International Economic Policy | Lecture 6

1. Renminbi internationalization

A goal of the Chinese government is the internationalization of the renminbi. Reliance on the dollar exposes the Chinese government to possibly erratic fluctuations of the US policy and to the risk of capital losses associated with the accumulation of dollars (or dollar-denominated assets) as foreign reserves.

- Renminbi internationalization, which started around 2010, is part of a larger goal of Chinese internal economic rebalancing: from investment and exports to domestic consumption and from manufacturing to services, financial services included.
- Renminbi internationalization attempts to make the renminbi a leading international reserve currency and to transform Shanghai into a first-class global financial centre.
- The US dollar is an example of a currency achieving rapidly the status of a first-class international and reserve currency: in 1914 is was not used internationally and by 1924 it become the dominant international currency. Eichengreen (2013) regards the position of the renminbi in 2009 as similar to the dollar's in 1913.
- Global economic covergence will contribute to make the US dollar a less satisfactory international reserve currency: under covergence, the US economy will represent a smaller share of the world economy and that will reduce the US economy's capacity to provide enough safe and liquid assets to meet the world's growing demands.

Eichengreen, Barry (2013): "Renminbi internationalization: Tempest in a teapot?," *Asian Development Review* 30(1), 148-164.

2. Attributes of an international reserve currency (Eichengreen, 2013)

A currency must possess three attributes to be international adopted in commercial and financial international transactions and held as reserve by central banks and governments.

- Scale: the country that issues the currency must conduct a sufficiently large amount of transactions with the rest of the world.
- Stability: the currency's users must believe that the value of the currency is sufficiently stable for the currency to perform well the functions of medium of exchange and deposit of value.
- Liquidity: financial assets denominated in the currency are available in sufficient quantities to be sold and bought, without the currency's value being significantly affected.

The country whose currency becomes internacionalized must develop an economy which is significantly open and integrated with the rest of the world (open capital account), a reputation for financial (economic, political) stability and liquid markets in dollar-denominated assets.

3. The Lewis turning point (Lewis, 1954) and China

Lewis (1954) suggests a two-sector development model (a dual economy consisting of a traditional and a modern sector) in which, initially, (i) agriculture (the traditional sector) dominates economic activity, (ii) there is an abundance of workers in rural areas and (iii) the productivity of labourers in rural areas is very small. In these circumstances, there is a transfer of labour force to the industrial activities (the modern sector developed in urban areas). Labour wages will remain stagnant for a relatively long time. When the industry's demand for labour (resulting from a continued productivity increase) starts to grow faster than the supply of labour provided by the rural areas, a turning point is reached, after which the abundance of rural labour is depleted and wages begin to rise (to attract further labourers from the rural areas, where labour productivity ceases to be very small). The Lewis turning point emerges when the surplus labour that the traditional sector provides for the modern sector begins to disappear and, consequently, industrial labour costs start scalating.

- A literature has been recently developed to assess whether China has reached or surpassed the Lewis turning point (whose definition is somewhat ambiguous: some researchers declare the turning point to occur when the transfer of rural workers switches from acceleration to deceleration).
- The significance of China's Lewis turning point stems from the fact that, once that point is surpassed, rapid economic growth can no longer be supported by a large surplus of rural labourers. At that point, continued growth requires agricultural modernization (improvement of the rural workers' human capital) to ensure the continuation of industrial innovation and upgrading, the consolidation of the urban transformation and the preservation of food security.

Lewis, Arthur (1954): "Economic development with unlimited supplies of labour," *Manchester School of Economic and Social Studies* 22(2), 139-191.

Wang Jin; Zhong Xiaohan (2012): "Has the Lewis turning point arrived in China? Theoretical analysis and international experience," *Social Sciences in China* 33(3), 81-100.

Yuan Zhang, Ting Shao, Qi Dong (2018): "Reassessing the Lewis turning point in China: Evidence from 70,000 rural households," China & World Economy 26(1), 4-17.

4. The demographic dividend in China

The demographic dividend refers to the (potential) gain in economic growth (a potential that can be capitalized and mobilized) that stems from a particular age structure of the population; specifically, from having the working age population growing at a higher rate than the dependent (old) population (the young joining the workforce exceed the old that retire and abandon the workforce).

- The demographic dividend concept views population growth optimistically. The dividend may have a positive effect on economic growth (i) by rising the number of workers relative to the number of dependent persons and (ii) by increasing the savings that accumulate into human capital and stimulate technological innovation. The first factor adds to economic growth through a larger supply of labour; the second, through the potential to increase productivity (industrial investment). In both cases, adequate policies are necessary to realize the dividend: a functional labour market and measures to encourage savings, the formation of human capital and rewards technological innovation. Without proper policy measures, the demographic dividend may turn into a demographic burden.

- When the working age population shifts from expansion to contraction and the dependence ratio from falling to rising, the demographic dividend ends (so the dividend is an exhausted source driving economic growth).
- A decline in the ratio between the working age population and the total population signals the start of the <u>demographic burden</u>, which causes a downward effect on economic growth because an increasing population depends on the income generate by a decreasing share of the working age population.
- China's reform and opening up has at least reached the 40 years mark in 2018. During this period, domestic economic development and participation in economic globalization have occurred simultaneously. China has participated in economic globalization through expansion of imports and exports, attraction of foreign investment, overseas investment, participation in global governance and, in the last years, the "Belt and Road Initiative." The development process has benefited from abundant labour force and the human capital previously accumulated (during the planned economy period).
- Two current hot questions. (1) <u>Is China's economic growth losing the growth momentum from its demographic dividend</u>? (Hence, the whole dividend has already been translated into a competitive advantage in manufacturing.) (2) <u>Has China's economic development reached its Lewis turning point</u> (the labour supply ceases in practice to be unlimited)?

Fang Cai (2010): "Demographic transition, demographic dividend, and Lewis turning point in China," *China Economic Journal* 3(2), 107-119.

Fang Cai (2018): "Perceiving truth and ceasing doubts: What can we learn from 40 years of China's reform and opening up?," *China & World Economy* 26(2), 1-22.

Nicole van der Gaag; Joop de Beer (2014): "From demographic dividend to demographic burden: The impact of population ageing on economic growth in Europe," *Tijdschrift voor Economische en Sociale Geografie* 1-16.

Ajit Kumar Singh (2016): "India's demographic dividend: A sceptical look," *Indian Journal of Human Development* 10(1), 10-26.

5. The status of the dollar

When the euro was created in 1999 some claimed that the euro would challenge the international status of the dollar (for instance the recipient of the Nobel Prize in economics Robert Mundell, 'the father of the euro'). Two decades after, this prediction does not appear to have materialized. The 2008 global financial crisis (and, specifically, the European debt crisis) has weakened the attractiveness of the euro as a global competitor to the dollar. The status of the dollar itself has been damaged by the global financial crisis: the confidence in the dollar as an international currency has been negatively affected by the unorthodox fiscal and monetary measures adopted in the US to combat the financial and economic effects of the crisis. These events have pointed to the renminbi as possible replacement of the dollar as a leading international currency. Chey (2013) contends that this replacement is unlikely in the medium run: politically and economically China is not yet an internationally strong power. What appears more likely is the emergence of the renminbi as an Asian regional currency.

Hyoung-kyu Chey (2013): "Can the renminbi rise as a global currency? The political economy of currency internationalization," *Asian Survey* 53(2), 348-368.

Cohen, Benjamin J. (2011): *The future of global currency: The euro versus the dollar*, Routledge, London and New York.

Eichengreen, Barry (2011): *Exorbitant privilege: The rise and fall of the dollar and the future of the International Monetary System*, Oxford University Press, New York.

6. Chinese view of the two global imbalances

The world economy appears to suffer from two associated imbalances, the global current account imbalance (countries with big foreign deficits and with big foreign surpluses) and the power imbalance embedded in the international monetary and financial system (which can be ascribed to the dollar international hegemony and the Western dominance of international monetary and financial institutions such as the IMF and the World Bank: abuse of the dollar dominance and biased IMF surveillance).

- Western analysts seem to attribute to China the major responsibility for the global economic rebalancing, as China's economy (over-dependent on exports, credit expansion and incentives to foreign investment) should itself be rebalanced (from investment to consumption) and deleveraged, and the renminbi allowed to appreciate as much as necessary. It has been suggested that China's economy is subject to a trilemma between rebalancing, deleveraging and growth sustainability.
- Chinese analysts recognize China's part in the problem but rather support the strengthening of multilateral collaboration forums (G20) and mechanisms for international cooperation. They also admit the Western dominance of the international economic system and their call is for its pragmatic reform taking into account the global economic interdependence created by economic globalization.

Yong Wang (2012): "Seeking a balanced approach on the global economic rebalancing: China's answers to international policy cooperation," *Oxford Review of Economic Policy* 28(3), 569-586.

7. On harmonizing international production standards

Anni Huhtala; Eva Samakovlis (2002): "Does international harmonization of environmental policy instruments make economic sense? The case of paper recycling in Europe," Environmental and Resource Economics 21, 261-286.

One of the benefits attributed to the international harmonization of policy measures is helping to guarantee fair competition in international markets. But harmonization should be expected to involve shadow costs. The paper above considers the goal of promoting the use of recycled material and analyzes the costs of harmonizing paper recycling standards, focusing on two policy measures: minimum content requirement of recycled material (the fraction of recycled inputs with respect to virgin material cannot be lower than a certain value) and utilization rate target (a minimum proportion of recycled inputs should be used in the production of final goods).

8. Achievements and weaknesses of the European monetary union

Trichet (2013) argues that European prosperity and influence depends on setting the correct path of European integration, both economic and political. Europe's EMU is itself viewed as a historically unique achievement: "a 'society of states' of a completely new type." He lists successes of the EMU: price stability and stable expectations on the value of the euro (future price stability), with these results attained in the presence of important global oil and commodity shocks and not at the expense of sacrificing employment creation. He also lists several EMU economic governance weaknesses. In particular:

- "the Stability and Growth Pact designed to ensure sound fiscal policies in the Euro area has not been correctly implemented."
- "at the start, the governance of the Euro area did not comprehend any serious monitoring and surveillance of competitiveness indicators, of nominal evolutions of prices and costs in any particular nation and of national external imbalances within the Euro area."
- The lack of an effective banking union (given the high correlation between the creditworthiness of a state and its banks).
- Neglect in the implementation of crisis management tools when the euro was created.
- Market integration (particularly, in services) has not been fully achieved.
- "The slow and hesitant implementation of the structural reforms foreseen in the Lisbon agenda and in the 2020 program."

Trichet, Jean-Claude (2013): "International policy coordination in the Euro area: Toward an economic and fiscal federation by exception," Journal of Policy Modeling 35, 473-481.

9. Trichet's (2013) economic and fiscal federation proposal

The current system (the Macroeconomic Imbalance Procedure) is one of 'fines' (a percentage of GDP) for countries whose improper conduct (materialized in excessive macroeconomic imbalances) puts at risk the stability of the EMU. Since such fines have not proved effective to deter countries in undesirable behaviour, Trichet suggests replacing this system with a new decision making process he calls 'the activation of an economic and fiscal federation by exception', in which fiscal sovereignty can be limited in exceptional cases by a majority vote of the members of the European Parliament from Euro area states.

- "The scope of interventions and the measures taken by the federal institutions would so rely, even in the much longer term, on the principle 'as little as possible in normal times, but as much as necessary in exceptional times'." It appears that the ECB applied this principle during the Euro area debt crisis (July 2012: Draghi's 'whatever it takes' speech).
- Trichet also proposes the setting up of a Ministry of Finance of the Euro area. "This ministry would have the responsibility of the activation of the economic and fiscal federation when and where necessary. It would be responsible for the handling of the crisis management tools like the ESM [European Stability Mechanism]. It would also be responsible for the handling of the banking union, within the limits of the executive branch responsibility. And it would represent the Euro area in international institutions and informal groupings."

Trichet, Jean-Claude (2011): "Tomorrow and the day after tomorrow: A vision of Europe," Humboldt University, Berlin.

"People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them." Jean Monnet

10. An academic malaise?

Since relatively long ago, international economic policy coordination is a fashionable concern in open economy macroeconomics. The international transmission of effects of decisions taken by foreign macroeconomic policymakers forces domestic macroeconomic policymakers to take into account those foreign decisions. International cooperation may help to internalize those effects, but then the problem is with what costs, using what instruments and to achieve what goals. The attempt to coordinate policies internationally may create more problems that it solves, as long as states retain full (or large enough) sovereignty. Darby (1986) questions the usefulness of game-theoretic models, as currently developed. They tend to lack economic intuition, fail to resolve basic issues on the international transmission mechanisms, focus on the cost of failure to cooperate when those mechanisms are already understood and, most importantly, are scarcely relevant in a world where policymakers disagree on desirable values of macroeconomic variable or the effects, global or domestic, of policy measures. In short, "game-theoretic analysis has not been and likely will not be a fruitful way to understand international macroeconomic policy coordination."

Darby, Michael R. (1986): "International economic policy coordination and transmission: A review," *Oxford Economic Papers* 38(3), 545-550.

Currie, David; Paul Levine (2009): *Rules, reputation and macroeconomic policy coordination*, Cambridge University Press, Cambridge, UK.

11. Coase theorem

"Let exclusive property titles to the environment be defined, and let them be transferable. Let there be no transaction costs. Let individuals maximize their utilities, and let them be non-altruistic. Then a bargaining solution among different users of the environment will result in a Pareto-optimal allocation of the environment. The resulting allocation is independent of the initial distribution of property titles."

Siebert, H. (2008): *Economics of the environment*, Springer, Berlin.

Wiesmeth, Hans (2012): *Environmental economics: Theory and policy in equilibrium*, Springer, Berlin.

"The negotiations are currently still in a deadlock because short-term national interests are blocking a prompt and effective global climate protection agreement… "

German Advisory Council on Global Change (WBGU) (2009): *Solving the climate dilemma: The budget approach*, Berlin.

"…the reasons for Americans' failure to recognize the great significance of climate change is that we are wedded to an economic model and practices that privilege competition over cooperation, selfish pursuits over promoting the common good, and greed over generosity. Ingrained in American society and practices are emphases on "big," "fast," "efficient," "competitive," and "profitable." We Americans have not especially privileged "sustainable" in our communities, society, and economy."

Judith Blau (2017): *The Paris Agreement: Climate change, solidarity, and human rights*, Palgrave Macmillan, Cham, Switzerland.

"… Pericles wisely observed that 'where there is no vision, the people shall perish.' Today, a lack of vision with respect to climate change adaption and mitigation will lead to populations and nations that indeed perish from flooding, drought, health crises and environmental destruction. The signs are clear and undeniable in all parts of the world where weather phenomena triggered by climate change are becoming increasingly evident and dangerous. Climate projections for the year 2100 are daunting…"

Ross Michael Pink (2018): *The climate change crisis: Solutions and adaption for a planet in peril*, Palgrave Macmillan, Cham, Switzerland.

12. Workers vs (businesses & government): new state of exploitation?

"Since the beginning of the twenty-first century, we have been living in a state of drastic social transition; indeed, it is surprising that nobody forecast such extreme changes. Especially in Japan, the increase in the gap between the rich and poor has become quite large (…) The power of big business is quite formidable, and the status of workers is in a very fluid state.

Indeed, it seems that so-called disposable workers are no longer "human beings." Younger generations are completely exhausted by the new state of exploitation (…) and have little hope for the future. They can be easily replaced by foreign unskilled workers. They are excluded from labor union protections that are typically in place solely for regular workers. And they are looking in vain for rosy opportunities just to become regular workers (…)

Foreign workers employed as technical interns also find themselves in terrible situations: they are being exploited with wage rates that are much lower than legal minimum standards. They must work long hours as unskilled workers and cannot acquire any new promised occupational skills. Disappointed from such unfair treatment, they quit their jobs, but then find (at least in Japan) that they have no public status or employment insurance. Some of them turn to crime (…)

On the other hand, big business is warmly supported by the government on the pretext of national profits and the maintenance of global competitive power. Why on earth is it that for 15 years we, the common people, have had to struggle for only small and ordinary levels of happiness?"

Kondoh, Kenji (2017): *The economics of international immigration: Environment, unemployment, the wage gap, and economic welfare*, Springer, Singapore.

Powell, Benjamin; ed. (2015): *The Economics of immigration: Market-based approaches, social science, and public policy*, Oxford University Press, New York.

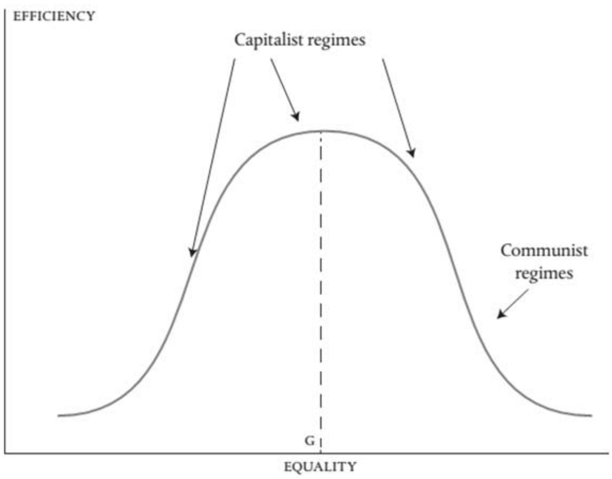
13. EU immigration policy: the tension between security and development considerations

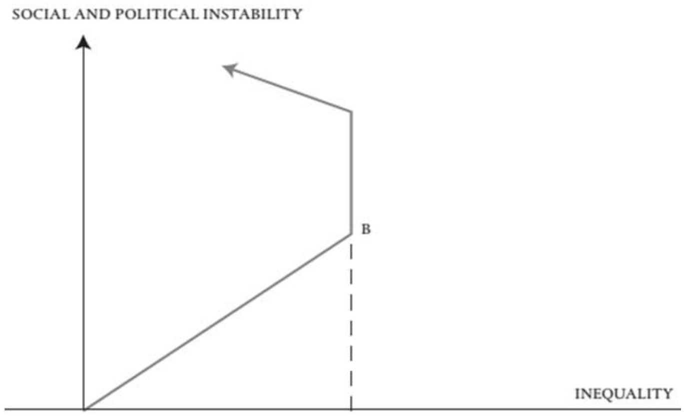
During the 2000s, the EU immigration (and asylum) policy appears to have shifted towards its externalization to non-EU member states (such as Turkey and Morocco). This strategy of external governance seems to have been reinforced by the Arab Spring and the Syrian civil war, as the have created for the EU the biggest migrant and refugee crisis since World War II. Migration flows are viewed under a two-fold perspective: as an internal security challenge to be addressed by cooperating with third countries to influence their migration policies; and as tool for national and regional economic growth and development. The tension between these two perceptions creates contradictions and inefficiencies in the EU immigration policy. By externalizing its immigration policy, is the EU sharing or shifting burdens?

Ayselin Gözde Yıldız (2016): *The European Union's immigration policy: Managing migration in Turkey and Morocco*, Palgrave Macmillan, London.

Andrew Geddes; Peter Scholten (2016): *The politics of migration and immigration in Europe*, SAGE, London.

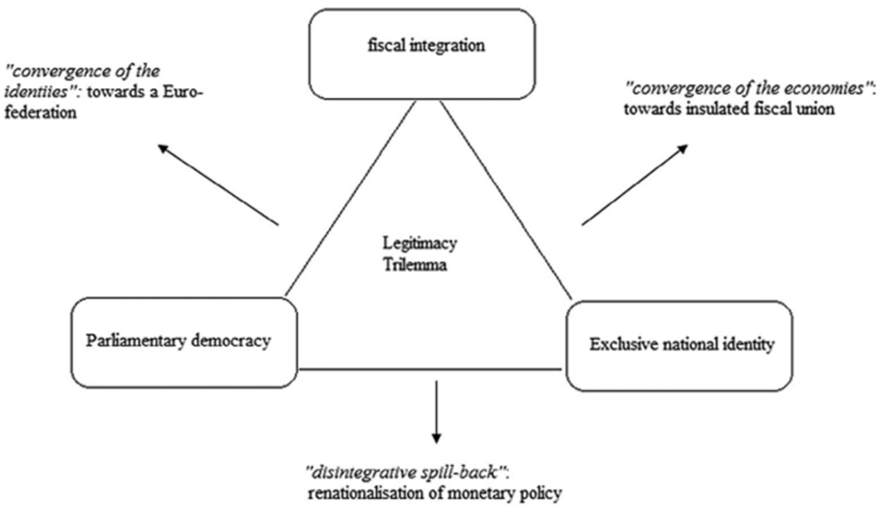
14. Government vs market





de Grauwe, Paul (2017): *The limits of the market: The pendulum between government and market*, Oxford University Press, Oxford, UK.

15. Economic integration and a legitimacy trilemma



Francesco Nicoli (2017): "Democratic legitimacy in the era of fiscal integration," Journal of European Integration 39(4), 389-404

Ansgar Belke; Daniel Gros (2009): "On the benefits of fiscal policy coordination in a currency union: A note," Empirica 36, 45-49.

Kiki Verico (2017): *The future of the ASEAN economic integration*, Palgrave Macmillan, London.

China Economic Review 47 (2018): Special issue on China's changing integration into the global economy

Francesco Paolo Mongelli (2008): "European economic and monetary integration, and the optimum currency area theory," Economic Papers 302, European Commission, http://ec.europa.eu/economy_finance/publications.

16. Explaining the divergence in the economic performance of EMU members

There is a big divide in the EMU between two groups of countries. One group is led by Germany and includes those countries (clearly, Netherlands, Austria, Belgium; less enthusiastically, France) that, since the early 1980s, have reorganized their macroeconomic institutions to match the performance of the German economy (by pegging their currencies to the Deutsche Mark and keep unit labour controls under control or facilitate their falling).

The second group is given by those who tried later to attain exchange rate stability by linking their currencies to the Deutsche Mark and, in general, adapted their instutional macroeconomic framework as a means to satisfy the Maastricth Treaty criteria to join the EMU (clearly, Portugal, Italy and Greece; also, Ireland and Spain). For the latter group, the initial drop in labour costs in the 1990s to get read for the EMU was replaced by a continuous increase in the 2000s after the adoption of the euro. The fiscal crisis of 2009-10 culminated that evolution.

- An explanation of the divergence is given by the (so-called) irresponsible fiscal policies, and the fiscal mismanagement, that resulted from the attempt to compensate through fiscal activism the loss of monetary policy independence. Before the 2008 financial crisis, the interest rate differentials between the debts of the two groups were very small. That allowed the members of the second group to run up large volumes of public debt. This created fiscal imbalances that make those countries strongly vulnerable under the extraordinary conditions of the global financial crisis. The perception of that vulnerability made the fiscal position of those countries untenable and led to the European debt crisis.
- A second explanation involves labour market regulations. When the fundamental policy tools (monetary, fiscal and exchange rate policies) cannot be freely used, as occurs in the EMU, other institutions and variables should be 'more flexible' (and that usually is supposed to mean the labour markets and wages). Lack of sufficient 'labour flexibility' in the members of the second group of countries makes the underlying macroeconomic problems and imabalances more serious. This argument seems to forget that the labour markets of the states in the first group are equally inflexible, as they have strong labour unions and their wage-setting systems are relatively rigid (but now the expression used is 'highly organized').
- A third explanation (applied mostly to Spain and Ireland) have more to do with speculative manias and financial considerations: asset price inflation and bursting bubbles. Low interest rates fuelled an asset and construction boom through cheap mortgages and rising housing prices.
- A fourth one revolves around poor financial regulation (that attracted risky capital).
- A fifth explanation blames EMU itself, as some troubles made apparent by the euro crisis (such as massive current account divergences) correlate well with the start of EMU.

Bob Hancké (2013): Unions, central banks, and EMU: Labour market institutions and monetary integration, Oxford University Press, Oxford, UK.

17. International tax policy

"Rising inequality, within as well as between states, demands effective institutional solutions. Income taxation has traditionally been the textbook policy tool for ameliorating such inequality. States' ability to promote their normative goals through their tax systems has been seriously challenged, however, by the decentralized structure of international taxation, which has set states in competition for capital, residents, and tax revenues. Due to this competition, states operating unilaterally are increasingly unable to sustain their tax bases and fully pursue their normative goals, that is, to collect sufficient taxes to finance their public goods in an efficient and just way (…) The driving argument made in this book is that international taxation should be analyzed as a decentralized competitive market, whereby governments have increasingly become strategic players maximizing their national interests."

Tsilly Dagan (2018): *International tax policy: Between competition and cooperation*, Cambridge University Press, Cambridge, UK.

18. Sino-US interaction: Thucydides trap, Churchill trap or co-ruling?

"The 'Thucydides trap' is in a large part an induction of historical experiences on great power politics. In the contemporary era, however, there is small risk of all-out war between a rising power and a hegemonic power. By contrast, the 'Churchill trap', whereby the superpowers fall into a long-term confrontation reminiscent of that between the US and the Soviet Union during the Cold War, presents a genuine risk and one that should be taken far more seriously (…) there is a third type of great power relationship between the two poles, which I call 'co-ruling', whereby rather than being geographically demarcated according to their respective 'spheres of influence', the two superpowers jointly lead all or most of the small and medium-sized countries in the system."

Yang Yuan (2018): "Escape both the 'Thucydides Trap' and the 'Churchill Trap': Finding a third type of great power relations under the bipolar system," Chinese Journal of International Politics, 1-43.