despite having de jure signed on to these rules. But going forward, perhaps one can be more confident that its stake in an open system will be more sustained.

There is another reason for believing that China's stake in an open system might deepen. The analysis above is that China is in fact promoting and seeking the rise of the renminbi, and the prediction in chapter 5 is that the fundamentals are moving in favor of such an outcome. If these are borne out, China is unlikely to act systematically in a protectionist and destabilizing manner. Such actions would undermine the reserve currency status of the renminbi that China seems to be seeking for external and domestic reasons. One would have to think that Chinese policymakers are unaware of the consequences and responsibilities of their aspirations for the renminbi. The steady criticisms and recriminations that have emanated from Beijing about the policies of the United States as the guardian of the major reserve currency suggest otherwise.

Arena of Cooperation: Trade Not Macroeconomics

Given the conjecture that exchange rate issues for China will become less salient over the next few years but trade will be of enduring importance, much of the focus of this chapter and the next is on international trade cooperation rather than macroeconomic cooperation. This might seem out of touch with current realities, especially considering that the Doha Round has been in a coma now for several years, while the recent global financial crisis and the effective response to it have rescued the IMF from nearly terminal irrelevance prior to the crisis. The public perception is one of a moribund multilateral trade system and a rejuvenated, relevant, and responsive multilateral economic and financial system, and almost all the policy discussion today focuses on reforms of the international monetary system.

However, the rationale here for focusing on international trade cooperation and neglecting monetary issues is twofold. First, it is likely that the vanes of taste and intellectual effort now pointing strongly in the direction of the IMF and the macroeconomic system will veer again toward trade and the trading system. That is likely not only because the rise of China will imply a shift toward trade issues, but also because there are greater limits to successful international monetary cooperation than to cooperation on trade. Put differently, the trading system has actually performed better than the macroeconomic system in two important respects: governance and as a forum of cooperation between the major players (which will be of relevance in thinking about China going forward).[7] Understanding why this is so will also explain

7. The appropriateness of comparing monetary and trade is itself controversial. Objections can come from opposite sides. One claim is that the same countries that sit around the table to discuss monetary matters also discuss trade matters, so there cannot be differences in cooperative outcomes across these areas. An entirely different objection to the comparison is that the theoretical rationale for macroeconomic cooperation is much less strong than it is for trade

the contention here that prospects for international monetary reform might not be quite as bright as they seem at the moment (box 8.1).

To project future cooperation involving China, historical parallels from the earlier half of the 20th century or the late 1800s may not be instructive, but there is the history of postwar economic cooperation between two superpowers in the trade arena (the United States and European Union) and to a lesser extent between the United States and various large countries such as Germany and Japan in relation to macroeconomic and exchange rate issues.

Of the three major multilateral institutions created after World War II—the World Bank, IMF, and the General Agreement on Tariffs and Trade (GATT), which subsequently became the WTO—the GATT/WTO is the one institution that has fared well in two key respects. First, its governance has evolved organically to keep up with changing economic (and political) realities. The international financial institutions (IMF and World Bank)—and it might be added the UN Security Council—suffer from a crisis of legitimacy in a way that is less true of the GATT/WTO. The IMF's outdated governance reflects the receded Atlantic-centered realities of 1945 rather than the ascendant Asia of the 21st century. Emerging-market countries have expressed skepticism about the role of the IMF and its credibility. In contrast, the GATT/WTO has changed its governance endogenously to broadly reflect changes in economic weight in the world economy. As explained below, these governance changes relate less to formal voting procedures (which have not changed substantially over time) and more to do with de facto governance, that is, perceptions of legitimacy and effectiveness that determine the fundamental incentives to cooperate, to agree to new rules and subsequently abide by them.

Second, in the postwar period the GATT/WTO was an important and effective mediator of trade relationships (especially of frictions and conflicts) between the major powers (notably the United States and European Union) in a way that the IMF seldom was in the macroeconomic arena. Macroeconomic issues have mostly been resolved through the G-5 or the G-7 industrial countries as in the Plaza and Louvre exchange rate accords of the mid-to-late 1980s.

What is the evidence for these two virtues—that capture two important dimensions of governance, legitimacy and effectiveness—of the GATT/WTO over the IMF? Take, for example, initiation of conflict resolution and compliance with rules.

The WTO has developed a reputation among its members as a forum for relatively impartial dispute settlement. Any country affected by the actions of others is able to complain to the WTO, bringing into play a well-established, frequently used, and generally respected system of dispute settlement. In fact,

cooperation, where the intellectual pedigree establishing the mutuality and magnitude of gains is time honored and well established. So comparison would not just be a case of comparing apples and oranges, it would also unfairly favor trade because of the clear expectation of benefits from cooperation.

Box 8.1 Limits to international monetary cooperation

Proposals for reform of the international monetary system are flying fast and furious around the globe. The key role played by the International Monetary Fund (IMF) in the crises of 2008–2011 has not only helped rescue it from the brink of irrelevance, it has raised the ambition for future systemic reform. This sense of possibility has also been fed by the return of the IMF as an intellectual player with its backing of un-IMF-like policies: fiscal expansion during the crisis and imposition of capital account controls more recently.

The prospects for any serious reform, however, remain slim because of the inherent limits to international monetary cooperation. Systemic threats arise from the policies of the largest countries, and in particular when polices pursued in self-interest conflict with the collective interest. But, by definition, it is difficult for the rest of the world to change the incentives of the large country to give more weight to the collective interest. Successful cooperation is fated to falter if not fail. This is in contrast to trade cooperation which can be reasonably effective even between the major players because of reciprocity and the exchange of concessions highlighted in the text.

Consider three of the major issues on the agenda of IMF reform: global imbalances, reserve currencies, and provision of emergency or crisis financing (the "global safety net"). Global imbalances are in part a manifestation of the asymmetric adjustment problem. Deficit countries have greater pressure on them to adjust via markets or via the leverage of financing that allows creditors to impose policy conditionality on debtors.[1] What leverage can be exerted over creditor countries, especially the large ones?[2]

If the world has found it difficult to persuade China to appreciate its currency and reduce its surplus, that is not the first instance of failure. As John Williamson (2011, 1) has noted: "It has been 80 years since John Maynard Keynes first proposed a plan that would have disciplined persistent surplus countries. But the Keynes Plan, like the subsequent Volcker Plan in 1972–74, was defeated by the major surplus country of the day (the United States and Germany, respectively), and today China (not to mention Japan or Germany) exhibits no enthusiasm for new revisions of these ideas."

The question to ponder is whether there is anything that the rest of the world could have done—by way of sticks or carrots—to have persuaded the US in 1944, Germany in 1973 or China in 2007 to change their positions or policies for the collective good.

On reserve currencies, the reform-related discussions have focused on creating official alternatives to the dollar by rehabilitating the special drawing rights (SDR). These discussions are a side-show because countries with reserve currencies—actual and aspiring—must be willing to actively take steps and make contribu-

Box 8.1 Limits to international monetary cooperation *(continued)*

tions to promote the alternative at the expense of their own currencies. It is like asking Coke to also tout the virtues of Pepsi in its ad campaigns.

Although the United States played a key role in the creation of the SDR in the 1960s that was in part an attempt to prevent a rush into gold, which would have jeopardized the role of the dollar. Its attitude to the SDR would have been quite different had the SDR become a serious rival to the dollar. China is likely to adopt a similar attitude to the SDR in the future. Natural market forces are inevitably, if slowly, working to elevate the renminbi to reserve currency status. China will have to undertake some key reforms to turn that possibility into reality. All the signs are that it is doing so because not a day passes without some foreign country, transaction or company gaining greater access to the renminbi. In these circumstances, why would China have any serious incentive to strengthen an SDR that might check the rise of its own currency? And if China decides to promote the renminbi, the rest of the world can do little to prevent or delay that as it has proved difficult to change the incentives for China to reverse its mercantilism.

A corollary of the observation that cooperation is least likely where the self-interest of the largest countries are at stake is that the prospects for successful cooperation are greater where these countries are less affected and when the demands on them are minimal. Building global safety nets via greater and more expeditious access to crisis financing is in fact one area where the greatest progress has already been made. The Fund's lending ability has been increased three-fold after the crisis and more may yet come. For the large countries, it is both desirable and effective to push for larger safety nets. The costs are relatively small, involving larger financial contributions rather than any major change of domestic policies. And the rewards are great because the system as a whole is strengthened while the individual clout of the large countries is increased.

The IMF will be what it always has been. It is a valuable provider of global public goods such as research, analysis and institution-building in member countries. And it is a very effective forum for "cooperation" between creditors and borrowers because of the clout that creditors can exercise. The IMF, with some exaggeration, stands for Insolvents Must Fawn, albeit with different insolvents having to fawn to different degrees. But the institution's dirty secret is that, outside this creditor-borrower context it has not really been successful in securing cooperation between the systemically critical players, in getting them to subordinate, in some

(box continues next page)

Box 8.1 Limits to international monetary cooperation *(continued)*

key instances, narrow self-interest over the collective good. That reality is unlikely to change materially. What is changing is merely the identity of the systemically critical players.

1. For debtors with reserve currencies these pressures might be attenuated.
2. It is true that the United States under President Richard Nixon in 1971 was able to get some surplus countries (including Germany) to revalue their currencies but it is worth remembering that that attempt: was directed against large but not the largest players, relied on trade sanctions not monetary or financial carrots and sticks, and in any event proved short-lived reflected in the break-down of the Bretton Woods system of pegged exchange rates in 1973.

disputes are the stuff of WTO proceedings, and it is not unusual to bring a dispute in the WTO, a possibility that is absent in the IMF.

The WTO's legitimacy is highlighted by the fact that bringing disputes in the organization has become much more of a two-way practice (in the sense of industrial and developing countries being both complainants and defendants). For example, the United States has been a complainant in 88 disputes and a defendant in 99 disputes. The analogous figures for India are 17 and 19; and for Brazil 23 and 14. Even China has initiated seven disputes in the WTO, of which five have been against the United States (Hufbauer and Woollacott 2010). Not only are the large developing countries active complainants, so are small countries. Tiny Costa Rica successfully challenged US trade practices. Tinier Antigua (with a population of less than 100,000) successfully challenged US gambling laws.

Effectiveness is illustrated by reasonably good (though not perfect) compliance with dispute settlement rulings. As of 2007, the compliance rate for all disputes was above 80 percent (Wilson 2007). Crucially, not just developing countries have complied. The major trading powers have exhibited good behavior. Of the 33 cases where violations were established, the United States has complied or is in the process of complying solely through administrative actions in 26 cases. The European Union has complied in nearly all the 16 cases where it was found to be violating WTO rules.[8]

One free-trade-oriented critique of WTO dispute settlement is that it is based on retaliation, which can be extremely dangerous. But instances of retaliation have been relatively few. Of the 109 cases surveyed, only in eight was retaliation requested and authorized. Compliance thus occurs mostly without actual retaliation, although some threat of it is always present and is perhaps even necessary. Experience suggests that the mere prospect of retaliation, as

8. There are, however, concerns about delays in compliance (Davey 2009).

well as the reluctance to be seen as a rule-breaker, are sufficient to ensure compliance, and there is rarely need for action.

The comparable picture for the IMF is dismal. In terms of legitimacy, the IMF has attempted periodically to revise its governance and decision-making structure by changing the allocation of quotas. Most recently at the G-20 summit in Korea, the IMF agreed to a further shift in quotas away from the United States and Europe toward the dynamic emerging-market countries. However, despite this effort and others, including the move to make money accessible at cheaper rates and with less conditionality, there is a fundamental problem with the IMF, captured in the stigma associated with borrowing from it. Ask any Asian country whether it would contemplate borrowing from the IMF in the foreseeable future and the answer is likely to be negative.

On effectiveness, especially where larger countries are involved, the IMF's record is poor. It should be remembered that while the IMF has been able to effect changes in member-country policies in the context of financial arrangements, it has not been influential without the leverage of financing. In its key surveillance function (where no financing is involved), there have been relatively few instances where IMF intervention has led to changes in the policies of large creditor countries even when such policies have had significant spillover effects on others. In other words, the IMF has not been able to persuade these countries to sacrifice domestic objectives for systemic ones. There seems to be an implicit "pact of mutual nonaggression," in IMF surveillance, as Bergsten and C. Randall Henning (1996) and long-serving IMF Economic Counselor Michael Mussa (2008) have argued.[9] The IMF has had a history and tradition of nonadversarial dialogue between its members in a surveillance context and has not had to develop a real dispute settlement system. There is no legal mechanism in the IMF for affected members to initiate action against the offending party.

And in fact, when serious problems have arisen—for example, over currency issues in the early 1970s (the break-up of the Bretton Woods System) and over the dollar and the yen in the mid-to-late 1980s—they were largely resolved outside the IMF, either bilaterally or through the G-5 and G-7. During the European Exchange Rate Mechanism crisis of the early 1990s too, Europe kept the IMF largely out of the discussions. And the IMF was involved in the recent turmoil in Europe largely because financial resources were at stake.

But the historical record is actually worse. It is also forgotten that the early years of the IMF were notorious for the major players largely ignoring the key IMF article requiring members to keep their exchange rates pegged and changing them only after consultation. Canada through much of the

9. Cohen (1998, 161–62) describes this asymmetric effectiveness well: "[T]he IMF's writ has come to run mainly to smaller and poorer member countries, where authority can be exercised through the organization's control of access to credit as well as through policy conditions attached to its loans. For larger and wealthier states, by contrast—arguably the most critical actors from a systemic point of view—the direct role of the IMF has dwindled over time . . ."

Bretton Woods period maintained a floating exchange rate. France devalued its exchange rate in 1948 and in 1969; and the United Kingdom devalued sterling in 1949 and 1967 and only nominally consulted the IMF. The Deutsche mark floated upward in 1962, in late 1969, and again in the early 1970s, which elicited the comment from the Canadian representative: "They'll have to build a bigger dog house now."

Except in rare instances, no erring country has been penalized.[10] Indeed, a cynical interpretation of the post-1973 IMF was that it reincarnated itself as a forum for soft cooperation based on surveillance because the harder form based on clear, hard obligations demonstrably failed.

Exchange and Reciprocity as Determinants of the Efficacy of the World Trade Organization

In order to examine how effective the WTO or WTO-type governance will be going forward, one needs to understand why the WTO works and whether these factors will persist over time and survive China's rise. There are two related reasons why the WTO has had more legitimate governance and been more effective in dealings between the rich countries than has the IMF.

First, trade inherently lends itself to exchange. If a country gets large, others automatically have an incentive to engage with that country in order to gain access to growing markets. The history of the GATT confirms this. In the seven bouts of tariff negotiations prior to the Uruguay Round and the formation of the WTO, only the industrial countries were meaningful participants in multilateral trade negotiations because only these markets were large (WTO 2007). They bargained among themselves to reduce trade barriers, while developing countries were largely left out of this process and had few obligations to liberalize. They availed themselves of the benefits of industrial-country liberalization, courtesy of the most favored nation (MFN) principle, but that defined pretty much the limits of their contribution to or benefits from the GATT. Industrial countries were content with this arrangement, in part because it alleviated the pressure on them to liberalize sensitive sectors such as agriculture and clothing, but perhaps more importantly because the markets of developing countries were not at that stage sufficiently attractive. It did not really matter enough to the industrial countries to exert pressure on developing countries to liberalize: The benefits were smaller than the costs of having to liberalize their own labor-intensive sectors (Wolf 1987).

As development and globalization proceeded apace through the 1980s, hitherto "small" developing countries started growing in size and becoming attractive to industrial-country exporters as markets. This "shock" of the economic transformation of a large number of developing countries (con-

10. France (1948), Czechoslovakia (1953), and Kampuchea (1978) were three early instances of countries having to face some kind of sanctions. Czechoslovokia was expelled from the IMF in 1954.

vergence) meant that the previous equilibrium whereby developing countries were left out of the GATT process needed to be revisited.[11]

The Uruguay Round was then precisely the required adjustment to this shock and established a new "equilibrium." The larger developing countries were brought into the fold because their markets started to matter, and they in turn had to take on many of the obligations of industrial countries. The two-tiered approach was abandoned to create a symmetry of obligations between all members.

The second reason the WTO works is reciprocity—the exchange of concessions to open markets. Robert Solow's demotion of the economics profession to accounting, quoted at the beginning of this chapter, nevertheless has powerful implications for trade. That one country's exports is another's imports and vice-versa creates the basis for reciprocity. This is the heart of the GATT/WTO process and one that ensures that all players feel that they have derived a fair political "bargain." Reciprocity ensures political buy-in to cooperation. What periodic negotiations have done in the GATT/WTO is to update this political contract between countries, redressing some old grievances and papering over others, with the implicit understanding that there will be a future occasion to take up the unsolvable problems of the day.

A consequence of reciprocity and the periodic updating of the political contract to cooperate, and another reason why the WTO works, is that this process creates the incentives to adhere to the dispute settlement contract. WTO dispute settlement is effective largely because countries feel that they have previously (and recently) made a reasonably advantageous, fair, and equitable bargain to which they must adhere. It is interesting here that a number of WTO rulings have gone against China, which it has not protested but rather chosen to implement. India, despite having strenuously opposed the introduction of intellectual property in the WTO, now complies with WTO dispute settlement rulings asking for changes to Indian intellectual property laws and practice. WTO governance works because negotiations to create the rules and agree on liberalization are perceived as fair and broadly equitable in outcome, which renders subsequent compliance with the rules and agreements possible.

From a governance perspective, whereas power in the Bretton Woods institutions was historically determined and has proved immutable (especially since the currently powerful have been reluctant to cede power), power and influence in the WTO evolve organically because they flow from market size. As China, India, and Brazil have grown rapidly, they have naturally and without any help from other countries become serious players in the trading system. They have commanded power. They have not needed it to be granted to them.

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11. This underlay the loaded rhetoric during the Uruguay Round that developing countries were free riders in the system, extracting the benefits from MFN status and offering little by way of their own liberalization.

One important caveat to this glossy reading of the WTO is the contention that WTO rules never impinge on big and important policy issues such as exchange rates or monetary policy. Cooperation on everything from underwear to shirts and semi-conductor chips will always be easier than cooperation on exchange rates or monetary policy. This charge—that some issues are too big to negotiate or litigate in the WTO—might have some validity but should not be overstated. Agricultural subsidies, intellectual property laws, tax policies, and consumer safety are all issues that have major political implications domestically and have been addressed with some degree of success in the WTO.

If this analysis of the WTO's efficacy is valid—and to the extent that China feels that it has gained from WTO accession and its terms, and values an open rules-based trade system from which it has gained immensely—China will have a reasonable incentive to abide by existing WTO rules. In this sense, it is encouraging that China is becoming more of a routine participant in WTO dispute settlement proceedings both as an initiator of disputes and as a respondent. It is also encouraging that so far, China has largely agreed to comply with the terms of WTO dispute settlement proceedings. For example, of the eight cases brought by the United States, three have been resolved by a memorandum of understanding, two are pending decision, and in three China has claimed compliance with the decision of the Dispute Settlement Body. China's actual compliance will take some time to ascertain, and there is always scope for circumventing actions—especially in China's case given the vast amount of economic activity controlled or directed by the state. But all the indications are that China takes its WTO commitments seriously.

If an economically dominant China will have a reasonably strong stake in maintaining the current open trade and economic system and if the existing trade institutions can be reasonably effective in coping with such a China, what then is the problem for the world and for economic cooperation? What could go wrong?