Institutional imbalances: can globalisation be sustained?

André **SAPIR**

pubblicato in *Foresight*, marzo 2010

The current wave of globalisation has much in common with the wave which swept the world at the end of the 19th century. Both are driven by two factors: technological change and political decisions to open up markets. Likewise both create vast economic opportunities and wealth, but also trigger huge economic and political tensions within and across borders.

Today we see such domestic tensions manifesting in the west as labour markets and welfare systems are bruised and in some cases battered by the global financial crisis. International tensions are simultaneously increasing as the gains and pains of globalisation are hotly contested amidst the excesses of market liberalism and the continuing hurdles facing the Doha round.

The question that follows is: will this wave of globalisation lead, like the previous one, to an era of global conflict and division?

During the first wave of globalisation tensions arose mainly between established colonial powers (primarily Britain, France and Russia) and new, aspirational nations (mainly Germany and Japan). The colonised nations, including China and India, were simply too weak economically and politically to be autonomous actors during this period. A combination of domestic and international tensions, predominantly within and between European powers, is what eventually led to World War One (WWI) and the concomitant disruption of the first wave of globalisation.

This time around, there are two major differences which can save us from the spiralling descent into global conflict and collective despair. The first is the respective role of the centre and the periphery. According to Angus Maddison, the economic historian, at the start of the first wave of globalisation in 1870 the two largest emerging countries, China and India, still accounted for about 30 per cent of world GDP (measured in purchasing power parities), down from their previous historical level of about 50 per cent that had prevailed up to 1820. When the first period of globalisation was brought to a close by the outbreak of WWI the combined weight of China and India had fallen to barely 16 per cent, and it continued to decline thereafter, staying below 10 per cent from about 1940 until 1980.

From the end of the 19th century till late in the 20th century, the centre specialised in manufactured goods while the periphery was confined to the role of producer and exporter of raw materials. As recently as 1975, developing countries accounted for only 9 per cent of world manufacturing exports, and manufacturing goods accounted for barely 16 per cent of these countries' total merchandise exports. The second wave of globalisation, which commenced around this time, has fundamentally altered patterns of production and trade, with large parts of the periphery assuming centre stage. By 2005, developing countries already accounted for 45 per cent of world manufacturing exports and manufacturing accounted for two-thirds of their total exports.

The second difference between the current and the earlier wave of globalisation concerns institutions. The domestic and international confrontations that brought the first wave of globalisation to an end happened in an environment where nations lacked adequate institutions to

resolve conflicts. It took WWI, the great depression and WWII for countries, mainly in Europe and the United States, to set up domestic welfare states and international institutions of global economic governance, such as the World Bank, the IMF and the GATT/WTO, aimed at containing the kind of economic and political tensions inherent to the processes of economic transformation brought about by globalisation. It is therefore worthwhile to consider how well these institutions have so far performed during the current wave of globalisation.

The performance of the welfare state

Well before the 2008/2009 financial crisis, there were signs that globalisation was threatening the welfare state institutions enacted in the west after WWII. At the turn of the century it was clear that opposition to globalisation was gathering pace within labour movements on both sides of the Atlantic.

In the US, where markets operate more efficiently, globalisation generated more wealth, but also more income inequality and adjustment problems than in Europe. The US median voter lost wages and experienced rising job insecurity, both of which resulted in fierce opposition to increased globalisation. In Europe, where the welfare state is more generous and markets are less efficient, globalisation generated less wealth, but also less income inequality and adjustment problems than in the United States. The European median voter in fact suffered relatively little; unemployment had increased, but its effect fell mainly on labour market outsiders: the young and the immigrants. Accordingly, European organised labour voiced less opposition against globalisation than in America. An important question, at the time, was whether these responses could be sustained in the face of major challenges.

The advent of the global crisis in 2008/2009 indeed delivered a significant and abrupt challenge to the situation of the median voter in America and the sustainability of the welfare state in Europe.

In Europe, before the crisis, there existed four types of social model, each with a different combination of efficiency and equity: a Mediterranean model, which is neither efficient nor equitable; an Anglo-Saxon model, which is efficient but not equitable; a Continental model, which is equitable but not efficient; and a Nordic model, which is both efficient and equitable. Given the tumultuous effects on markets and spiraling public debt figures induced by the crisis, it is now clear that the Continental and Mediterranean models, unsustainable even before the crisis set in, are in dire straits. Furthermore, debts have sharply increased in the previously low indebted countries belonging to the Anglo-Saxon model, rendering them unsustainable. This leaves the Nordic model as the only one in Europe capable of handling economic and social changes in a sustainable manner.

In the US, the effects of the crisis had severe impacts on income distribution, poverty and unemployment levels giving rise to a situation which is bound to result in increasing protectionist pressures, targeted especially against emerging countries.

The performance of global governance

There were also signs, before the financial crisis, that globalisation was threatening the global governance system put in place after WWII. By the early 2000s, the global economy had little in common with that of only 20 years earlier when a collection of integrating, but still highly segmented national economies co-existed with quasi-autarkic blocks (China, India, the Soviet Union and its satellites) representing about half the world population. Yet, the global economic governance regime - the set of global rules that govern international economic relations, the network of institutions that support and enforce those relations and the processes that steer change

in this system - had not undergone a parallel transformation.

Some changes had taken place. The core institutions had taken up new roles - the IMF, for instance, moved from financing current account deficits in the fixed exchange rate era of the early post-World War II years to managing debt crises, marshalling the transition to the market and addressing financial account crises. Flexible responses to the transformation of the trade scene had been found through the creation of informal negotiation groupings within the WTO. Also, ad hoc structures such as the Financial Stability Forum had been created to steer cooperation between institutions.

But reforms had remained limited to adaptation and tinkering within the post-war system. The only significant institutional reform over the past 25 years was the creation of the World Trade Organization (WTO) in 1995. The other essential pillars of the post-war economic order - the Bretton Woods institutions - remained basically unchanged, in particular with respect to the role of the Group of Seven (G7). The cold truth was that for the last quarter of a century decisions were made by the G7, which accounts for about 40% of world GDP (measured in purchasing power parities) and only 10% of world population.

It was clear that considerable changes in the global economy had not been mirrored in the structure and missions of global institutions. The suspension of the WTO Doha Round in July 2006 clearly indicated the difficulty of delivering at the multilateral level; the two global institutions long seen as the most effective, the IMF and the World Bank, were struggling to adapt to new realities and seemed to have lost relevance; almost ten years after the Kyoto protocol on global warming was signed it was still rejected by the US and major emerging economies; and scarcity of fossil fuel and other natural resources was creating international tensions that the international community was ill-equipped to tackle.

This situation raised major, perhaps unprecedented policy challenges. Yet the changing global balance of economic and political power made their resolution more difficult than at any time since WWII. Global economic governance had been a stable and relatively simple game in a western-dominated world under US leadership. Now it had become much more unstable and complex due to the rise in the number and diversity of players, and the growing weight of new economic powers that had long been kept on the periphery of the global system.
Urgent reform was, and is, needed. It is desirable not simply for the sake of fairness and legitimacy, but also to create incentives for a strong commitment to multilateralism on the part of emerging powers without which the perennity of the multilateral system itself cannot be ensured.

Could this continued disparity, combined with rising domestic tensions in the west, prove to be a heady mix for a fundamental restructuring of the international regime?

Awakening giants in the east

Despite the weak state of global economic governance at the start of the financial crisis, the international community was able to act cooperatively and prevent a replay of the "beggar-thy-neighbour" policies that plagued international relations during the Great Depression of the 1930s. The G20 summit entered the lexicon of global governance, marking the end of an era where America, Europe and Japan dominated world affairs and the beginning of one in which there exists the potential for a new, more balanced relationship between mature and emerging economies.

Whether or not the G20 leaders will be able to continue cooperating after the crisis, to further the process of evolution towards a political body capable of defining global priorities, and agree on coherent policy and institutional reforms remains to be seen. But what is sure is that the list of areas

requiring urgent international cooperation is long, ranging from international finance and international trade to climate change and natural resources.

The current phase of globalisation marks the end of a century which is likely to remain exceptional. Never before had the share in world income and production of the two most populated nations in the world, China and India, fallen so low. The re-emergence of these two giants (and the emergence of other developing countries) to positions of global prominence had already produced, before the financial crisis, major changes that tested the resilience and relevance of the domestic and international economic institutions put in place after WWII. By hitting so severely the mature economies and leaving the emerging countries relatively unaffected, the crisis will accelerate the process of global transformation in favour of the latter, and test these institutions still further.

The future of the welfare state in mature economies is by no means obvious. Although its rigid labour market and its generous welfare state have greatly helped Europe escape from severe social consequences of the crisis, the generosity of the system may not survive the crisis. Clearly the costs of the crisis combined with the costs of an ageing population pose a huge challenge of fiscal sustainability to Europe. In the United States the problem is pretty much the other way round: the more flexible labour market has meant that the crisis has produced more industrial restructuring and more productivity gains than in Europe, which - together with better demographic trends - probably implies better medium-term growth and sustainability prospects. In the short term, however, the US suffers from greater unemployment than Europe, a situation which is once again bound to result in rising protectionist pressures especially against emerging countries.

Under these conditions, reforming global governance institutions and global policies will be crucial in order to sustain globalisation. The replacement of the G7 by the G20 as the global forum for economic issues is definitely an important step in the right direction, but it is only a beginning. G20 members must now come forward with concrete reform proposals. On the side of the advanced countries, the European Union has a special responsibility to contribute to the reform of the Bretton Woods institutions where its members are grossly over-represented in terms of voting rights and board seats. Decreasing their weight would allow a better representation of emerging and developing countries, and might even increase the EU's influence if its reduction in voting rights coincided with a unified representation. For their part, emerging countries, particularly China and India, must commit to play a more active role in global institutions and policy design. Their greater economic and political weight must go hand-in-hand with greater sharing of global responsibility.

André Sapir is professor of economics at the Université Libre de Bruxelles and a senior fellow at Bruegel, the Brussels-based international economics thinktank