

RICE UNIVERSITY'S
BAKER INSTITUTE | 20 YEARS
1993–2013

2013 POLICY RECOMMENDATIONS FOR THE OBAMA ADMINISTRATION

Russell A. Green, Ph.D.
Will Clayton Fellow in International Economics

© 2013 by the James A. Baker III Institute for Public Policy of Rice University

This material may be quoted or reproduced without prior permission, provided appropriate credit is given to the James A. Baker III Institute for Public Policy.

These papers were written by researchers who participated in a Baker Institute research project. The research and views expressed in this paper are those of the individual fellow(s), and do not necessarily represent the views of the James A. Baker III Institute for Public Policy.

U.S. Economic Diplomacy: Adapting to Shifts in Global Economic Powers

by Russell A. Green, Ph.D.

Overview

International financial markets will undoubtedly remain at the mercy of developments in the Eurozone crisis for at least the first year of the new U.S. presidential term, yet the president will find himself with relatively few levers to influence the outcomes. Hence a productive strategy for U.S. international financial policy would be to shore up defenses against a major crisis, while focusing on longer-term developments, namely the rise of emerging market economies as the dominant sources of global growth over the next several decades. Fostering a cooperative relationship with these rising powers during the next four years will pay dividends for the governance of the international financial system for years to come.

- **Recommendation 1:** Prepare for the worst in Europe.
- **Recommendation 2:** Retain a policy of engagement-as-equals with major emerging economies.
- **Recommendation 3:** Do not label China a “currency manipulator.”
- **Recommendation 4:** Allow a non-American to become the next president of the World Bank.

Background

Globalization of financial markets has advanced even faster than globalization of markets for goods or labor, establishing rapid transmission channels between developments in foreign markets and our own economic health. The most obvious example of this is the potential for the Eurozone to experience a major financial crisis from a disruptive partial breakup of the euro. The evolution of the ongoing crisis in Europe will likely dominate the international financial priorities of the early part of the next U.S. administration, if not the full term, yet the United States plays only a small role in the important decisions that will determine how the current challenges get addressed.¹

While certainly not a foregone conclusion, the possibility exists that the crisis could get much worse, with experts imagining global financial markets freezing up again like they did after the collapse of Lehman Brothers in 2008.² Risk-based capital ratios and leverage ratios in the U.S. banking system have improved since 2008, and direct exposure to southern European financial markets is small.³ Nevertheless, French and German banks

have substantial activity in the United States and key U.S. trading partners, and U.S. banks have indirect exposure to European trouble spots indirectly through exposures to French and German banks.⁴

In the next decade and perhaps beyond, global economic growth will be concentrated primarily in emerging markets.⁵ These countries largely possess underdeveloped financial centers with growing but, at times, tentative linkages to global financial markets. Yet since the financial crisis they have been the largest contributors of additional resources to institutions like the International Monetary Fund (IMF). Unless Europe and Japan are able to execute significant turnarounds, and assuming the United States avoids a debt crisis of its own, the emerging markets will be America's major partners in overseeing the stability and vigor of international financial markets.

Recommendation 1: Prepare for the worst in Europe.

Since U.S. efforts to resolve the financial crisis in Europe constitute largely symbolic involvement, a productive and prudent approach to the problem must include preparation for the potential that a larger disruption occurs. For instance, large portions of post-crisis financial reforms, like implementation of the Dodd-Frank law, remain undone. More difficult measures to understand and supervise cross-border financial activity remain on the agenda of the financial regulatory community.⁶ For instance, harmonization of a cross-border bank resolution to handle the collapse of a bank with significant activity in multiple jurisdictions would prove extremely useful if one of Europe's major international banks required sudden intervention from regulators.⁷

This harmonization work will require significant effort from the United States to quicken the pace, as European regulators are understandably preoccupied. Historically at the G20, at the IMF, in the Basel Committee, or on the Financial Stability Board, most significant international financial reform efforts require prioritization from either the United States or Europe to achieve rapid results.

Recommendation 2: Retain a policy of engagement-as-equals with major emerging economies.

The traditional economic powers of North America, Western Europe, and Japan have controlled the development of the post-World War II international financial system, but economic realities indicate a much broader set of players will wield influence in this century. The United States must adopt a new set of priorities in order to maintain influence and a productive agenda in the governance of finance's global commons.

First, the United States must cultivate common values in the emerging world for market-based approaches to economic policy, including good transparent governance and level playing fields. Most countries—regardless of level of development—turn more naturally than the U.S. to state-centric interventions, and emerging economy institutions may still

be grappling with a legacy of significant rent-seeking behavior. Upward mobility in the populace generally contributes to building a constituency for market-based approaches to economic policy. Inclusive growth must therefore become an important watchword for U.S. international economic policy to bolster popular support for pro-growth initiatives.

Second, the United States must practice skillful economic diplomacy to build coalitions in a more complex power arrangement. This complementary goal requires deepening ties with fast-growing emerging economies to better understand the compulsions of their domestic and external economic policy. Likewise, close interpersonal ties among senior leadership in the U.S. and rising powers facilitates cooperation and conflict resolution.

Both of these necessities suggest a strategy of building bridges with emerging economies in a manner that acknowledges their status at the high table of international financial governance. The United States is well poised to do this, having pursued initiatives like increasing the representation of emerging economies at the IMF for the past 10 years. In addition, the U.S. Treasury Department has launched high-level economic dialogues with China, India, and Brazil, which undertake joint projects, ensure frequent dialogue, and help address conflict areas. Of the 12 countries with a U.S. Treasury attaché, only one is located in a developed country (Brussels).

The financial crisis that centered in U.S. markets in 2008-2009 forced a different, more humble approach to U.S. financial diplomacy. The crisis damaged the U.S. financial system's image as a model for financial liberalization, and U.S. policy accordingly softened to an approach that the leadership of emerging economies found more palatable. For instance, in India and elsewhere Treasury Secretary Timothy Geithner often expressed appreciation for the regulatory conservatism that shielded some emerging economies from the worst impacts of the financial crisis. This was a marked contrast with the often aggressive, occasionally paternalistic strategy practiced in the past of converting developing economies to the gospel of American-style economic success.

Continuing to engage emerging economies as equals will pay dividends in assuring them that the institutions that frame the financial "rules of the game," which often reflect strong U.S. influence, can function in their interest as well. Identifying joint projects where priorities are already aligned, such as the G20 initiative on financial inclusion, also provides opportunities for increased familiarity at the interpersonal level. These connections often prove invaluable when a crisis occurs, as familiarity hastens the coordination necessary for an effective response.

Recommendation 3: Do not label China a "currency manipulator."

Among the working relationships that will prove most important in years to come is the bilateral relationship between the United States and China. Bilateral trade in goods and services amounted to about \$600 billion, or 10 percent of all U.S. trade in 2011. While that trade favored China three-to-one, the future growth of China's domestic market relative

to ours suggests great potential for U.S. exports. Treasury Secretaries John Snow, Henry Paulson, and Timothy Geithner recognized the importance of this bilateral economic relationship and engaged in intensive negotiations with Chinese authorities to address concerns about unfair trade advantages. Aside from specific markets like auto parts or tires, the U.S. primarily focused on exchange rate manipulation and subsidized credit, both of which reflect a highly state-controlled financial system.

Despite the often frustratingly slow pace of progress in reducing either of these factors, the Treasury Department refrained from naming China a currency manipulator. Such an act would draw an immediate response from Congress for remedial measures, risking the beginning of a trade war with our second-largest trade partner. Both previous administrations judged that the resulting damage to the bilateral trade relationship would hurt the U.S. as much as it would hurt China.⁸

The case for restraint has only strengthened in recent months, as the actual evidence of currency manipulation has disappeared. Manipulation refers to a country deliberately keeping its currency low in order to make its products cheaper on international markets. Selling that currency in exchange for another currency pushes the price down, and the other currency gets added into international reserves. So a country's direct currency manipulation can be observed from changes in the levels of international reserves.

In the second quarter of 2012, Chinese reserves fell for the first time, implying the government is not actively suppressing the value of its currency. Since the second half of 2011 Chinese reserve accumulation has been moderate, and the exchange rate has exhibited two-way movement that resembles a somewhat market-determined exchange rate. This is in contrast to the period prior to the global financial crisis, when Chinese reserves rose at a rate of 24-40 percent per year, and market pressure on the exchange rate was exclusively to strengthen.

The trade accounts also reflect dramatic improvement, with a bilateral trade surplus for China of 3.7 percent of Chinese GDP in the year ending Q2 2012. This represents a continuous fall from 9 percent of Chinese GDP reached in the third quarter of 2005. The mirror image from the U.S. standpoint shows the trade deficit as a much smaller share of GDP at 0.5 percent of U.S. GDP in the year ending Q2 2012. This is roughly the same proportion of U.S. GDP as before the financial crisis.

With such little evidence of currency manipulation, naming China a currency manipulator and any ensuing remedial trade measures the U.S. adopts would draw global approbation. Certainly the IMF, ostensibly the objective supra-national arbiter of such matters, would not support the U.S. action. Hence, it would work directly against the second recommendation to cultivate productive relationships among emerging market economies.

Recommendation 4: Allow a non-American to become the next president of the World Bank.

By tradition, the United States selects an American to be the president of the World Bank, Europe selects one of their own to lead the IMF, and Japan selects a Japanese president of the Asian Development Bank (ADB). This tradition looks increasingly archaic as emerging economies take a more prominent place in the global economy. In the case of the ADB, China has even supplanted Japan as the largest shareholder.

With newfound confidence in their rightful role in contributing to the governance of the global financial commons that these International Financial Institutions (IFIs) preside over, emerging markets have insisted that the traditional leadership transition process give way to a more open, competitive, and transparent selection process. When the IMF managing directorship became vacant in May 2011, a non-European candidate became a serious contender against the European candidate for the first time in the history of the institution. Similarly, the World Bank presidency vacancy in the spring of 2012 for the first time presented a true option between the American candidate and a non-American.

Yet, as long as the three beneficiaries of the traditional selection pattern vote in solidarity to preserve the traditional arrangement, contenders will have little hope of breaking in. Emerging markets perceive this as palpable exclusion from access to influence and visible deviation from principles of meritocracy that development banks espouse in their business operations. Furthermore, in current times of investors eagerly seeking investments in farther fringes of “frontier markets” like Kenya and Bangladesh that are prime clients of World Bank international development assistance, supporters of the World Bank increasingly struggle to defend its relevance.⁹ As support—both political and financial—from emerging markets increasingly underpins the legitimacy and potency of the IFIs, this discrepancy is increasingly untenable.

The primary benefit to the U.S. from the traditional arrangement is assuring the World Bank’s leadership shares common values to U.S. leadership. These include commitments to uphold high standards of integrity, and enforcing safeguards for environmental and human rights protection. In addition, World Bank leadership should maintain a focus on serving areas where the private sector is unwilling or incapable of competing. Without pursuit of these priorities the World Bank risks losing support among the U.S. populace, in particular in Congress.

Yet an American president is not the only avenue to achieving an alignment of values. Many of the serious non-American candidates in the recent selection cycles have qualified in this regard. Further, the U.S.-Europe-Japan voting block could still effectively ensure that candidates whose values deviate too far from theirs do not advance. Since the World Bank is an institution that still serves U.S. interests, sacrificing the right to select its president may be required to preserve its relevance.

While relinquishing the presidency may make sensible policy, it should not be given away lightly. First, a U.S. move essentially implies the Europeans and Japanese must do the same, so careful coordination should occur to ensure that they are not caught off guard. But more importantly, this is a valuable bargaining chip, and the administration should ensure that a fair trade occurs. The rising importance of emerging markets suggests a growing list of requests that the United States should make in return.

Conclusion

Preparing for a storm is prudent, and so is preparing for changing seasons. An economic storm coming from across the Atlantic will hopefully not materialize, but the rise of emerging markets is unavoidable. Attention to the financial development needs of emerging economies will pay dividends in terms of building more robust markets for U.S. exports, especially financial services; investing the citizens of the emerging world in like-minded pro-market institutions (literally and figuratively); and fostering cooperation between the U.S. and foreign governments through the pursuit of joint goals.

References

1. See, for instance, Raymond J. Ahearn, James K. Jackson, Derek E. Mix, and Rebecca M. Nelson, *The Future of the Eurozone and U.S. Interests*, CRS Report for Congress (Washington, D.C.: Congressional Research Service, January 17, 2012).
2. See, for instance, International Monetary Fund, *World Economic Outlook April 2012*, World Economic and Financial Surveys (Washington, D.C.: International Monetary Fund, 2012).
3. Ben S. Bernanke, "Banks and Bank Lending: The State of Play" (speech, 48th Annual Conference on Bank Structure and Competition, Chicago, IL, May 10, 2012).
4. International Monetary Fund, *World Economic Outlook April 2012*, World Economic and Financial Surveys (Washington, D.C.: International Monetary Fund, 2012).
5. See, for instance, Willem Buiter and Ebrahim Rahbari, "Global Growth Generators: Moving Beyond 'Emerging Markets' and 'BRIC,'" *Global Economics View* (n.p.: Citigroup, February 21, 2011).
6. Jaime Caruana, "Progress and Challenges in Financial Reform" (speech, XXI International Banking Congress, St. Petersburg, Russia, June 6, 2012).
7. Stijn Claessens, Richard J. Herring, and Dirk Schoenmaker, 2010. *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, Geneva Reports on the World Economy (Geneva, Switzerland: International Center for Monetary and Banking Studies, July 2010).
8. For the history of Treasury exchange rate reports and discussion of its motivations to identify manipulation or not, see Jeffrey A. Frankel and Shang-Jin Wei, "Assessing China's Exchange Rate Regime," *Economic Policy* 22 (51) (2007): 575-627, doi:10.1111/j.1468-0327.2007.00185.x.

9. See, for instance: Danny Leipziger, “Next World Bank Chief Must Restore Its Vision,” *Financial Times*, March 9, 2012; Arvind Subramanian and Devesh Kapur, “World Bank Risks Losing Relevance,” *Bangkok Post*, February 23, 2012; and Robert B. Zoellick, “Why We Still Need the World Bank,” *Foreign Affairs*, March 1, 2012.

Russell A. Green, Ph.D., is the Will Clayton Fellow in International Economics at Rice University’s Baker Institute. From 2007 to 2011, Green served as the U.S. Treasury Department’s first financial attaché to India.