liquidity?

Globalisation has had major effects on the New Zealand economy over the last decade or two. Monetary policy has certainly not been immune. Some of the impact has been very helpful to us in our primary task of achieving price stability. We have enjoyed a useful disinflationary impact from the flood of cheap manufactures available from China and other newly industrialising countries. We have enjoyed the benefits of trading with a buoyant world that has been enjoying good stable growth rates with stable prices. More recently however, we have had to focus on a related phenomenon which has had some unanticipated effects: the growth of global liquidity.[1]

- global liquidity has increased dramatically over recent years. In our part of the world, this reflects:
- a surplus of savings relative to investment in the East Asian and oil-exporting countries;
- new players, new products, new transactions and markets; and in particular
- the impact of the "carry trade" fuelling investment flows into a range of markets.

A feature of the period of relatively strong growth in the world economy over the past several years has been large and growing financial imbalances among the world's major economies. The US current account deficit has increased significantly over this period, although it has stabilised over the past year relative to the size of the US economy. Meanwhile, most East Asian countries have consistently run current account surpluses since recovering from the 1997/98 financial crisis, when many experienced deficits. More recently, the rise in oil prices has underpinned a substantial increase in the surpluses of the oil exporting nations.

Figure 1: Current Account Balances

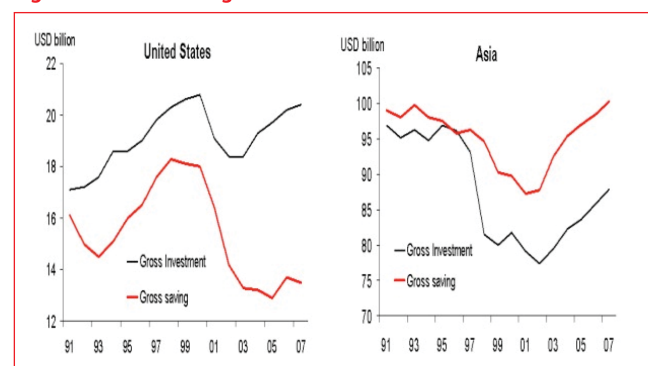


Source: IMF World Economic Outlook, September 2006; RBNZ

These relative current account positions broadly reflect the contrasting balances between saving and investment in these countries. In the case of the deficit countries – such as the US, Australia and New Zealand – investment has exceeded saving, with the excess savings of surplus countries financing the shortfall. Excess savings relative to investment amongst the surplus countries has increased substantially since the late 1990s, led by Asia, a range of developing countries and more recently the oil exporters. This has given rise to a phenomenon that US Federal Reserve Chairman Ben Bernanke has referred to as a "global savings glut".[2]

For many of these countries – particularly the developing economies – this represents a considerably different set of circumstances to that existing prior to the late 1990s, when developing economies (including many of those in Asia) were net recipients of capital. In the case of the developing economies in Asia, the response to the 1997/98 financial crisis has been to focus on export-driven growth and the associated accumulation of foreign exchange reserves – a strategy that most are continuing to pursue almost a decade after the crisis. The strength of exports relative to domestic demand has seen saving outstrip investment in most of these economies – even in the case of China, where investment growth has been very strong. Accordingly, we have the ironic situation whereby a range of developing countries are (in net terms) the providers of capital to some of the world's most developed economies. This rapidly rising "savings glut" has been a principal source of increased global liquidity.

Figure 2: Gross saving and investment



Source: IMF World Economic Outlook, September 2006; Economics@ANZ

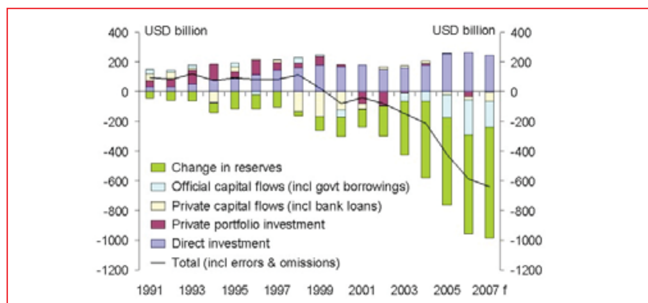
How is this being recycled?

Along with financial deregulation and the general opening up of economies, the flow of increased global liquidity through markets has provided the impetus for many changes. In a recent speech,[3] Malcolm Knight, General Manager of the Bank for International Settlements, highlighted a number of important new features:

- the unbundling and re-pricing of risk through major advances in financial engineering, resulting in improved ability to lever lending via new markets such as for credit transfer products;
- the emergence of new financial players such as hedge funds and private equity firms that have not been traditional intermediaries;
- more reliance of financial firms on markets to handle growing complexity;
- a reliance on market liquidity even in stress situations; and
- a surge in volume and value of transactions.

The search for means to generate a return on this liquidity has spurred massive growth in securitisation of debt and the development of a vast array of derivatives. The propagation of these instruments can itself be seen as a source of liquidity growth and, by some estimates, a substantial one at that. From a monetary policy perspective, this implies a very big increase in the liquidity that is not directly controlled by central banks.

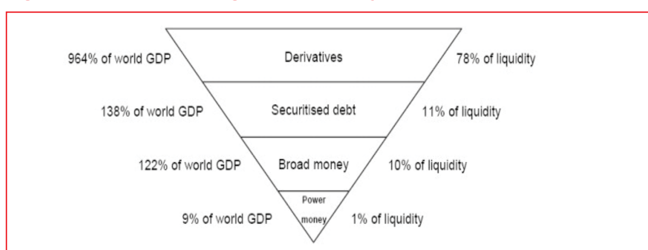
Figure 3: Capital flows to developing economies



Source: IMF World Economic Outlook, September 2006; Economics@ANZ

A particular development of interest to us has been the increasing integration of housing finance into these liquid international markets. A recent article in the *Financial Times*[4] reports on a significant slice of new mortgages in Hungary being issued in Swiss francs while households in Latvia and Romania are borrowing in yen. The article then goes on to focus on what they see as one of the biggest flows, the bonds denominated in NZ dollars by European and Asian issuers.

Figure 4: Estimates of global liquidity



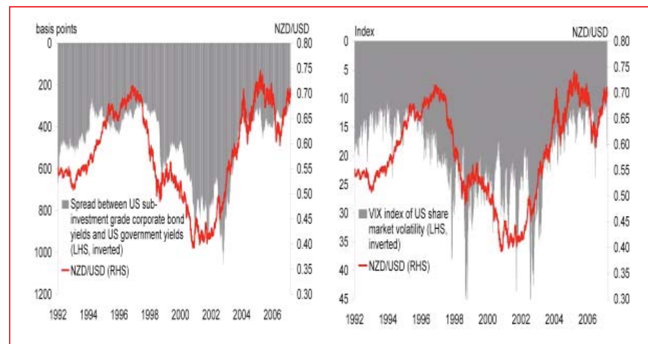
Source: Independent Strategy

What are the global effects of this liquidity?

The flows associated with the growth of global liquidity has played a role in helping to prolong the period of strong global growth seen in recent years. The associated search for yield has pushed down interest rates, bid up equity prices and generally put downward pressure on returns across a range of asset classes.

Many of these effects have been clearly welfare-enhancing. But in contrast to how markets might have reacted a decade ago, it has also allowed less disciplined economic behaviour by some households and firms. It has allowed global imbalances, particularly those associated with the contrasting current account positions of the major economies, to build up and persist beyond what might have previously been considered sustainable. It has meant that when large economies operate with distortions in their own markets, those distortions can be felt halfway around the world.

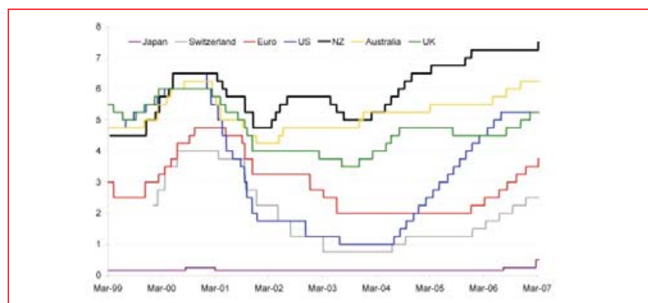
Figure 5: Risk aversion and market volatility



Source: Bloomberg; DataStream

Risk appetites in global financial markets have generally been very strong in recent years. This perhaps reflects the extended period of relatively strong growth in the world economy underpinning investor confidence. This confidence has been bolstered by generally low market volatility, which has also lowered perceptions of risk.

Figure 6: Global policy rates

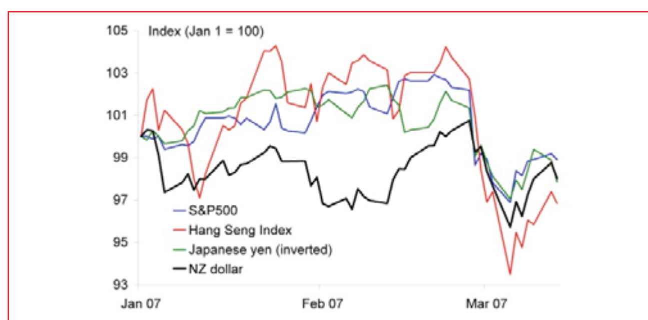


Source: DataStream

Perceptions of a relatively benign risk environment have provided the basis for investors to engage in a vast range of so-called "carry trades". These involve borrowing to invest in an asset that is either yielding – or is expected to yield – a higher rate of return than the borrowing cost. In this regard, relatively low risk aversion and market volatility are important conditions for carry trades, so that traders are less fearful that sharp market moves could eliminate the expected yield differential. Currency carry trades, whereby investors borrow in low interest rate currencies to invest in higher interest rate currencies, have been some of the most popular. Relatively low interest rates in some economies, particularly Japan and Switzerland, have been used as the basis for a raft of leveraged investments and in so doing have further fuelled global liquidity.

The events of the past few weeks have provided a timely reminder of the importance of low risk aversion and market volatility for the carry trade. Fears sparked by a sharp retracement in China's share market and growing concerns regarding the ramifications of problems in the US sub-prime mortgage market saw investors rush to reduce positions in a range of markets. Notably, this episode saw currency carry trades scaled back, with funding currencies strengthening and recipient currencies weakening – although the sell-off proved highly correlated across a wide range of asset classes. This period of turbulence has proved relatively contained to date, with risk appetites and markets recovering. But it does demonstrate the potential widespread impact of an increase in risk aversion and market volatility.

Figure 7: Market developments since the beginning of the year

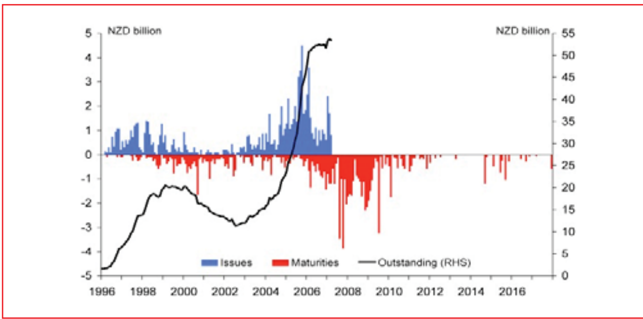


Source: Bloomberg

How does it impact on the NZ economy?

Given our relatively high interest rates, New Zealand has attracted a disproportionate share of global liquidity in recent years, putting upward pressure on the NZ dollar despite a relatively large current account deficit. These flows have come in many forms. One particular avenue has been the issuance of NZ dollar denominated bonds in offshore markets: Eurokiwi and Uridashi bonds. The derivative transactions associated with Eurokiwi and Uridashi issuance have provided a mechanism for the New Zealand banks to hedge the interest rate and currency risks associated with their offshore borrowings at cheaper rates than would otherwise have been the case. The upward pressure this has put on the New Zealand dollar and downward pressure on interest rates has exacerbated the current problematic imbalance between traded and non-traded sectors in New Zealand.

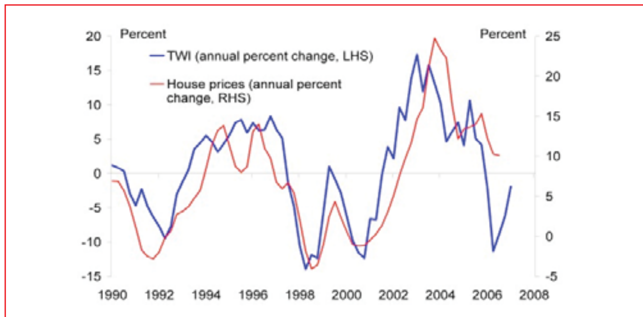
Figure 8: Offshore NZ dollar denominated bond issuance (Eurokiwi & Uridashi bonds)



Source: Reuters; Bloomberg; RBNZ

But it is important to recognise that the attractiveness of the NZ dollar for offshore investors is not just a reflection of the current level of interest rate differentials, but also investors' views regarding their sustainability. In this regard, it is interesting to note the relatively close correlation between house prices and the NZ dollar over the last 15 years. Without claiming a direct relationship between the two, this goes some way to illustrate the extent to which persist domestic inflation pressures have underpinned the outlook for interest rates, which in turn has maintained upward pressure on the NZ dollar. Accordingly, a sustained retracement in the NZ dollar from the highs seen in recent years could be contingent on our efforts to rein in domestic inflation pressures.

Figure 9: House prices and the NZ dollar Trade Weighted Index (TWI)



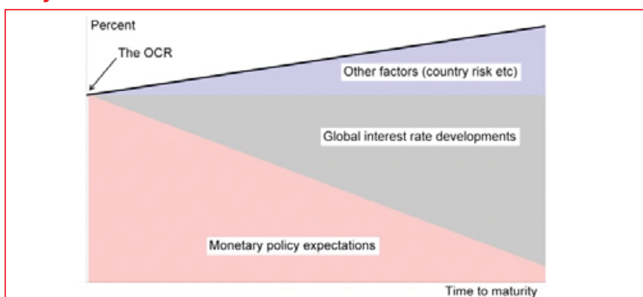
Source: Quotable Value; RBNZ

Of course the inward capital flows that have kept pressure on the NZ dollar would not have happened without a strong domestic demand for borrowing. In this case it is New Zealand households' desire to keep investing in housing, while at the same time consuming strongly, that fuels their demand for funds, and represents the other leg to these international transactions.

How does it affect monetary policy?

No central banker today can ignore these effects on domestic monetary policy. A recent speech by Ben Bernanke[5] observed that financial market globalisation has made the Fed's analysis much more complex. He notes that even for the US there is no such thing as total monetary independence. For example, correlations between long term interest rates in the US and other industrial countries have risen significantly. Having said that, he concludes that, despite Alan Greenspan's term of "conundrum", this has not significantly constrained their ability to influence domestic financial conditions.

Figure 10: A stylised representation of the relative influences on the yield curve

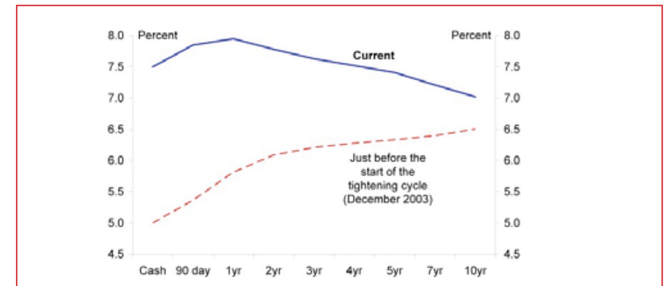


Source: RBNZ

This is more problematic for a number of small open economies with higher interest rates – not only New Zealand, but also Iceland, Hungary, Australia and South Africa. The downward pressure created by abundant global liquidity on market interest rates has had implications for the operation of monetary policy. In general terms, the Reserve Bank has most impact on the shorter end of the yield curve, both by setting the OCR itself and influencing market expectations about the outlook for monetary policy. But further out the yield curve, other factors – including global interest rate developments and country risk premia – also influence interest rate levels.

Low global interest rates have restrained the rise in longer-term interest rates relative to the upward pressure monetary policy has been able to exert on shorter-term interest rates during this tightening cycle. This has seen the yield curve progressively flatten and become negatively-sloped during the past few years.

Figure 11: The change in the yield curve since the beginning of the tightening cycle

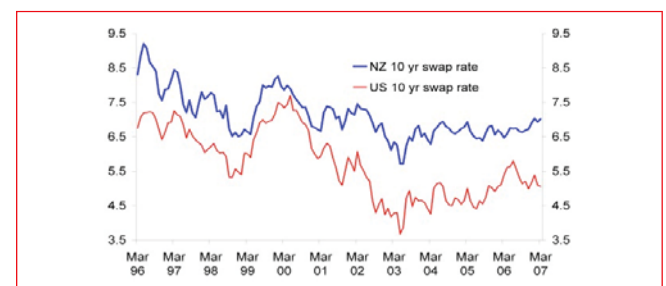


Source: Bloomberg

A negatively-sloped yield curve has encouraged borrowers to take out term loans at relatively lower rates. Households in particular have favoured fixed rate mortgages, which now account for more than 80 percent of mortgage borrowing, and increasingly for longer terms. This has muted and delayed the impact of policy tightening in this cycle, although we have now seen the effective mortgage rate rise by around 110 basis points since its lows in late 2003.

A further practical constraint for us has been that, although the TWI is influenced by a wide range of global events, in recent years we have not wished to add to upward pressure on the NZ dollar. We have also remained conscious of our obligation to avoid unnecessary instability in output, the exchange rate and interest rates, as required under section 4b of the Policy Targets Agreement. This has meant we have been more cautious in our OCR tightening path than might otherwise have been the case.

Figure 12: New Zealand and US long term interest rates



Source: Bloomberg

Figure 13: The OCR and the effective mortgage rate

Source: RBNZ

New Zealand policy in a global context

The circumstances we face at present do not necessarily represent an enduring structural change in the environment in which policy operates. At some stage in the future when the large East Asian trading blocs are able to trade currencies and products with the world at more sustainable prices, a significant distortion to our own rate setting process will be removed. However, for that we must wait for G-7, Doha and other international forces to do their work.

As for New Zealand, we need to see realisation amongst borrowing households and lending banks that this recent period of cheap international money has been unusual, and at some point will revert to more normal financial conditions. That means thinking about other eventualities ahead, and in some cases showing less exuberance.

Monetary policy always impacts with long and variable lags. Those lags have been longer in this cycle, but as household debt grows the OCR becomes a more potent policy instrument. We are continuing to assess alternative measures that might support the OCR, working with the relevant government agencies. These include a tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle. However, we will continue to rely on the OCR as the primary instrument of monetary policy. ■

1 *Based on a speech by Reserve Bank Governor Alan Bollard to the Wellington Chamber of Commerce on Thursday 15 March 2007*
2 *The Global Saving Glut and the US Current Account Deficit, March 2005*
3 *"Now you see it, now you don't: risk in the small and in the large", February 2007*
4 *"Why the yen borrowing game could end in players taking a tumble", 14 February 2007*
5 *"Globalisation and Monetary Policy", March 2007*

Financial Stability Implications of Changes in the International Investor Base and the Globalization of Financial Institutions

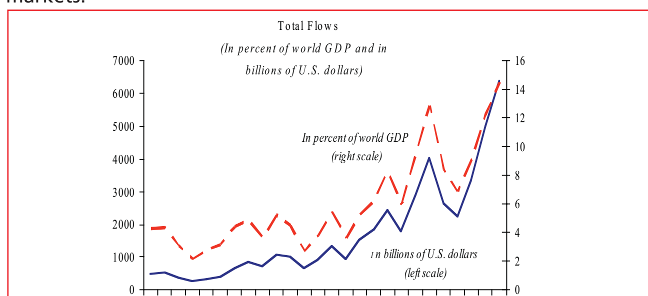
Jorge Chan-Lau and Mangal Goswami are in the Monetary and Capital Markets Department of the International Monetary Fund

Introduction

Favourable global economic prospects, including strong momentum in the euro area and in emerging markets led by China and India, continue to serve as a strong foundation for global financial stability. However, some developments in the international investor base and the continuing process of globalization of financial institutions warrant attention. The increasing diversity that can be observed in the mix of assets, source countries, and types of cross-border investors helps, for the most part, to stabilize global markets. But the trend has been reinforced by low interest rates and low volatility in many mature markets, which has made investors seek higher-yielding assets across the globe. Similarly, the globalization of financial institutions may have helped to reduce risks for individual institutions, but it has also fostered increasingly complex international linkages that do not necessarily enhance the resilience of financial systems. These two issues, and their potential implications, are examined below.[1]

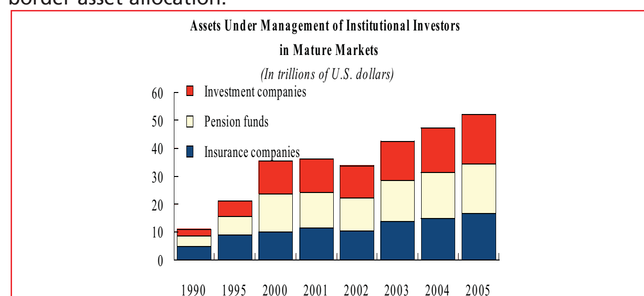
Implications of changes in the international investor base

Financial globalization has manifested itself in the tripling of cross-border capital flows to $6.4 trillion (2005 data) over the past decade. This has fostered unprecedented growth and deepening of financial markets. Much of this phenomenon has been driven by the broadening of the investor base, aided by a sharp increase in savings channelled into financial instruments across borders, technological innovations and faster information flows accompanied by financial liberalization. Such dynamics have enabled investors to diversify into new markets and new instruments. Certain classes of investors, such as private institutional investors from mature market (MM) economies and official institutions from emerging market (EM) economies, have gained in importance in global financial markets. Analyzing these changes in the international investor base and their investment allocation behaviour is fundamental to understanding the build-up of strengths and weaknesses in international financial markets.



Source: IMF staff calculations on data from IMF, International Finacial Statistics and World Economic Outlook.

The forces that continue to shape the global financial landscape and influence investor decision making are both cyclical and structural in nature. Cyclical factors include high levels of global liquidity and low real and nominal interest rates for much of this decade, and consistently strong growth in many parts of the world. These factors have influenced investor decision-making as a broad set of institutional investors have used "carry trades" by deploying their capital from low-interest-rate countries to markets where returns are higher. Structural factors such as demographic changes, changes in accounting and regulatory frameworks, and windfall gains accruing to commodity producers, have also led to increase in asset accumulation and changes in asset allocations. Indeed, assets under management of mature market institutional investors have more than doubled over the past decade to about US$53 trillion in 2005. US institutional investors accounted for about half of this amount and continental Europe for over a quarter, followed by Japan and the United Kingdom. This increase in assets under management of traditional investors has been accompanied by a decline in home bias (defined as portfolio allocations being biased toward home country instruments) and increased investment in internationally oriented hedge funds. The official sector has also become a key player in cross-border asset allocation.



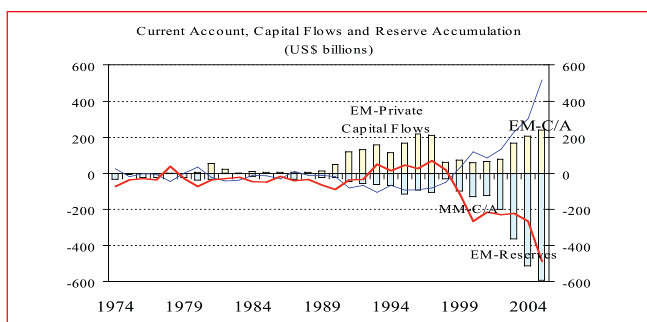
Source: International Finacial Services, London; OECD; and IMF staff estimates

Pension fund assets have expanded significantly and their decision making process has also been changing. In particular, because of the increase in expected liabilities of pension funds, such investors have sought to diversify investment strategies that not only match more closely their liabilities but also achieve the highest risk-adjusted return. Portfolio allocations of the institutional investors, such as pension funds and mutual funds from mature market countries, have been characterized by an increase in their investments in emerging markets. Part of the increase reflects "pull factors" such as robust and diverse growth opportunities and the opening of economies, including financial sectors, to foreign investors. But "push factors" such as the low level of interest rates in many mature markets have also increased the demand for financial instruments in EM countries. Dedicated US EM mutual funds have been growing rapidly, from $27 billion in late 2000 to about $230 billion as of mid-2006, albeit with some periods of volatility. In an asset management survey of 175 global financial services executives, around two-thirds of the

respondents said globalization would be the main profitability driver going forward.

Institutional investors are increasingly relying on hedge funds as a vehicle to achieve higher returns. Pension funds have become important investors in hedge funds. Lower returns from conventional investments have induced a change in the investment behaviour of institutional investors, making them more attracted to absolute return investments and leading them to actively seek "alpha" — the excess return on a particular asset. According to market estimates, assets under management of the hedge fund industry, though small compared to other institutional investors, have grown from US$30 billion in 1990 to more than US$1.4 trillion at the end of 2005. Global institutional investors' capital allocated to hedge funds is estimated at US$360 billion at the end of 2005, representing 30 percent of total hedge fund assets.

Emerging market countries, though still a small share of overall capital flows, have seen their share grow significantly due to the large current account surpluses of Asia and, more recently, oil exporters. Emerging market countries, as a group, have become net exporters of capital and an important investor class in mature markets over the past five years. The contribution to cross-border flows from Asia — the emerging economies, newly industrialized economies (Hong Kong SAR, Korea, Singapore, and Taiwan Province of China), and the oil-producing countries — has risen significantly since 2000, with their outflows mirroring the US external financing gap. This notable shift that casts a spotlight on global payments imbalances is primarily driven by the official sector in emerging markets, particularly central banks and sovereign wealth funds. Gross official reserves have more than doubled since 2002 to reach nearly US$5trillion by September 2006. In addition, the governments of commodity producing countries have become large investors in financial instruments, in particular bonds and equities, through sovereign wealth funds. Market estimates indicate that these funds manage more than US$1.4 trillion. Indeed, the volume of US treasury securities held by foreigners has more than tripled over the past decade, and the acquisition by foreign official institutions has contributed significantly to this build-up. By end-2005, foreign official institutions were estimated to be holding more than 50 percent of all foreign-held US long-term securities.



The globalization of capital flows and the changes in investor base have implications for financial stability, both positive and potentially negative. A more globally diverse investor base, representing different types of institutions and different countries, is less likely to suffer simultaneous, symmetric, and significant shocks and therefore may be better able to manage risks and absorb shocks during a period of stress. Moreover, long-time horizons and lower leverage of institutional investors like pension funds imply greater propensity to ride out market volatility. Also, from the global imbalances perspective, the globalization of capital flows and the attractiveness of the US financial markets have supported inflows that have financed the US large current account deficit. That said, the speed and the magnitude that these changes are taking place may temporarily distort prices in financial markets and create pockets of vulnerabilities. Investors may not have adequately factored in the possibility that a "volatility shock" may be amplified given the increased linkages across products and markets, especially with volatility across asset classes close to historic lows and spreads on a variety of credit instruments tight. Furthermore, while the wider dispersion of risk enhances the resiliency of financial markets, the identification of the ultimate holders of risk is now more tenuous in a world of complex new instruments and the co-mingling of the different investor classes seeking cross-border investment exposures. This makes it difficult to map capital flows to the investor base and the analysis of cross-border asset allocation highly difficult.

Capital inflows to many emerging markets have risen rapidly, in part reflecting improved economic fundamentals, but also reflecting the search for yield given low interest rates in most mature markets. In some emerging market countries, increased demand has outpaced the availability of domestic financial assets, leading to a sharp increase in asset prices, rapid credit growth, and currency appreciation. While in many EM countries the sovereign external debt has become less risky, international issuance of corporate debt and equities has risen rapidly to accommodate investor demand. As a result, investors have been venturing down the "credit ladder" into investments in which they have little experience. Such concerns are amplified by the growing role of leveraged investors, such as hedge funds, that may introduce a greater potential for asset prices to overshoot during good times, increasing the probability of downside risks when financial conditions worsen.

Adapting to the changing world of globalized financial markets and the internationalization of the investor base is a daunting challenge from a regulatory and supervisory standpoint. The efficacy of balancing policies to capitalize such dynamics, while fostering financial stability, is likely to continue to evolve as markets become more sophisticated. Therefore, the focus of prudential regulation and supervision will have to shift towards international risks conveyed through financial market instruments. Countries can reduce vulnerabilities by developing sound markets and instruments and by providing the enabling environment for market participants to share and transfer risks to those most able and willing to bear them.

In order to capitalize on the globalization trend, recipient countries have to continue to establish a track record of credible macroeconomic policies. Vulnerabilities can be reduced by promoting efficiency, stability, and the effective regulation of domestic capital markets (including the development of local debt markets) so as to increase their attractiveness to a stable investor base. Liberalization of capital outflows from domestic investors, though not a panacea, may help balance the effects of capital inflows and allow domestic investors to better manage their risk. Last but not least, mechanisms to deal with considerable gaps in global financial information flows can facilitate a more effective oversight.

Implications of the globalization of financial institutions

Financial institutions have globalized in response to a wide range of motivations. These include the expectation that knowledge and efficiencies in undertaking business and underwriting risk in one market can be transferred into others; that economies of scale and scope can be achieved when operating multi-country operations; and that a cross-border group can better allocate a large and stable capital base profitably across business lines to those where profitability is expected to be greatest, while also diversifying risk.

Greater globalization of financial institutions has also interacted with broader structural changes in the financial sector. Deregulation and increased openness to foreign intermediaries in many countries have facilitated the emergence of conglomerates combining banking, securities, asset management, or insurance activities in one organization; mergers and acquisitions (M&A) have led to *consolidation* of the industry; ongoing *securitization* and the expansion of derivatives markets have allowed institutions to transfer within and across borders a range of risks that had previously been held on their balance sheets;[2] and risk management capacities in general have been strengthened within institutions.

Improvements in information processing, telecommunications, and financial technologies have played an important role in spurring the globalization of financial institutions. For example, technological innovation in risk management, back-office support, and transaction processing has enabled banks to manage risks at lower cost without geographic proximity to the customer. Similarly, in the insurance sector, information technology advances enable consolidated cross-border databases to be maintained on actuarial, claims, underwriting, and policyholder data.

These trends have, inter alia, created larger institutions with a greater international scope, frequently operating in multiple sectors ("large,

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Financial Industry Mergers and Acquisitions, 1996–2006 1/

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
					(in billion USD)						
By regions											
Developed Countries 2/	76.4	238.9	477.5	362.0	459.5	306.0	215.0	302.1	442.1	513.0	778.5
Cross-border	0.3	0.0	8.3	4.9	56.2	79.6	93.1	80.0	117.9	174.9	273.8
Rest of the world	2.7	4.8	23.7	16.2	42.5	70.2	44.1	28.8	57.3	85.3	124.1
Cross-border	0.0	0.2	0.0	2.0	8.5	29.5	17.6	14.8	22.2	54.6	85.6
Total	79.1	243.7	501.2	378.2	502.0	376.1	259.1	330.9	499.4	598.2	902.5
Cross-border	0.3	0.2	8.3	6.9	64.8	109.1	110.6	94.9	140.1	229.4	359.5
					(in percent of total)						
Cross-border M & A											
Developed Countries 2/	0.3	0.0	1.7	1.3	11.2	21.2	35.9	24.2	23.6	29.2	30.3
Rest of the world	0.0	0.1	0.0	0.5	1.7	7.8	6.8	4.5	4.5	9.1	9.5
Total	0.3	0.1	1.7	1.8	12.9	29.0	42.7	28.7	28.1	38.4	39.8

Source: Bloomberg L.P. 1/ Includes only deals where both the target and the acquirer are classified as a financial institution. 2/ Australia, Canada, Japan, New Zealand, the United States, and Western Europe.

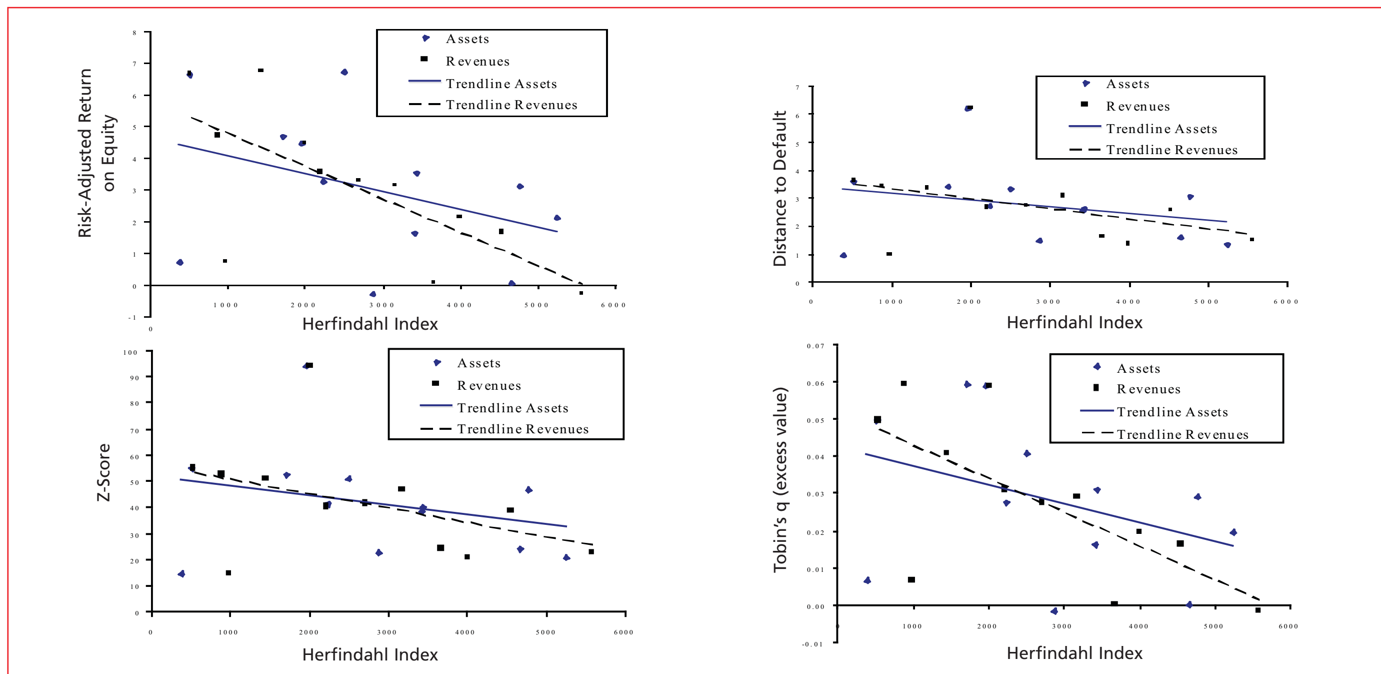
complex financial institutions," or LCFIs), and also often relying increasingly on funding from international markets rather than from domestic sources. At the same time, institutional globalization is not limited to the activities of LCFIs: another key aspect is the cross-border expansion of even smaller and less complex bank groups into markets where they have become systemically important.

Although no one indicator fully captures institutional globalization in all its aspects and forms, one telling illustration is the volume of cross-border M&A in the financial sector. As the table shows, M&A activity in the financial system has risen sharply since 2000, with cross-border M&A rising from less than 1 percent to nearly 40 percent of the total value of financial sector M&A's from 1997 to 2006. Over this period financial institutions in emerging and developing countries grew increasingly attractive as M&A targets. By 2006, almost one-quarter of cross-border financial M&A (or 10 percent of total financial M&A) involved institutions outside developed countries. Cross-border consolidation was particularly active in Europe, following substantial deregulation of cross-border economic activity in both financial and non-financial markets and the adoption of the euro.

In banking, where there is more data to examine, this globalization of institutions seems to have brought a number of benefits in terms of financial stability, at least at the level of individual financial institutions and at the system level in relatively benign times. For individual financial institutions, geographic diversification has brought lower volatility of income and asset values, reduced exposure to domestic markets, and access to foreign markets. It also seems to have brought broader financial sector development and efficiency benefits for many host countries, especially in emerging markets, that have benefited from knowledge and technology transfer.

Such benefits appear to have been priced in by market participants. The four charts below plot the cross border diversification of large individual banks in Asia, Europe, and the United States, as proxied by a Herfindahl index, against various proxies for profitability (the risk-adjusted return on equity (ROE), soundness (a z-score based on accounting data, and a stock price-based measure of likelihood of default, the distance-to-default (DD)), and a measure of market valuation (Tobin's q).[3] The analysis indicates that large banks with more internationally diversified revenues and, to a lesser extent, assets, have been characterized by higher average risk-adjusted returns, higher levels of individual soundness, and higher market valuation than other large banks. In addition, some two-thirds of the

Cross-Border Diversification and Individual Bank Soundness, 1994–2004



Source: BankScope: WorldScope; Annual Reports; and IMF Staff calculations.

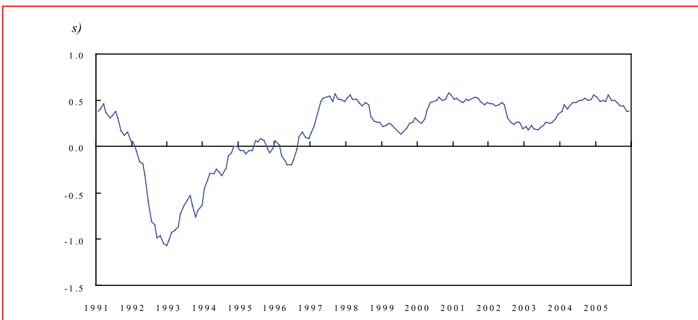
Note: The risk-adjusted ROE is defined as the bank's average ROE divided by the bank's standard deviation of ROE in 1994–2004. The z-score is defined as the ratio of the sum of equity capital, as percent on assets, and return on assets, to the standard deviation of return on assets. The DD is defined as the difference between the expected value of the assets at maturity and the default threshold, which is a function of the value of the liabilities. The "excess value" is defined as the difference between the actual Tobin's q and a weighted average of estimated Tobin's q for the constituent entities.

banks have more diversified operating revenues than assets, and their foreign operations tended to be more profitable than their home country business.

At the level of individual institutions, therefore, cross-border diversification appears to have benefits both in terms of profitability and market valuation, and in terms of soundness indicators.[4] The relationship between internationalisation and individual soundness is far from universal, however. Indeed, as Figure 1 shows, there are examples of diversified banks with low z-scores.

An open question, however, remains: what is the effect of institutional globalization on system-level stability in less benign times? In particular, while banking systems appear to have been quite robust globally in the face of a number of specific shocks in recent years, they have — fortunately — not been tested by more extreme shocks that threaten to spill over across borders, institutions, and markets. Some indicators suggest that, were such shocks to occur, increased institutional globalization may facilitate their cross-border transmission, reflecting either increased exposure to common shocks, or institutional spillovers from ownership, trading or other linkages. Moreover, a relatively small number of institutions are increasingly playing a major role in a range of local and international banking markets potentially making financial systems more vulnerable to a common shock. Indeed, the data shows that risks among internationally diversified banks as a group appear to be higher than risks among the entire group of large banks, as the expected losses for a portfolio comprising the former are higher than for a portfolio comprising the later, as shown in the figure below. Further, this is not only an issue at the global level involving the largest institutions. It is also important at the regional and national levels, and for somewhat smaller banks operating internationally.

Expected loss differential on a $100 Portfolio of Internationally Active Large Banks and a $100 Porfolio of All Large Banks (in US dollars)



Source: IMF staff calculations based on data from Bloomsberg L.P.; and ©2003 Bureau van Dijk Electronic Publishing - Bankscope.

When addressing financial stability concerns, the nub of the issue for policymakers is the mismatch between the scope of institutions' activities, versus that of legal, regulatory, and supervisory frameworks. This mismatch can be particularly problematic when foreign banks' activities have substantial importance for a host country. Further, the problem is only partially resolved if a foreign bank presence is as a locally incorporated subsidiary rather than a branch. The key policy challenges are to ensure that there is effective cross-border coordination between home country and host country regulators, both in ongoing supervision of cross-border banks and in terms of crisis management arrangements should this need to be called on. In addition, general surveillance of financial system risks needs to pay attention to issues arising from globalized banks, including issues at the regional level where such banks are involved in several host countries.

Cross-border supervisory and crisis management cooperation faces a number of challenges arising from legal, political, and cost constraints. There are often wide country differences in legal powers and objectives, relative expertise and resources, preferences with regards to risk, and deposit protection and insolvency frameworks. Such factors will likely also make it difficult to predetermine the division of any loss, or burden sharing, between the respective authorities in the home and host countries in the case of the failure of a cross-border institution. While these constraints are important considerations, significant work to improve collaboration in both crisis prevention and crisis management is nevertheless being undertaken, especially in the major financial centres and within Europe, as a reflection of the importance of the most significant global institutions.

Such work needs to accelerate and be undertaken by a broader set of host and home countries. There is a menu of possible options that may be appropriate in different circumstances, ranging from ad hoc discussions on issues of mutual interest to mutual reliance in the performance of tasks and the delegation of authorities. Mutual understanding and confidence building is a cornerstone. Ongoing joint crisis simulation exercises will further increase awareness and commitment of supervisors and national authorities, while the continuing evolution and application of international supervisory and other standards and the convergence of good practices should help to make national arrangements and policies more transparent and better understood within countries as well as between countries.

Conclusions

Increased diversity of assets, source countries and investor types contributes to a globalized financial system, which, by allowing capital to flow freely, should enable a more effective diversification of risks, enhance the efficiency of capital markets and support financial stability. However, the growth of domestic financial assets, especially in emerging market countries, has been rapidly outpaced by the demand from global investors. As a result, the recipient countries have experienced a rapid increase in asset prices, an acceleration of credit growth, and a strong appreciation of their currencies. Policy makers, hence, need to underpin the strength of the financial system through structural reforms, improved functioning of domestic markets, and strong macroeconomic policies.

Similarly, the progress of globalization of financial institutions has generally improved financial stability. It should not be taken for granted, though, that global financial systems are now more resilient in the face of extreme events. Indeed, increased international linkages within and across countries may make crises more broad-ranging and complicated to deal with. It is necessary to improve mechanisms for multilateral collaboration, specifically for strengthening ongoing supervisory and crisis management coordination. Even relatively modest but practical steps to make progress on domestic policies and procedures, while enhancing cross-border cooperation and coordination, will increase the benefits of globalization while mitigating some of the potential risks to financial stability. ■

1 *This article summarizes Chapter II and III of International Monetary Fund, April 2007, Global Financial Stability Report, Market Developments and Issues (Washington, DC)*
2 *Some major institutions play central roles in the markets for a range of such products, as well as in providing services to other key players in those newer markets (eg, prime brokerage services for hedge funds).*
3 *The z-score and the DD are two analogous measures of individual institutions' soundness, the first one based on accounting data, and the second one using stock price data. Both measures illustrate the probability that the market value of a financial institution's assets becomes lower than the value of its debt (the higher the indicator, the lower the probability). The DD is a useful proxy for individual bank default risk when bank stocks are traded in liquid markets; the z-score provides an alternative measure that does not require such markets.*
4 *All the slope coefficients in Figure 3.6 are significant at the 10 percent level. The slope coefficients for risk-adjusted ROE and Tobin's q are also significant at the 5 percent level.*

The Role of the World Intellectual Property Organization: The Global Challenge to Combat IP Crimes

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The Geneva-based World Intellectual Property Organization (WIPO) is the global body – a specialized agency of the United Nations - charged with promoting the protection and enforcement of intellectual property (IP) for economic, social and cultural development. The protection of property rights is one of the keystones of a free and flourishing society. The IP system promotes innovation and creativity through national laws that protect copyright, patents, designs and trademarks. Protecting IP from unauthorized use and ensuring that creators, rightholders and governments reap the full benefits offered by the IP-based industries is a top priority at both national and international levels. And never before, in WIPO's 35-year history, or that of its 184 member states, has IP occupied such a central position in economic, cultural and political life.

Recent rapid technological developments, increased global market integration and the advent of the knowledge economy have transformed the economic environment, spawning new business models and revolutionizing the way we create and share information. In the knowledge economy, value lies in intellectual, as opposed to physical, capital. Today, over 80% of the value of the top companies comes from intellectual assets.[1] It is increasingly clear that the contribution made by IP-based industries, including the 'creative industries' (such as film, television, publishing, music and software) to national economies is significant.

WIPO has developed a Guide on Surveying the Contribution of the Copyright-Based Industries,[2] which is being employed in numerous countries to measure the economic contribution of these creative industries. The results to date demonstrate that this contribution is sizeable and significant in all countries at varying stages of development:

Country	Contribution to GDP	% of Employment
USA	11.12	8.49
Singapore	5.70	5.80
Canada	4.50	5.55
Latvia	4.00	4.50
Hungary	6.67	7.10
Philippines*	8.17	8.89
Russia*	5.06	4.59
Mexico*	8.07	11.01
Brazil*	5.60	6.90

Ongoing WIPO surveys - Romania, Colombia, Jamaica, Peru, Tanzania, Malaysia, Lebanon, Ukraine, China, Morocco
(*preliminary figures, March 2007)

If properly protected, IP can offer enormous opportunities for wealth creation, and strategic use of the IP system plays a key role in opening up new pathways for economic development. However, it is frequently said that IP rights are only as valuable as they can be protected, and enforced: "a right without a remedy is not a right". While WIPO has been working assiduously with its member states to support the development and implementation of modern legislation and to strengthen effective administration of IP rights across the globe, the effective enforcement of IP rights remains a significant challenge in all countries. As the significance of IP as a key tool for economic development becomes more broadly recognized, so too, it is clear that effective enforcement of IP rights is increasingly critical for all countries that see economic benefit in their creative and innovative human resources and, indeed, for all companies that wish to remain competitive.

While digital technologies, most notably the internet, have enabled vast commercial opportunities, and revolutionized the way in which we do business and communicate, those very same technologies have fuelled a dramatic escalation in IP-crime. In this context, while there is no uniform international terminology, 'infringement' of IP covers both 'piracy', which typically refers to intentional violations of the exclusive rights of a copyright or related rights owner on a commercial scale, or for profit making purposes, and 'counterfeiting', which refers to unauthorized reproduction of works protected by a trademark or patent resulting in physical copies that imitate the genuine product with the intent to deceive or defraud. Combating IP infringement, especially in its serious forms of counterfeiting and piracy, is becoming a top priority for many countries and regional institutions, key among them the European Union.

Counterfeiting and piracy are no longer victimless crimes, affecting luxury brand owners alone. Whereas in the past counterfeiting operations were typically confined to the world's largest brands, today, many well-known, everyday and household goods are falling prey to these crimes.[3] Moreover, consumers are being exposed to significant and sometimes life-threatening safety and health risks associated with fake products. Of particular and growing concern, is the growth in the distribution of fake pharmaceuticals, food stuffs and spare parts.

These IP crimes undermine the economic sustainability of many industries and fields of law and commerce. For example, one billion unauthorized music tracks are downloaded using peer-to-peer (P2P) networks every month,[4] and 400,000 to 600,000 films are illegally downloaded every day.[5] The consequences of these unauthorized and illegal activities on the music and film industries, and all those who derive their livelihood from them, are severe. The routine misuse of trademarks on the internet is yet another example of these abuses of IP. The illegal use of marks or trade names on websites or in domain names - a practice known as 'cybersquatting' - is a constant and escalating problem. Since the launch in December 1999 of the Uniform Domain Name Dispute Resolution Policy (UDRP) - a quick and cost effective dispute resolution procedure - through December 2006, 10,177 UDRP cases have been filed with the WIPO Arbitration and Mediation Centre, covering 18,760 separate domain names. The number of cybersquatting disputes filed with WIPO in 2006 increased by a record 25% as compared to 2005. Another area in which piracy is a growing phenomenon is in broadcasting, where signal theft and unauthorized retransmission of signals over the internet is rampant, particularly for sports programming.

The global scale and sophistication of these activities has a significant economic and social impact, harming national and business interests, threatening employment, innovation, investment, economic growth, tax revenues and the services they support. Considerable health and safety risks also arise from the distribution of fake goods. These crimes smother local industry, engender corruption and bribery within government, lead to reduced employment, create links to organized crime, discourage international trade and foreign direct investment, cultivate a negative international image for countries hosting these operations, and place a heavy burden on enforcement authorities. The effects are many, and are felt at all levels of the society.

The enforcement of IP rights is a collective duty: rightholders themselves have a key role to play in cooperating with enforcement authorities to uphold the rule of law and to institute criminal proceedings. In fact, in most circumstances we do not need new laws, as governments can achieve a great deal in combating IP crime by effectively implementing the legislative frameworks that are in place, and by giving real meaning and adequate support to the enforcement mechanisms already at their disposal. Little can be achieved, however, without raising awareness among members of the judiciary of the destructive consequences of IP crimes, and the need to mete out effective and deterrent penalties under national laws. Similarly, members of police and customs authorities need to be made aware of the scale and character of the problem, and given adequate resources to address it effectively. In this respect, right holders also have a key role to play, in particular to ensure proper product identification. One shining example of legislative processes in that regard is the amended proposal for a Directive of the European Parliament and of the Council on criminal measures aimed at ensuring the enforcement of IP rights, which would impose stringent penalties. Proposed remedies can also include seizure and destruction of counterfeit goods. ▸▸

The scale and value of trade in counterfeit and pirated goods remains difficult to estimate, but there is growing empirical evidence that its consequences are far-reaching and extremely damaging. For example, in the pharmaceutical sector, life-threatening counterfeit drugs have been estimated to account for some 1% of sales in developed countries rising to 10% of sales in developing countries, and in some parts of Africa, Asia and Latin America, 30% of all drugs on sale are fake. Counterfeit drug sales are estimated to climb to a value of US$75 billion globally by 2010, an increase of over 90% from 2005.[6] Seizures of counterfeit goods at the borders of the European Union increased by almost 1000% between 1998 and 2004, and customs cases involving an increasing number of fake household items more than doubled between 2003 and 2004. As companies rely increasingly on IP as a key component, or value-added, to their products, IP-crime has become a major concern for all business sectors in all countries.

As part of its response to these issues, and in response to demand from its member states, WIPO is examining copyright piracy, its effects and ways in which it can be measured. Of course, the clandestine nature of the problem makes collection of reliable statistics problematic. Neither production nor consumption are openly conducted, and measurement must focus on volumes (estimated through surveys, seizures and decreased sales of legitimate products), on values (estimated through lost profits), and on people-based assessments (targeting consumers of pirate goods, employees of pirate activities and quantifying jobs lost in legitimate employment).

Counterfeiting and piracy are global problems that require global solutions. WIPO continues to play a proactive role in the field of international enforcement of IP, identifying problems and working with global partners to reach workable solutions. Together with a diverse group of stakeholders, WIPO's Enforcement and Special Projects Division is cooperating in the development of effective government and industry anti-counterfeiting and piracy strategies, focusing on awareness-raising, legislative assistance, improved coordination and capacity building. Many efforts are being undertaken to coordinate activities at the international level and to strengthen cooperation between intergovernmental (IGO) and non-governmental organizations (NGO) in combating counterfeiting and piracy.

With this focus, in January 2007, WIPO hosted the Third Global Congress on Combating Counterfeiting and Piracy, in collaboration with the International Criminal Police Organization (Interpol), the World Customs Organization, and a number of industry groups. The purpose of the Congress was to raise awareness of the problems of IP crime, share relevant information, develop strategies to combat this illegal trade and identify practical actions and solutions. A special session was held on the health and safety risks associated with the problem.

Such events offer valuable opportunities to raise awareness about the widespread impact of counterfeiting and piracy, to enhance cooperation and to identify more effective strategies in combating IP crime. These events have led to various regional forums, resulting in the adoption, for example, of the Shanghai Initiative (2004) and the Rio Declaration (2005), which identified counterfeiting and piracy as major problems causing significant harm to national and business interests. The global impetus generated by these developments has also led to initiatives such as 'Operation Jupiter', launched by Interpol in 2004. Under this scheme, the pharmaceutical, recording, motion picture and tobacco sectors, together with the federal police and customs agencies of Argentina, Brazil and Paraguay, joined forces to combat IP crime, with very positive results.

Similarly, other regions and countries have launched anti-counterfeiting initiatives. These include the 2004 launch by the European Commission of strategies to address the enforcement of IP rights both within and beyond the European Community, and the Strategy Targeting Organized Piracy (STOP) launched by the United States of America. In 2005, trade ministers of the Asia Pacific Economic Community (APEC), endorsed measures to increase their capacity to deal with counterfeiting, and the combat against piracy and counterfeiting was for the first time included in the political agenda of the G-8 Summit at Gleneagles in July 2005. On this occasion, G-8 countries agreed on a statement on IPR piracy and counterfeiting, referring, inter alia, to the work of WIPO and other international organizations in this field.[7] This process was continued at the 2006 summit, under the Russian presidency, where G8 countries formulated a number of concrete measures to be taken.[8] An IPR Expert Group was established for the purpose of the summit declarations on IP, and WIPO participates in this group's meetings, in particular to give advice on technical assistance projects to be developed under the auspices of the G-8. Under the German presidency in 2007, the protection of innovations against product and trademark counterfeiting is again identified as one of the focus areas on the agenda.[9]

These initiatives are steadily encouraging greater attention by government ministries, law enforcement agencies, including customs and the judiciary, and stimulating the allocation of increased resources to combat IP-crime. These are important steps towards increasing the risks faced by counterfeiters and pirates and their suppliers and reflect a growing recognition by all countries of the pivotal importance of effective enforcement of IP rights.

On the day-to-day operational level, WIPO provides a number of IP services that are designed to help businesses around the world obtain international protection for their trademarks, patents and designs, and to better guard themselves against illegal uses. Whereas all IP rights are territorial, WIPO's international filing and registration systems offer a timely and cost-effective means of obtaining IP protection in multiple countries. In addition to the cybersquatting dispute resolution described above, WIPO's Arbitration and Mediation Centre also provides a range of dispute resolution services which offer considerable advantages in certain IP disputes by offering a single, rapid, cost-effective and neutral procedure.

Through its Advisory Committee on Enforcement (ACE), WIPO provides a forum for international review and discussion of IP enforcement issues. The next session in November will address the theme of international, regional, and national coordination and cooperation in enforcement. Having previously taken up civil remedies, the focus of this meeting will be on coordination and cooperation to streamline the criminal enforcement of IP.

The Organization also provides countries, at their request, with legal advice on the protection and enforcement of IP rights. In this respect, countries are placing a much greater emphasis on enforcement than before. Effective enforcement requires active involvement from many; including judges, customs, police, prosecutors, administrative authorities, and attorneys. WIPO therefore supports the efforts of all countries to combat counterfeiting and piracy through, for example, the organization of training programs for judges and other actors in this field. In promoting better coordination and cooperation with organizations actively engaged in combating IP-crime, WIPO is committed to facilitating an informed and balanced global debate on adequate responses to the challenges to IP enforcement caused by counterfeiting and piracy and the economic consequences of inefficient IP protection and enforcement.

We cannot afford to ignore the significant threats posed by counterfeiting and piracy. In the face of this escalating problem, however, there is cause for optimism. There is increasing recognition of the defining importance of effective enforcement mechanisms and mounting political commitment among governments, regional organizations and the private sector in a growing number of countries to tackle the problem of IP-crime in a concerted way. There are also increasing public-private sector partnerships in addressing this problem. More and more countries are recognizing that it is in their own national interests to provide for efficient mechanisms that enforce these laws to safeguard the economic value harnessed by the IP system.

WIPO is committed to ensuring that all of its 184 member states are aware – and make full use – of the enormous potential of the IP as a tool to create value and enhance economic growth. Companies and governments around the world are increasingly recognizing the strategic importance of IP in promoting national and commercial interests. The establishment of an IP culture – one of WIPO's principle objectives - in which there is broad-based understanding of the role

and potential of the IP system, is a key ingredient in promoting greater respect for IP rights. This, coupled with effective and transparent licensing mechanisms and a well-functioning IP enforcement mechanism, are the best means to limit the number of violations of IP rights and to ensure that rightholders and the society as a whole can fully reap the benefits from the IP system.

While the challenge is great, there are important signs of change in awareness, political will and readiness for cooperation and concerted action. It is heartening to see a growing, deep-rooted concern to uphold and respect IP rights. Just as in today's knowledge-based economy, the possibility of achieving sustainable economic growth depends on effective use of the IP system, so too, the credibility of the IP system depends on the enforceability of IP rights and those who carry out this important task. ■

1 *In 2006, over 80% of the value of the top S&P500 companies was found in intellectual capital. Source: OceanTomo.*
2 *The Guide and published results are available at http://www.wipo.int/ipdevelopment/en/creative_industry/economic_contribution html.*
3 *Preliminary findings of an on-going Organization for Economic Cooperation and Development (OECD) study on the economic impacts of counterfeiting and piracy point to a significant expansion in the scope of products being counterfeited and pirated. See: http://www.oecd.org/document/36/0,2340,en_2649_34173_35281444_1_1_1_1,00.html.*
4 *Source: Big Champagne, February 2007 (MusicAlly Report).*
5 *Source: Motion Picture Association (MPA).*
6 *Data from the US based Center for Medicines in the Public Interest reported by the World Health Organization (WHO), at http://www.who.int/medicines/services/counterfeit/impact/ImpactF_S/en/index.html.*
7 *See http://www.fco.gov.uk/Files/kfile/PostG8_Gleneagles_CounterfeitingandPiracy.pdf.*
8 *See declaration at http://en.g8russia.ru/docs/15.html.ix For more information see http://www.g-8.de/Webs/G8/EN/Homepage/home.html.*
9 *For more information see http://www.g-8.de/Webs/G8/EN/Homepage/home.html.*

US Capital Markets May Be Dangerously Overregulated

William A Niskanen is chairman of the Cato Institute and the contributing editor of *After Enron: Lessons for Public Policy*

Two recent bipartisan reports make the case that US capital markets may be dangerously over regulated.

The Committee report

The first report of the blue ribbon Committee on Capital Markets Regulation, issued on 30 November 2006, documented several types of evidence that the competitiveness of US capital markets appears to be eroding and made 32 recommendations to enhance that competitiveness. This committee of private experts is headed by Hal Scott, a professor at the Harvard Law School; Glenn Hubbard, the dean of the graduate business school at Columbia University; and John Thornton, the chairman of the Brookings Institution. Over the next two years, the Committee also expects to issue reports on the competitiveness of mutual funds and derivative markets. The major findings of this first report are the following:

- In 2000, 50 percent of the value of world-wide initial public offerings was raised in the US, falling to five percent in 2005.
- The US share of total equity capital raised in the world's top 10 markets was 41 percent in 1995, falling to about 28 percent in 2006.
- The listing premiums on US stock exchanges have declined substantially.
- Private equity firms, almost non-existent in 1980, sponsored more than $200 billion of capital commitments in 2005.
- Since 2003, private equity fundraising in the US has exceeded net flows into mutual funds, and going private transactions have accounted for more than a quarter of publicly announced takeovers.

Some of the decline in the US share of world equity markets is probably due to the increased efficiency of major foreign markets. The dramatic increase in the use of private US markets, however, is important evidence that regulation and litigation are contributing to the flight of many companies from the public markets.

Policy recommendations

Although the findings of this report are quite dramatic, the Committee's recommendations are surprisingly tepid. The Committee proposed several increases in shareholder rights based on little more than a wistful hope that this would reduce litigation. The financial regulatory organisations are encouraged "to move to a more risk-based regulatory process, emphasising the costs and benefits of new rules" and to periodically test existing rules by the same standard. And, of course, "There should be more effective communication and cooperation among federal regulators." The most substantive proposals would limit the authority of the federal enforcement authorities and the liability of outside board members and the audit firms. The report concludes that only "If the SEC finds that, even after the general reforms outlined above are implemented, the revised Section 404 is still too burdensome for small companies, it should recommend that Congress exempt small firms from auditor attestation." The report offers surprisingly little analysis and evidence that their recommendations would enhance the competitiveness of US capital markets, and it makes no proposals to change the major federal regulatory laws.

The Schumer-Bloomberg Report

A second report, issued on 22 January 2007, "warned that New York financial markets, stifled by stringent regulations and high litigation risks, are in danger of losing businesses and high-skilled workers to overseas competitors," estimating that US financial service revenues would fall between $15 billion and $30 billion a year without a major change in the public policies affecting US capital markets. This report was commissioned by US Senator Charles Schumer and New York City Mayor Michael Bloomberg, prepared by McKinsey and Company, and informed by interviews with more than 50 financial service specialists. Somewhat of a surprise, this report was endorsed at its release by Eliot Spitzer, the newly elected governor of New York, who was critical of the prior report by the Committee on Capital Markets Regulation. The Schumer-Bloomberg report recognised "that while many of the causes (of the erosion of the competitiveness of US capital markets) are due to improved markets abroad and sophisticated technology that has virtually eliminated barriers to the flow of capital, a significant number of the causes … are self-imposed," focusing on the effects of stringent US regulations, higher litigation risk, and restrictive immigration policy.

Policy recommendations

To my surprise, the Schumer-Bloomberg report recommends a substantially different set of policy changes than does the prior report by the Committee. The major policy recommendations that are quite different include the following:

- Implement securities litigation reform with particular short-term emphasis on leveraging the SEC's existing authority.
- Ease immigration restrictions facing skilled non - US professional workers.
- Protect US competitiveness in implementing the Basle II Capital Accord.
- Modernise financial services charters and holding company structures.

Potential Congressional action

The fact that two reports that addressed much the same issue led to such different policy recommendations will make it more difficult for Congress to resolve what to do about this problem of increasing concern. Nevertheless, both Barney Frank and Christopher Dodd, the new chairmen, respectively, of the House and Senate banking committees, are expected to hold hearings on the issues raised and the policy recommendations by these two reports. And the SEC has already made some minor changes to the implementation of Section 404 of the Sarbanes-Oxley Act to respond to these concerns. The new Democratic Congress seems willing to address these issues primarily because of the substantive findings of these two reports, the ▸▸

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bipartisan endorsement of these reports, and the concentration of the financial industry in the northeastern states that are now represented primarily by Democrats.

Major remaining problems

My primary disappointment with both reports is that they do not address the major conditions that limit the rate of return on US equity markets.

- Very few corporate boards now include a member with sufficient voting shares to be a credible threat to the incumbent management. The origin of this problem is the federal Williams Act of 1968, which substantially increased the cost of successful tender offers and completely eliminated the potential for surprise. Over the next several decades, corporations chartered in almost every state were authorised to implement one or more takeover defenses, and most did so. An important 2003 study by Paul Gompers and colleagues, however, found that the rate of return on the equity of individual corporations has been a strong negative function of the number of takeover defenses in that firm. This issue has not been subject to a public discussion and nothing has been done to correct this problem.
- The Sarbanes-Oxley Act substantially increased the role of the independent auditing firms and created an expensive and arguably unconstitutional board to regulate these firms. This Act, however did not correct the major potential conflict of interest between corporations and their independent auditors, in that the audit firms are still paid by the corporations that they audit.
- The primary public rationale for the Sarbanes-Oxley Act was to restore investor confidence by improving the quality of reported earnings, and the Committee report asserted that this has been the effect. The best test of this effect is whether investors are now willing to pay a higher price for a stock per dollar of reported earnings. The price-earnings ratio on the S&P 500-stock index, however, has declined continuously since the Sarbanes-Oxley Act was being drafted in the spring of 2002. Five years later, there is still no objective evidence that this Act has restored investor confidence in the equity values of the stocks listed on US exchanges and thereby subject to the regulations required by the Act.
- The largest long-term cost of the Sarbanes-Oxley Act, however, may be more risk-averse behavior by corporate managers and board members. Most CEOs, for example, are not accountants, and the requirement that they personally attest to the accuracy of the audits at the risk of a jail sentence is likely to divert the CEOs from more productive activities and lead to more risk-averse decisions. Individual shareholders can reduce the risk of their portfolio more efficiently by investing in a broad-based mutual fund rather than by counting on individual corporations to reduce the risk of individual stocks. Legislation designed to reduce the probability of "another Enron" may reduce US economic growth.

My major disappointment about this whole episode is the recognition that so many intelligent and informed adults do not acknowledge that Congress has probably made a mistake that should be reversed rather than be considered a new pillar of American securities law. Michael Oxley, recently retired from Congress, was asked whether he would have done anything differently if he knew then what now is known about the effects of the Sarbanes-Oxley Act. "Absolutely," Oxley answered. "Frankly, I would have written it differently, and he would have written it differently," he added, referring to Sarbanes. "But it was not normal times." Now is the time to revise or repeal the Sarbanes-Oxley Act. ■

World Chambers Congress

Turkey's Prime Minister, a former US Secretary of State, a Nobel Peace Prize winner and a host of business leaders – including International Chamber of Commerce (ICC) Chairman Marcus Wallenberg – were among the distinguished guests who addressed the 5th World Chambers Congress, held from 4-6 July in Istanbul. The event attracted 1600 business and chamber leaders from 118 countries, who deliberated fresh ways to grapple with some of the biggest challenges to business development.

Organized by ICC's World Chambers Federation (WCF), the World Chambers Congress is the only international forum devoted to the global community of over 12 000 chambers.

Held every two years, the congress has established an enviable reputation as the place where chamber of commerce and business leaders get to know international peers and share experience and best practice on issues that have a direct impact on the chamber of commerce community.

Madeleine Albright, formerly US Secretary of State and currently principal of The Albright Group, delivered a keynote speech on the first day during the plenary session on how to better manage global risks through closer collaboration between business and government.

Other plenary sessions dealt with securing energy in an era of volatile energy prices; how to create flexible, well-designed labour markets amid rapidly-changing migration patterns; and how to cope with rising threats to the multilateral trading system.

Nobel Peace Prize winner Mohammad Yunus delivered a keynote address during a special session on 5 July. Mr Yunus received the Nobel prize in 2006 jointly with Grameen Bank, which he founded in his native country of Bangladesh, for his groundbreaking work in microcredit. To date, Grameen Bank has provided small loans to more than 7 million impoverished Bangladeshis. Mr Yunus told delegates that global poverty could be eradicated easily and that business people could play a vital role by creating "social businesses" or projects whose principal aim is to achieve a social good, while still being founded on sound business principles.

A series of 23 workshops at the congress offered practical, hands-on solutions to local chambers of commerce for addressing the daily challenges that they and their business community face.

The workshop topics included: customer service, the seven measures of success, leadership versus management, intellectual property issues for chambers and SMEs, and IT and e-business for chambers.

Other workshops discussed issues surrounding chamber branding, women in business and how businesses can thrive in the 21st century. The World's Top 100 Cities – sponsored by the Dubai Chamber of Commerce and Industry – showcased the bold ideas and special

activities of world class cities.

World Chambers Federation Chair Rona Yircali said: "Chambers know that to serve their members effectively in today's global economy they must work together – and that means building human relationships through personal contact. The World Chambers Congress is the ideal place to build partnerships for prosperity."

Delegates traveled from as far as the Democratic Republic of Congo, Australia, Ecuador, Mongolia, Nepal, Fiji, Madagascar, Uganda, Algeria, Philippines, Saudi Arabia, Afghanistan, Ivory Coast, Costa Rica and Cuba.

Chambers from some of the world's nascent economies attended the World Chambers Congress for the first time, reflecting the increasingly broad-based participation in the World Chambers Federation.

Thanks to funding provided by the Center for Private Enterprise (CIPE), an affiliate of the US Chamber of Commerce, which furnishes management and financial support to chambers in developing countries, 12 chamber representatives participated from Afghanistan, Ethiopia, Iraq, Malawi, Nigeria, Peru, the Philippines, Russia, Tanzania and Yemen.

"It's an opportunity to host chambers we have worked with, and for them to exchange what they've done and learn from their counterparts," said John Sullivan, Executive Director of CIPE. Mr Sullivan also moderated a session at the congress on advocacy and policy reform.

Another first, the United Nations Development Programme underwrote attendance by five chambers from Cameroon, the Republic of Congo, Ghana, South Africa and Uganda.

The Union of Chambers and Commodity Exchanges of Turkey (TOBB) was the host of the 5th World Chambers Congress, which took place during an exciting phase of Turkey's history, as it negotiates membership in the EU.

Previous congresses have been held in Marseilles (France), Seoul (South Korea), Quebec City (Canada) and Durban (South Africa). In 2009 the congress will take place in Kuala Lumpur. The Mexico City Chamber of Commerce has already announced its intent to bid to host the congress in 2011 when it is scheduled to be held in the Americas. Chambers from Argentina, Brazil, and the United States are also in discussions with WCF. Rotterdam formally presented its intention to bid to host the congress in 2015, during the 5th World Chambers Congress. Interest to host the event stretches as far as 2017.

World Chambers Competition

Recognizing the most innovative projects undertaken by chambers of commerce and industry from around the world, the World Chambers Competition is a key feature of the congress and the only global awards programme of its kind.

Finalists in the 2007 World Chambers Competition presented their projects to an international panel of judges during the congress. The awards were given at a gala dinner on 6 July, marking the close of the congress.

The winners in each category were as follows:

Best unconventional project for small and medium-sized enterprises
Federation of Chambers of Commerce and Industry of Sri Lanka

Best international cooperation between chambers
Confederation of Brazilian Commercial and Business Associations, Brazil/KHS – Essen Chamber of Arts and Crafts, Germany

Best new membership recruitment
Vancouver Board of Trade, Canada

Best skills development programme
The Dhaka Chamber of Commerce and Industry, Bangladesh

This year also saw the inclusion of a special recognition award for the best project from a chamber of a developing country. The award recognized achievement and success in a challenging business environment and was given to two chambers, Anguilla Chamber of Commerce and Industry, Anguilla and Chamber of Economy of Sarajevo Canton, Bosnia and Herzegovina.

Through the World Chambers Competition, WCF continues to fulfill its mission to encourage chamber excellence and dynamism while fostering information exchange and business development.

Chambers of all kinds – from bilateral, local, regional and national to public and private law – are eligible to enter the competition which provides a unique opportunity for chambers to:

- showcase originality and ingenuity
- demonstrate determination to strengthen SMEs
- improve services to members

Since its inception in 2003, the competition has produced an array of case studies demonstrating entrepreneurial diversity and inspiring other chambers. Previous finalists and winners of this increasingly popular event have experienced a significant impact on their local and national profile and on their influence due to the recognition received for their participating projects.

Members of the World Chambers Competition Jury comprise representatives of local, regional, national and transnational chamber groups.

With over 55 entries from 38 countries received, this year's competition was the most popular and diverse in its history.

The finalists were as follows:

Best unconventional project for small and medium-sized enterprises
Victorian Employer's Chamber of Commerce and Industry, Australia
Federation of Chambers of Commerce and Industry of Sri Lanka
Mongolian National Chamber of Commerce and Industry
Liverpool Chamber of Commerce and Industry, United Kingdom
Chamber of Economy of the Federation of Bosnia and Herzegovina
Massif Central Chambers of Commerce and Industry Union, France

Best international cooperation between chambers
Chamber of Industry and Trade of Stuttgart, Germany/Chamber of Industry, Commerce, Services and Tourism of Santa Cruz, Bolivia
Confederation of Brazilian Commercial and Business Associations, Brazil/KHS – Essen Chamber of Arts and Crafts, Germany
Barcelona Official Chamber of Commerce, Industry and Navigation, Spain
Chamber of Commerce for Bedfordshire, United Kingdom
Sheffield Chamber of Commerce and Industry, United Kingdom

Best new membership recruitment
Anguilla Chamber of Commerce and Industry, Anguilla
Chamber of Economy of Sarajevo Canton, Bosnia and Herzegovina
Vancouver Board of Trade, Canada
Goderich & District Chamber of Commerce, Canada
Eastern Province Chamber of Commerce and Industry, Saudi Arabia

Best skills development programme
The Dhaka Chamber of Commerce and Industry, Bangladesh
Tampere Chamber of Commerce and Industry, Finland
Iraqi American Chamber of Commerce and Industry, Iraq
County Carlow Chamber, Ireland

Profiles of all finalists and winners can be found on the World Chambers Competition website:
www.worldchamberscompetition.com

Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?

Liu Ping, World Customs Organisation, and Caroline Silberztein, OECD Centre for Tax Policy and Administration

Transfer pricing is more important than ever to multinational enterprises ("MNE"). What is transfer pricing? "Transfer pricing" refers to the determination of the price and other conditions for the transfer of goods, services and assets between affiliated companies situated in different tax jurisdictions. Where goods, intangibles or services are transferred across the borders within an MNE, transfer pricing becomes an important issue for the taxpayers as well as for the national tax and customs authorities which have the responsibility of overseeing these cross-border flows.

Along with increasing globalization, international transactions between related parties (between parent company and their affiliates or between affiliates) are playing an increasingly significant role in world trade and economy. As multinational enterprises are said to account for about 60% of world trade, transfer pricing has become the number one issue in the international tax arena. Globalization is providing opportunities for economic development and growth through intensified cross-border trade, investment and services. At the same time, there is also a growing trend, in both developed and developing economies, of government regulatory bodies stepping up their control over transfer pricing compliance through transfer pricing regulations and audits, with a view to protecting their tax base while avoiding double taxation that would hamper international trade.

While the importance of transfer pricing is increasingly appreciated, the focus has traditionally been on direct taxation and transfer pricing still largely remains a subject for tax specialists. In the past decade, however, it has become obvious that the customs duties and, more recently, the VAT (value added tax) dimensions of transfer pricing can also take quite a toll on a company's profits and on government revenues, and they are now increasingly attracting the attention of governments and businesses. Valuation of Related Party Transactions for Transfer Pricing, Customs and VAT purposes was the subject of two major conferences jointly organised by the World Customs Organisation (WCO) and the Organisation for Economic Cooperation and Development (OECD) in May 2006 and May 2007.

Transfer pricing: what is at stake for governments and businesses?

Transfer pricing influences the level of both direct and indirect taxes that governments collect. The price of cross-border transactions is the starting point for assessing customs duties and for determining profits arising to each party involved and therefore the allocation of tax bases among countries. Transactions between related parties or associated enterprises are not always subject to the same market forces as transactions between independent actors. As a consequence there is a potential for manipulation, through under or over-pricing, of the customs duties basis and allocation of taxable profits.

For tax purposes, transfer pricing determines the amount of income that each party earns and thus, the amount of income tax that is due in both the country of export and the country of import. A higher transfer price may reduce the taxable income in the country of importation and increase the taxable income in the country of export. A lower transfer price has the opposite effect.

For customs purposes, the transfer price has a direct impact on the determination of customs value. The lower the transfer price, the lower the customs value and the applicable customs duties. This also applies to the collection of inland taxes (eg. VAT and excise) when they are calculated on the basis of the customs value of the imported goods.

What are the issues?

The business community has explained on several occasions that the existence of two sets of rules, and, in many countries, of two different administrative bodies to deal with direct taxes and customs duties, can make cross-border trade overly complicated and costly, contrary to the objectives of the international organisations and national governments concerned.

What international rules do national tax and customs authorities use to approach transfer pricing?

Direct tax authorities tend to follow the arm's length principle and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) which set the international standard for transfer pricing. Customs authorities apply the relevant provisions of the WTO Customs Valuation Agreement (the WTO Agreement). Furthermore, practices in applying certain provisions of these international standards at the national level by customs and tax authorities can vary, to a certain degree, from country to country.

As a basic principle, both sets of rules require that an "arm's length" or "fair" value be set for cross-border transactions between related parties and associated enterprises. That is, the transfer price must not be influenced by the relationship between the parties or it must be set in the same way as if the parties were not related. However, there are significant differences in the application of this broad principle, eg. in relation to such major factors as policy objectives, operational functioning, timing of valuation, valuation methods, documentation requirements and dispute resolution mechanisms.

Institutionally it is often the case that two administrative bodies value or review the valuation of international transactions between related parties or associated enterprises. A striking point is that customs and revenue authorities within the same country can often have conflicting interests. On a given import transaction, a customs officer's natural inclination would be to verify whether or not the value declared by the importer was under-estimated, as the customs officer would be interested in collecting more duties, while a revenue authority's natural inclination would be to verify whether or not the import value declared was over-estimated, as the revenue officer would be interested in limiting what would be regarded as an excessive tax deductible amount in his/her jurisdiction. Or to put it in another way, where the "arm's length" or "fair" value is not clear, might the customs specialist within a multinational enterprise be tempted to declare an import value on the lowest side of the range, while his/her tax colleague might possibly be interested in higher transfer prices if they can generate greater deductions.

Does this situation make sense from theoretical and practical perspectives? To what extent is it acceptable to have different rules because the agency policy objectives are different? Do different answers to the same question ("what is the arm's length price?") alter the credibility of the assessing authorities? Is there a need for greater convergence of the two sets of rules? If so, what should be the conceptual framework, at national and international levels? These are some of the tough questions that were discussed at the joint WCO-OECD conferences and on which significant further work would be needed.

In addition, these issues can also arise in relation to VAT to a certain extent. First of all, the determination of the acceptable transfer price and subsequent "adjustments" to be made to it under transfer pricing and customs value determination can affect the amount of VAT to be levied and charged on cross-border transactions. Furthermore, a recent EC (European Communities) Council Directive 2006/69/EC opens up the possibility for tax authorities to adjust the valuation of certain goods or service transactions in specific circumstances in case the value declared differs from the "open market value". This has prompted concerns about the additional uncertainties that might be created and complexities that might be added by yet a third set of rules governing the valuation of cross-border related party transactions that business has to comply with. In effect, the Council Directive does not provide any guidance as to the methods to be used to determine the "open market value" and neither the Commission nor the member states concerned have developed guidance on valuation methods so far.

How different are transfer pricing and customs valuation rules?

A discussion of the pros and cons of possibly greater convergence and of more coordinated administrative approaches must start from an ▸▸

examination of the similarities and differences of direct tax and customs rules on the valuation of related party transactions.

Customs, as a border enforcement agency, analyses each product and each import transaction to determine, usually at the time of the importation, what the customs value is for a specific product involved in a specific transaction. This enables the customs authorities to collect the right amount of duty for each product that can be subject to different rates of duties to be calculated on the basis of its value and its tariff classification. The customs value of imported goods means the value of goods for the purpose of levying ad valorem duties of customs on imported goods. However, although there are no specific provisions regarding valuation treatment of services and intangibles, these can be relevant for customs valuation purposes if they are connected with the importation of goods.

In valuing a related party transaction, customs uses the transaction value of the goods that is free from the influence of the relationship between the parties. To determine whether the price would be an acceptable basis for the transaction value, two tests are used: (1) the "circumstances of sale" test to determine whether the relationship influenced the price, and (2) the "test values" test which is used to determine whether the transaction value closely approximates one of three types of "test" values. The "circumstances of sale" test, which is more commonly used, is fairly broad and the provisions strikingly concise.

In case it is established that the transaction value of the imported goods is not acceptable, customs determines the customs value by applying, in a hierarchical order, one of the following alternate valuation methods: transaction value of identical or similar goods, deductive value, computed value and fall-back method.

Enforced by revenue authorities, transfer pricing is grounded in Article 9 of the OECD and UN Model Tax Conventions which establishes the arm's length principle. The arm's length principle is a proxy for open market conditions that ultimately seeks to allocate taxable profits between related parties to achieve a fair allocation of tax revenues amongst tax authorities and avoid double taxation. All cross-border commercial and financial transactions between associated enterprises (goods, services, intangibles, financial transactions) are within the scope of transfer pricing. There are also transfer pricing issues for attributing profits to permanent establishments (ie. between various parts of a single legal entity situated in different tax jurisdictions).

The arm's-length principle requires a comparison of the conditions of a taxpayer's controlled transactions with the conditions of comparable uncontrolled transactions. Two transactions are regarded as comparable where either there are no material differences between them or reasonably accurate adjustments can be made to eliminate the effect of any such differences. The OECD Guidelines provide a set of criteria to be employed to assess comparability between controlled and uncontrolled transactions (characteristics of products/services, functions performed by each party taking account of the assets used and risks assumed, contractual terms, economic circumstances and business strategies). Comparability adjustments are made where comparability can be enhanced.

In terms of hierarchical order for applying transfer pricing methods, traditional methods (comparable uncontrolled price, resale price method, cost plus method) are preferred over transactional profit methods (transactional net margin method, profit split) in the current OECD TP Guidelines. All OECD-approved methods have a strong transactional focus and there are rules for aggregation of a taxpayer's transactions where they are interrelated or form a continuum. The choice of the method depends on the circumstances of the case. One generally arrives at an arm's length range rather than a single point.

Generally speaking, transfer pricing valuation by taxpayers takes place either at the point in time when the transaction is entered into (the so-called "arm's length price-setting approach"), or upon filing of the tax return (the so-called "arm's length outcome" approach). In countries which follow the "arm's length outcome" approach, end-of-period adjustments to the value initially reported can be common when there are differences between the initial pricing and the outcome of the analysis performed at the time of the filing of the tax return. Typically, information is available to revenue authorities at the year-end upon filing of the tax return and/or later upon retrospective audits (eg. 3-4 years after the transaction).

Another important aspect about transfer pricing is documentation. Transfer pricing documentation typically covers, quite extensively, the economic context (industry and taxpayer's), a description of the controlled transaction (terms and conditions), an explanation of the choice and application of the transfer pricing method, the comparability analysis (including data on uncontrolled transactions that are used as comparables). Tax authorities have access to information through domestic provisions (general tax audit provisions, specific transfer pricing documentation requirements) and bilateral treaties (exchanges of information). In contrast, the WTO Agreement does not detail the information to be used for the determination of the acceptability of the transfer price for customs purposes. The documentation requirements for customs purpose depend on the declaration and documentation requirements of the importing country.

The above general introduction reveals that while common purposes and similar concepts obviously exist in international transfer pricing and customs valuation rules, there are also significant divergences. At the national level, the situation varies in relation to the degree of convergence of the rules and of coordination of the tax and customs administrative efforts. As things stand now, tax and customs authorities are not obliged to accept a value that is calculated in accordance with each other's legislative requirements. Customs administrations need to develop specific strategies, procedures and expertise to address transfer pricing. MNEs need to comply with obligations under both tax and customs legislation and regulations as well as other regulatory requirements (eg. foreign exchange control) where applicable.

Convergence or not: the tale of two schools of thought

Due to the growing importance of transfer pricing to international trade transactions and in order to address the tough questions presented by transfer pricing, the WCO and the OECD have joined hands to hold two joint international conferences on Transfer Pricing and Customs Valuation of Related Party Transactions, in May 2006 and May 2007 respectively, initiating a promising dialogue. The common objective of the two organisations was to provide a platform for public and private sector representatives to collectively explore, and attempt to advance, the issues identified and to encourage global coordinated efforts among business and governments, tax experts and customs specialists.

At the first conference, two schools of thought seemed to have emerged on the desirability and feasibility of having converging standards for transfer pricing and customs valuation systems: those who viewed convergence of rules as highly desirable and largely feasible; and those who were more cautious. While these two views still exist, there was at the second conference held in May 2007 greater recognition in general of the benefits that could be derived from improved consistency and increased certainty in the two systems.

Those who are in favour of convergence point out that a credibility question does arise if two arms of the same ministry can come up with different answers to virtually the same question ("what is the arm's length/fair value for a transaction?"). They hold that this situation results in greater compliance costs for businesses which must follow and document two sets of rules, and greater enforcement costs for governments which must develop and maintain two types of expertise (ie. have customs specialists and transfer pricing experts examine the same transactions at different points in time and in light of two different standards).

Those who are more cautious about convergence point out that the two systems are grounded in different theoretical principles (direct versus indirect tax systems). Hence they argue that convergence could be more costly than the status quo. They also express concerns about the state of capacity building of revenue authorities in developing economies in the areas of transfer pricing and customs valuation. In fact, developing economies are often much more dependent on customs than on direct tax revenues, and many of them are still

experiencing difficulties in the application of the basic provisions of the WTO Agreement.

A number of specific issues were discussed at the May 2007 conference. First of all, there was the question of the consequences of a transfer pricing adjustment to a value previously accepted by customs and vice versa. Acceptability by customs authorities of post import/end-of-period adjustments and of transfer pricing analyses that rely on aggregated transactions (in particular when a transactional net margin method or comparable profit method is used for transfer pricing purposes) was often at the centre of the debate.

The usefulness of transfer pricing documentation for customs purposes is also an important area to explore. Transfer pricing compliance requirements, including the need for taxpayers to prepare specific documentation packages, have been put in place in an increasing number of countries. MNEs often put a lot of compliance efforts into developing such transfer pricing documentation packages and could find it advantageous if they served a dual purpose. Customs authorities could also be interested in being provided with the extensive information that is generally found in these documentation packages, if it addressed their valuation requirements.

Furthermore, the possible development of joint advanced customs and transfer pricing agreements was perceived as promising, despite limited and contrasting experiences in countries so far. In the transfer pricing field, an Advanced Pricing Arrangement ("APA") is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (eg. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. A presentation of recent experiences in the United States and in Australia, where rulings could be concluded involving both the revenue and the customs authorities, was very favourably received by the audience, as those experiences open up the prospects for an effective, coordinated dispute prevention mechanism.

In addition, the conference discussed the possible development of joint customs and transfer pricing audits, the objectives of which would be to reduce the time and efforts spent in audits by the taxpayer and the authorities and to arrive to the extent possible at a common determination of the valuation of related party transactions that would be acceptable for both customs and tax authorities. More generally, the conference participants discussed the pros and cons of greater cooperation between customs and revenue authorities at both domestic and international levels. In these areas, recent regional developments show encouraging trends towards convergence of administrative approaches, including joint actions and information sharing between tax and customs authorities.

The way forward

At the two conferences, the WCO and the OECD noted that they wish to encourage dialogue between customs, tax authorities and business, possibly by establishing a mechanism for liaison. In particular, it seems desirable to continue sharing best practices between countries' revenue and customs administrations. A "whole of government" approach is desirable between customs and tax authorities. In this connection, both customs and tax authorities could benefit from better understanding each other's rules, objectives and constraints.

Many interesting proposals were presented by the participants at the second conference, including the possible setting up of a central arbitration body and the greater use of technology-based audit mechanisms. The WCO Technical Committee on Customs Valuation could play a role in examining specific proposals from its membership.

At the global level, the WCO and the OECD should continue their existing cooperation, such as sharing of knowledge and developing training material, including an e-learning module.

There was a suggestion to create small focus groups of customs and tax experts involving also the WTO and business representatives, in order to study further the issues identified, with an initial focus on practical and concrete case studies, based on commercial reality. Specifically, further work could be done in the following areas:

Valuation:

These issues would benefit from an examination of the interaction between the valuation methods used by customs and revenue authorities, the hierarchy of methods used, what role if any functional analysis could play for customs, and whether a common definition of intangibles could be arrived at.

Provision of greater certainty for business:

The prospect of making more use of joint rulings or APAs attracted a lot of interest among the participants. Another related topic that could be explored is whether more effective dispute resolution mechanisms can be developed, possibly covering both direct taxes and customs duties.

How can we improve compliance?

One practical area for possible study is whether greater consistency could be achieved in the transfer pricing and customs documentation requirements, eg. the extent to which transfer pricing documentation packages prepared by taxpayers could be a useful basis for customs authorities' reviews. A related question is whether better flows of information can be achieved between tax authorities and customs authorities, including an examination of the pros and cons of joint audits that could go with joint dispute resolution mechanisms.

Improving administrative capacity of tax and customs departments:

Governments should continue building their administrative capacity in better addressing transfer pricing and customs valuation. The WCO and OECD discussed whether joint training programmes could be developed. It would be worth reviewing the experience of countries that have merged or de-merged their customs, VAT and direct tax departments.

The two organisations intend to explore further with their members and other stakeholders, including the business community, how best to pursue these recommendations. ■

This article expresses the views of its authors and not necessarily the views of the WCO, of the OECD or of their members

Business-Government Dialogue Enriches OECD Work on Taxation

Nicole Primmer is a Senior Policy Manager at BIAC, the Business and Industry Advisory Committee to the OECD

The challenge – resolution of tax treaty disputes

For businesses operating in the increasingly globalised economy, one of the most complex challenges facing CEO's and CFO's is the issue of double taxation. This situation occurs when two or more taxes may need to be paid for the same asset, financial transaction and/or income due to overlapping tax laws or lack of co-ordinated treatment between different countries.

As globalisation progresses, goods and services tend to be exchanged freely with very low tariffs, and private capital moves around the

world without restraint seeking higher returns. However, cross-border tax systems continue to be based on a network of bilateral tax treaties with no single authority or agency overseeing the system. This makes today's cross-border taxation issues progressively more complicated, thereby leading to double taxation situations which increasingly act as real barriers to cross-border trade and investment. Resolution of these double taxation cases between two governments has historically been time consuming and costly for both business and governments alike, taking sometimes several years to resolve.

Both the number of cross-border disputes and the complexity of the cases involved, as highlighted by the Organisation for Economic Co-operation and Development (OECD), have increased, and unresolved issues have become more frequent. For example, statistics produced by Canada and the United States for 2005 and 2006 indicate that between 9% and 20% of the negotiated mutual agreement cases completed during these years did not result in full relief from double taxation. In 2006, the US Competent Authority received 240 requests for double taxation relief, the highest number of new cases in several years. When it does occur, business leaders need efficient resolution of these cross-border tax disputes.

At the same time, business also looks to governments to reduce cross-border barriers by establishing policy frameworks that make it easier for companies to invest abroad. Addressing the issue of double taxation is therefore a serious concern of the private sector, and one that more and more the global business community is calling on the OECD to provide the answers.

The OECD – an organisation of 30 member countries committed to democracy and the global market economy – is seen as the world leader in setting standards for international taxation policy, and business has come to rely upon the guidance provided by two of the OECD's most important policy instruments, the OECD Model Tax Convention, and the 1995 OECD Transfer Pricing Guidelines, as these instruments seek to eliminate double taxation and form the basis for clear and predictable tax rules.

OECD – governments (and business) working together

Founded in 1961, the OECD is a unique forum for governments to work together to collectively address the economic, social and governance challenges for global integration, and to realise globalisation's opportunities. Known by many for its reliable economic statistics and forecasting, the Paris-based OECD provides the setting, necessary information, and analysis for member governments to compare policy experiences, seek answers to common problems, identify best practices and co-ordinate domestic and international policies.

A commitment to sustainable economic growth is at the heart of the OECD's work in shaping economic, social, and environmental issues at national and international levels. In recent years the OECD has expanded it membership, and has committed to expanding further with a number of the world's major emerging economies. Since its founding, the OECD has afforded the business community a seat at the table in major OECD policy discussions, and indeed the business community has been the catalyst of many important OECD initiatives.

The Business and Industry Advisory Committee to the OECD (BIAC), also based in Paris, serves as the primary and official voice of business community to the OECD. BIAC comprises the major industrial and employer organisations in the 30 OECD member nations, along with observers from several non-OECD member countries. BIAC members participate in OECD meetings and consultations with OECD leadership, government delegates, committees and working groups and serve as a vital source of business advice and experience to contribute to OECD's work.

BIAC's main objective is to positively influence the direction of OECD policy initiatives so that all resulting recommendations to governments contribute to fostering a competitive business environment which allows companies to flourish in the global economy.

Tax and fiscal matters at the OECD

The OECD agenda regarding tax and fiscal affairs is set by its Committee on Fiscal Affairs (CFA) on which tax executives of each of the member states of the OECD are represented. The secretariat for the CFA is the OECD's Center for Tax Policy and Administration (CTPA), a permanent staff of tax experts in the various areas of international taxation. BIAC maintains a parallel Tax Committee to provide the CFA and the CTPA with business advice and judgements regarding the commercial, operational and legal impact of their work in the tax area. The BIAC Tax Committee consists of representatives from its member organisations in each of the OECD states. The Tax Committee is comprised of senior experts on business tax issues from companies, advisory and law firms and associations.

The BIAC Tax Committee is the primary vehicle though which business engages the CTPA, the CFA and the various working bodies etablished by the CFA. BIAC also engages more broadly with business to coordinate business views for OECD pubic consultations. Primary objectives of BIAC in the area of taxation are the elimination of double taxation and to achieve internationally consistent implementation of widely accepted tax principles, eg. the arm's length standard as promulgated by the OECD Transfer Pricing Guidelines.

BIAC works on the full range of OECD tax projects covering transfer pricing, tax treaty issues, consumption tax, tax administration, dispute resolution, and increasing is addressing issues relating to doing business in non-OECD countries such as Brazil, China, India, Russia and South Africa.

BIAC has many examples of co-operation with the OECD that have resulted in positive outcomes including the recent work to develop guidance related to improvement of cross-border tax dispute resolution processes.

The solution – OECD recommendation to governments

The OECD has a recent success regarding dispute resolution processes. In early February 2007, it released a new report entitled "Improving the Resolution of Tax Treaty Disputes". This report goes directly to the heart of these problems – the need for more efficient resolution of cross-border tax disputes through what is called the Mutual Agreement Procedure (MAP), the mechanism for settling inconsistent tax applications by multiple taxing authorities over the same items of income or expenses, in the context of their bilateral income tax treaty.

Most significant to this point, the report contains an OECD recommendation that governments include in their tax treaties a binding arbitration procedure as a supplemental dispute resolution mechanism as part of the MAP, for cases that remain unresolved beyond two years from the start of the MAP process. This new procedure to engage independent arbitrators will effectively guarantee that a timely resolution will be achievable, and that double taxation problems will be resolved in a principled manner.

Ultimately this will save both time and money for business. Implementation of arbitration into the tax treaty protocols between countries will be a significant step in reducing impediments to a more efficient dispute resolution process.

The conclusion – swift implementation needed

This OECD report follows more than three years of work, including extensive consultation between the business community, and OECD member and non-member governments. The report also includes other features to facilitate resolution of tax disputes welcomed by business, including guidance on how the current MAP should work, and the development of an on-line tool called the MEMAP (Manual on Effective Mutual Agreement Procedure), for both tax administrations and taxpayers, outlining procedures and best practices related to tax dispute resolution.

Going forward BIAC urges swift implementation of the OECD dispute resolution recommendation into tax treaty protocols by governments, which will constitute the real success of this OECD initiative. Business encourages governments to take heed of this important OECD report and looks forward to the increased co-operation and efficiencies that may result.

Several other projects are undertaken by the OECD that create opportunities for improved global trade efficiency, or hazards to

trade. It is the BIAC Tax Committee's consistent mission and approach to assist the OECD and its member states to focus their work and the development of their projects on practical ways of facilitating international trade and equitable fiscal treatment of cross-border transactions.

While the bottom-line impact for a company is real, and often in the present, the OECD work is long-term and achieving positive results requires attention and investment. BIAC's role as the voice of business to the OECD allows the realities of the market place to enter into the policy making arena, and at the highest levels – BIAC regularly interfaces with ministers, ambassadors, and senior government officials. Top executives need to understand and endorse their company's engagement with BIAC and the OECD so to ensure that competitive business environments result from the economic policy co-operation between governments. ■

Business Aviation Serves Rapidly Growing Global Economy

Dan Hubbard is Vice President of Communications at the National Business Aviation Association

A globalized economy demands direct, rapid communications. Doing business in this environment increasingly requires information, ideas and data to be exchanged 24-7. We are connected via a myriad of digital devices but we still need to be in the right places at the right time, on the right budget and often only face-to-face contact will do.

As deadlines get tighter, and demands on our time grow ever more exacting, it is critical to have a flexible means of getting key managers, specialists and other businesspeople from point A to point B, and maybe on to point D with a stopover in point C. Using general aviation aircraft for business transport is often the most effective way to obtain the level of flexibility and efficiency that businesses require today to get from place to place within an ever-stretched schedule.

If you need evidence of the growing numbers of companies and organisations that rely on general aviation for business purposes, look no further than the 8,000 members of the National Business Aviation Association (NBAA) in the United States. In the US, general aviation contributes billions of dollars to the economy and provides jobs for tens of thousands of people.

Business aviation represents a diverse community, from companies that provide charter and fractional ownership of aircraft and fixed base operations at small airports, to schools, churches, non-profits and companies that fly internationally, as well as small, family-owned businesses that fly to small airports. In the US, thousands of small- and medium-sized companies depend on business aviation as a critical transport lifeline, especially in smaller communities that are underserved by commercial airlines.

Serving business for 60 years

The business aviation community depends on NBAA for leadership in critical areas: providing information and training on the latest aviation safety, security and operational advances; offering a wide variety of seminars and events for aviation business operations; and representing the industry on aviation public policy.

NBAA was established 60 years ago in 1947, before the age of the airline jumbo jet, but when the post-war resurgence of commercial, business and personal flying was getting underway.

Since then, despite the emergence of international airlines carrying millions of passengers every year, general aviation, including business aviation, has continued to augment the service provided by the airlines.

This has made it more important than ever for the business aviation community to come together to share best practices and work for the advancement of the industry. In this spirit, NBAA hosts every year the largest gathering of civil aviation in the world at its Annual Meeting & Convention.

NBAA's 2007 Annual Meeting & Convention will mark the Association's 60th anniversary, along with the largest exhibition and trade show in the industry. Members and exhibitors will gather at the Georgia World Congress Center in Atlanta, Georgia, from September 25-27 for three days of meetings, presentations and to conduct business.

NBAA's Annual Meeting & Convention today ranks among the top 10 largest US trade shows. Its 59th session last year drew a record crowd of more than 33,000 visitors and 1,100 exhibitors to the Orange County Convention Center in Orlando.

The event attracts aviation business leaders, government officials, manufacturers, engine suppliers, aircraft handling organisations, fractional share providers, charter and leasing companies, and aircraft resellers. What unites them more than anything is a stake in the future of business aviation and a commitment to making sure its voice is heard in the often crowded debates on aviation issues.

Business aviation growing in Europe, Asia

Growth in general aviation for business purposes is a global trend. Today's business aviation community is worldwide, with an established network in Europe, and rapidly growing demand in Asia, including India and China where geographical distances even within countries are vast and transportation alternatives often limited, if not non-existent.

The potential for business aviation in Asia is seemingly boundless. Indeed, the theme for this year's Asian Business Aviation Association Convention & Exhibition (ABACE) in Hong Kong, co-sponsored by NBAA, was, "Asia is Now Open for Business Aviation." The convention and exhibition theme was designed to help catalyze the Asian market, educate regulatory authorities in the region and expose Asia's business leaders to the benefits of business aviation.

In Europe, the European Business Aviation Convention & Exhibition (EBACE), located each year in Geneva, is the continent's major event focused solely on business aviation. EBACE serves as an important forum for aviation industry professionals to share knowledge regarding industry best practices and international perspectives. The May 2007 event attracted over 11,000 visitors, with sessions covering some of the industry's major issues including carbon emissions, single-sky airspace for Europe, security procedures, and regulatory oversight.

The business aviation market is expanding globally at an ever-faster pace, in the United States and Europe, and increasingly in Asia. As NBAA's diverse membership continues to demonstrate, business aviation has become an essential component at the heart of many business operations.

The future of business aviation clearly can be found in offering measurable value for business leaders and investors looking for competitive advantages to advance their companies' goals wherever their business takes them – from Kalamazoo, Michigan to Kuala Lumpur, Malaysia. ■

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The NBAA Annual Meeting & Convention is THE business aviation event of the year – every year. It's the place where major announcements are made, new products are launched and everyone in the industry gets together to talk business.

NBAA is the only place in the world where business aviation professionals can:

- Compare every industry product and service side by side in 1,000,000 square feet of exhibit space indoor plus another 1,000,000 square feet at the airport
- Be among the first to hear about new product developments announced exclusively at the Convention
- Have the chance to connect with over 30,000 industry colleagues from around the world
- Learn about a wide variety of business aviation topics in Information Sessions conducted by industry experts
- Keep up-to-date on developments, regulations and other issues that affect the industry

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