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Rebuilding the Global Economy

A special series outlining policy priorities
and solutions in 2021



Adam S. Posen, editor

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1 Introduction: Rebuilding the Global Economy

Adam S. Posen

The world economy is experiencing a [corrosion of globalization](#). The web of economic and commercial ties across the world is fraying, with more frequent and larger gaps in it—even as trade in goods, services, and technology shifts locations and in some places grows. For globalization is multidimensional, encompassing much more than international trade, though panic about trade gets most of the political and press attention. What matters for human welfare is the quality, not the quantity, of globalization. As global economic integration deteriorates, its benefits for everyone are eroding.

Worldwide, people want to be left in peace, make a decent living, educate their children, look after their families, and, if possible, save for the future. For decades that simple but profound state of economic safety and freedom became ever more widely attained, largely hand-in-hand with increased international openness. But we have been going mostly in the wrong direction on both counts since at least 2008, well before COVID-19. The economic and social impact of the pandemic has not just accelerated the corrosion of commerce and relationships across borders but also made undeniable the extreme vulnerability of the world's population to disease, economic insecurity, and exclusion.

As a result, the risks of the most genuinely existential threats—climate change, technological slowdown, racial and gender-based oppression, digital disinformation and removal of privacy, aging populations, and the likely recurrence of epidemics—have risen. All of these threats are global, in that they are common to all humanity, and can be lastingly reduced only by global cooperative action. All of these threats are economic, in that beyond their direct human toll, their causes and lasting impact are meaningfully changed by our economic activities and policies. Both markets and international institutions have failed to deliver economic safety in the absence of global engagement by governments. Successful economic cooperation needs specific constructive policies with tangible deliverable results.

That is why we at the Peterson Institute for International Economics (PIIE) have provided work plans for Rebuilding the Global Economy. At the start of a new US presidential term, we are telling policymakers what needs to be repaired by defining critical and practical priorities and solutions. Our series, featuring memoranda to policymakers and virtual events with experts, were published on a rolling basis in November and December 2020, accompanied by online public meetings. This PIIE Briefing republishes their papers to guide policymakers in 2021.

Rebuilding is a very deliberate and, we believe, apt verb for the task at hand. The global economy continues to exist, and it is necessary for the future well-being of all people, whether or not governments decide to withdraw

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from it. People and nations need a safe structure in which to conduct their economic lives, to join communities, and to be left in privacy. The building, however, has been allowed to sink into disrepair and, in some ways, has ceased to be fit for purpose. The architecture of the 1940s, updated on the fly in the early 1970s and again after 1989, does not meet today's standards of inclusion and accessibility, does not have room enough for many growing (and some already grown) economies, and is inadequate shelter against the environmental threats we now face.

But the global economy is repairable. What is needed now are actionable plans setting out clear priorities for economic policymakers. These plans must reject the status quo and must be objective and specific in their assessment of what can be salvaged and repaired as opposed to what should be torn down and replaced. These plans must not, however, be grandiose architectural fantasies—we all have to continue living and working in the global economy even while substantial renovation is underway, and there are limits to how far people want to be disrupted. This is where the Peterson Institute can make a meaningful contribution.

The starting point for our Rebuilding the Global Economy program is a set of 39 memos targeted at specific senior policymakers in the US government, the European Union, and international organizations. In these memos we have specified what the policymaker and their agency or department should prioritize to rebuild the global economy in their remit, what critical things they should stop doing or reverse immediately, and what institutional relationship they need to change or repair.

We have limited our recommendations to policymakers in official positions because that is where actions must be prioritized and implemented. Nongovernmental organizations and interest groups—including labor unions, business organizations, environmental watchdogs, and representatives of excluded groups—must have a voice in this process, but the Institute does not presume to speak for any of them. We hope to engage them in discussion of our proposals over the coming year. Similarly, we have directed our memos to American, European, and especially international officials, where our fellows have experience, standing, and background. The officials of other regions of the world and some international organizations beyond our scope of research should be at the table just as much as the governments of the Group of Seven (G7) countries. We look forward to engaging with them as well. Later in 2021, we will launch an annual high-level conference on Rebuilding the Global Economy to be held in Singapore, cohosted with the Lee Kwan Yew School of Public Policy to facilitate inclusive global dialogue. In addition, PIIE will track the state of the global economy and the success of policy measures adopted to rebuild it in an accessible online format, to provide ongoing assessment of progress.

Constructive economic solutions to the existential threats we face are possible, but they must be targeted at practical rebuilding, and they must be global. Please join us in this effort.

2 Overview of Policy Recommendations

Steven R. Weisman and Anjali V. Bhatt

Rebuilding the global economy is essential to addressing many interlocking problems at once, including recovery from the pandemic, climate change, inequality, and limiting international conflict. The Peterson Institute for International Economics (PIIE) therefore enlisted scholars and stakeholders to deliver 39 memoranda to a wide range of top policymakers and institutions. Their suggestions call for dozens of specific measures to counter an economic crisis that was activated by a global pandemic but that was also years in the making.

The mandate of the Institute's "Rebuilding the Global Economy" project has been to connect a long-term strategy with precise policy actions to achieve rapid results at the start of a new US presidential administration. The emphasis has been on advising policymakers and senior officials, as well as the public, in the United States and the European Union, and at the Bretton Woods international economic institutions. At least in this phase of the project, PIIE restricted itself to places where the authors had standing and experience to speak. Other nations, regions, and institutions merit the same voice on rebuilding the global economy, so while the Institute does not presume to speak for them, its leadership is encouraging them to engage with the Institute in offering their own similar advice.

Many memoranda stress that the disorders they are addressing have accumulated slowly over the last two decades or even longer, culminating with the nationalism and protectionism of recent years and finally in the COVID-19 pandemic and the worldwide economic shock of 2020–21.

This overview summarizes the views of the individual authors and is not intended to reflect any institutional recommendation from PIIE. They do, however, reflect a common set of values, in terms of believing in the benefits of international economic cooperation and liberal commerce, as well as transparency and rigor in arguing for policy changes. As varied as the memoranda are, they generally address five areas:

- 1 Subduing the COVID-19 pandemic and its economic impact.
- 2 Achieving sustainable and equitable economic growth.
- 3 Reviving international trade and investment.
- 4 Combating climate change.
- 5 Adapting the global system to the rise of China.

Steven R. Weisman is vice president for publications and communications at the Peterson Institute for International Economics. **Anjali V. Bhatt** is the social media editor at the Peterson Institute for International Economics.

SUBDUING THE COVID-19 PANDEMIC AND ITS ECONOMIC EFFECTS

Authors in this volume called for the United States to rejoin the World Health Organization (WHO), which has since occurred, and collaborate with European countries to oppose “vaccine nationalism,” by lifting export controls on vaccines and ensuring an unobstructed supply of medical equipment and medicines. Also as recommended, the United States has rejoined the COVAX alliance, led by the WHO along with two independent groups, Gavi and the Coalition for Epidemic Preparedness Innovations, to accelerate the development, manufacture, and equitable distribution of vaccines.

The United States should cooperate with the World Bank and the World Trade Organization (WTO) as well as the WHO to ensure availability of future medical supplies to poor as well as rich countries. The Organization for Economic Cooperation and Development (OECD) can play a role in developing reforms and defining best practices for national health systems and pandemic preparedness. Various authorities need to set up an international market information system for medical supplies and medicines.

On the domestic front, the US government should develop and impose national standards and enforcement for COVID-19 testing, tracing, masking, and social distancing, while widening access to health care generally by making benefits more portable, increasing worker protections, and investing in the health and nutrition needs of children in low-income families. On the international front, the United States should work with regional organizations like the United Nations Economic Commission for Africa (UNECA) and the Inter-American Development Bank in Latin America to ensure distribution of food and vaccines, while helping countries in these regions institute strict social distancing measures, widespread testing, and contact tracing. Poor and middle-income countries also need help to finance adequate testing and safety systems.

ACHIEVING SUSTAINABLE AND EQUITABLE ECONOMIC GROWTH

For the United States and the advanced economies of Europe, the authors generally endorse expansionary fiscal and monetary policies, taking advantage of low interest rates, to reverse the economic collapse and warn against premature reversal of such approaches. Many emphasize further that spending programs promote inclusive growth, with emphasis on the poor, working class, and disadvantaged minority groups, in rural as well as urban areas. Workers in these categories suffered disproportionately from the pandemic. An additional emphasis was on investing in education and health of children.

An expanded federal budget role in the United States should accordingly include extending unemployment insurance, food assistance, fiscal relief for state and local governments, expanded health care, and spending on infrastructure and research and development. Another common theme was advocacy of automatic stabilizers, i.e., budgetary spending and tax relief that self-activates at times of future downturns. A future tax system should increase the burden on highest-income households and raise and reform the corporate income tax, while working with other high-income countries to prevent corporations from exploiting tax havens. Some authors in this compendium advocate expansion of immigration, not simply to help immigrants but as an economic stimulus.

Monetary policy by the Federal Reserve and the European Central Bank should continue or expand large-scale asset purchases if economies are not revived. The European Central Bank should work cooperatively with European authorities to continue fiscal stimulus, with revision of the European Union's longstanding rule putting a ceiling on debt and deficit levels. Europe also needs more tools to provide lifelines to financially troubled countries in the region. To guard against future economic shocks, the authors favor more stringent bank regulations, including stress tests and recapitalizations, reversing the regulatory relief of the previous administration. Advanced economies should also use existing international frameworks to crack down on bribery, money laundering, terrorism financing, and other dangers to the system.

With many economies facing financing difficulties, the International Monetary Fund needs to expand its lending facilities and foster temporary debt relief and debt restructuring. The Fund and other international organizations also need to accelerate governance reform to give more fair representation to emerging-market economies. Similarly, the World Bank should step up its aid to poor countries struggling with the pandemic, joining with regional development banks to help Africa, Latin America, and parts of Eastern Europe where governments face enormous challenges obtaining and delivering vaccines.

REVIVING INTERNATIONAL TRADE AND INVESTMENT

Revitalizing, reforming, and rebuilding trust in the world trading system is essential to any global economic recovery. A first step must be to avoid protectionism that disrupts vaccine and medical supplies as the world struggles with COVID-19. The United States should work with a broad range of countries to de-escalate tariff wars, include climate goals in trade agreements, and avoid industrial subsidies and self-defeating "Buy American" policies. Governments should agree to eliminating unfair subsidies and reaching reciprocal agreements to allow competitive bidding on infrastructure and procurement.

The US government should promote new trade agreements while guarding against abuses, such as currency manipulation used to gain unfair trade advantages. Among the potential expansions for the United States should be an agreement on trade in services, inviting Britain and others to join the US-Mexico-Canada Agreement (USMCA), and joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). The next generation of trade agreements—either multilateral or with likeminded countries—should deal with not only subsidies but also new issues, such as e-commerce, data privacy, and national security rules affecting high technology investments and goods. In the United States, there needs to be better focused on those technologies that are truly sensitive to a country's security needs, without jeopardizing free-flowing investment and innovation.

International organizations need reform to strengthen trade. The World Bank should play a bigger role in helping poor and middle-income countries realize that trade can boost development. But the ailing WTO is especially troubled. It needs a new director general and should step up to play an expanded role in countering vaccine nationalism and curbs on medical supplies. New trade rules must ensure that international commerce contributes to the effort to reduce carbon emissions without constricting commerce through border adjustment

taxes. The international community must revive and reform the WTO dispute settlement system, currently moribund because of an impasse over its rules and composition.

COMBATING CLIMATE CHANGE

As with the WHO, authors in this volume called for the United States to rejoin the Paris Agreement to limit carbon emissions according to agreed-upon timetables. The Biden administration has done so. But much more needs to be done to implement the Paris goal. Cooperation with China on climate issues was widely identified as a high priority, along with efforts to help developing countries meet their carbon emission targets without disrupting their economies. Policies to meet the goals of the agreement would include faster conversion of energy generation to more carbon-neutral options in utilities and transportation. Investment in transmission lines was also cited, but one of the boldest and most important steps was identified as raising the cost of carbon through taxation or such devices as cap-and-trade. Leading high-income economies in the OECD should use that organization to analyze macroeconomic tools, such as pricing, with the aim of channeling public and private investment into energy-saving technologies.

The European Union has perhaps the most ambitious plans to limit carbon emissions and impose border adjustment taxes to ensure that other countries do not take advantage of the higher cost that European countries are willing to incur. Nevertheless, the European Union should commit itself to not using climate change for beggar-thy-neighbor policies that punish neighboring exporters. Rather it should lead the way to build a climate coalition with similarly minded countries, possibly including the United States.

The State Department should include threats to the environment in its assessments of national security concerns. Such threats could come not only from changes in the natural environment but also from the cost of adaptation- and mitigation-related efforts. Future trade negotiations should contain decarbonization targets and rulemaking to end fossil fuel subsidies while allowing appropriately designed renewable energy subsidies. For example, energy market liberalization in the US-Mexico-Canada Agreement could reinstate energy market liberalization in Mexico.

The issues of trade and financial stability should incorporate an agenda to address climate change. Agreements on decarbonization and carbon taxation—taxing goods based on their carbon footprints—would be welcome additions in trade agreements and negotiations. The Financial Stability Board (FSB), a global body set up in 2009 to stabilize the global financial system, should establish mandatory climate impact disclosures for the largest companies in the largest jurisdictions. The FSB and other organizations can do a lot to establish minimum baseline standards on carbon emissions. They should encourage businesses to integrate climate risks into their planning and embed climate considerations in the global financial system, helping to establish metrics for investors and banks as they support industrial expansion.

ADAPTING THE GLOBAL SYSTEM TO THE RISE OF CHINA

The United States must not count on China changing its fundamental approach to look after its immediate economic, political, and security interests. But Washington can identify a select few high priority areas where China is receptive to change. These areas might include China doing more to open its economy to foreign business investment, enforcing intellectual property rights, and agreeing to mutual lifting of barriers to trade and investment. China's poor human rights record cannot be ignored. But the United States has little choice but to recognize China's expanding role in the world. Pursuing a goal of "decoupling" of the world's two leading economies is infeasible in light of China's global economic footprint.

The new administration must think about ways of adjusting and perhaps rewriting Trump era trade agreements with China, such as the artificial purchase targets in the US-China phase one deal. But Washington must also be willing to use such tools as countervailing currency intervention to prevent future currency manipulation by China, a practice it has abandoned in recent years. Washington should also encourage the World Bank and other public lending agencies to step in with loans to countries surrounding China in East and South Asia so that they become less dependent on China's Belt and Road Initiative. Many of these countries have piled up debts to China because of this ambitious infrastructure lending program. Since China is now a major lender to these countries, Washington should support enlargement of the Paris Club to include China. The Paris Club is an organization of major creditor countries favoring coordination of efforts to resolve payment difficulties of debtor countries. Many countries are burdened by debts as a result of loans from China.

In general, the United States and European Union should try to find ways where they can work with, rather than against, China, such as climate change, opposing terrorism, and discouraging North Korea's nuclear ambitions. The United States should not be afraid to join the China-sponsored Asian Infrastructure Investment Bank (AIIB), a step in which it could monitor and guard against Chinese abuses of its infrastructure program. In the technology transfer area, Washington should take a tough but selective approach to sharing sensitive technologies and allowing China to invest in sensitive areas of technology and infrastructure. A careful approach would be more acceptable than a broad-brush one that stifles competition and is aimed at subsidizing Western industries rather than guarding against national security breaches.

3 Memoranda to policymakers

THE UNITED STATES

THE WHITE HOUSE

Jason Furman to the Director of the National Economic Council

Karen Dynan to the Chair of the Council of Economic Advisers

Nicholas R. Lardy to the Chair of the US Delegation for Bilateral Economic Talks with China

Douglas A. Irwin to the Director of the National Trade Council/Office of Trade and Manufacturing Policy



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MEMORANDUM ON

PRIORITIES FOR ECONOMIC POLICY

To: The Director of the National Economic Council

From: Jason Furman

October 2020

Background: The global economy is reeling from a pandemic that has exposed and exacerbated some of the previously growing weaknesses in the international economic order. Your first priority is fixing the US economy—both jump-starting the cyclical recovery and also addressing the deeper structural problems that were evident even in the relatively strong economy prior to the pandemic. At the same time, it is critical that you—and the Deputy for International Economics who also serves as the G20¹ Sherpa—restore US leadership in the collective project of the global economic community, enlisting it to strengthen the US and global recoveries.

KEY PRIORITIES

- **A global program of fiscal stimulus to strengthen demand and protect households and other priorities.** With interest rates stuck at zero across the advanced economies, fiscal stimulus has powerful spillover effects that when done collectively will help reenergize both US and foreign growth. While a fully coordinated fiscal approach is impossible, returning to the mutual commitments to fiscal stimulus at the onset of the global financial crisis would have a salutary effect. The form will vary from country to country and in the United States should include unemployment insurance, nutritional assistance, and fiscal relief for states and localities—ideally all made a function of the unemployment rate so they last as long as needed.
- **Making the US economy work for families is critical in its own right and also to give Americans the security and confidence to participate in greater global integration and a greater US role in the world.** Many elements go into this, but if you had to prioritize one, it should be investments in children, which not only provide direct assistance today but have long-run benefits in the form of increased work, higher earnings, better health, and less imprisonment. The 2014 G20 included a goal of increasing women’s labor force participation; consider whether a similar goal of investing in children would make sense for the G20 going forward.

Jason Furman, nonresident senior fellow at the Peterson Institute for International Economics, is Professor of the Practice of Economic Policy at Harvard University. He served as a top economic adviser to President Barack Obama, including as the 28th chair of the Council of Economic Advisers from August 2013 to January 2017, acting as both President Obama’s chief economist and a member of the cabinet.

¹ The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

- **Reforming the tax code—and furthering international tax cooperation.** You will need to raise more revenue given that just prior to the pandemic the tax code was raising the lowest amount of revenue for that stage of the business cycle in more than half a century. Raising individual taxes on high-income households is one part of that agenda. But you will also want to raise and reform corporate taxes, something that would work much better with international cooperation given the mobility of US companies, the tax competition in some jurisdictions, and ad hoc digital and other taxes on US companies in other jurisdictions. The Organization for Economic Cooperation and Development’s Base Erosion and Profit Shifting (OECD BEPS) project has the potential to build on a reformed version of the US global intangible low-taxed income (GILTI) provision and also have it substitute for more bespoke digital taxes being contemplated around the world.
- **International cooperation on climate change.** As the United States steps up its efforts to combat climate change, there is a risk that some of the benefits will be offset by leakage as manufacturing and other industries move overseas. Border adjustment would not only address this leakage but provide an incentive for other countries to accelerate their own carbon abatement policies. Additional trade measures on top of pure border adjustment could further these incentives, creating the “climate clubs” advocated by Nobel Prize Winner William Nordhaus. All of this will require clarification or changes to World Trade Organization (WTO) rules and is best done in collaboration with other countries. In addition, geoengineering will likely need to be part of the climate solution, and the United States will need to engage through the United Nations on global governance.
- **Competition policy and digital competition.** The United States has the right goal for competition policy—maximizing consumer welfare—but it has not been faithful in living up to that goal. New legislation will be needed, but until then greater enforcement using existing law can help prevent both excessive mergers and monopolization actions throughout the economy. The digital sector is a special case where a pro-competition regulator, along the lines of the Digital Markets Unit being established by the United Kingdom, would be a welcome addition to the US policy landscape. Although the policies in this area will and should remain national, increasing the convergence of the competition and regulatory approaches across the major economies is critical to give companies the predictability they need to operate around the world while also effectively protecting consumers. The French put this issue on the agenda of the 2019 G7², the first time finance ministers and central bankers had discussed it, and the United States should continue to push it.

WHAT TO STOP AND REVERSE

- **All limits on immigration should be halted immediately and replaced with policies that are as permissive as possible under existing law.** The US economy is sustaining long-term damage from restrictions on immigration that are deterring talented people from coming to the country and contributing to US economic growth. Immediately ending these and replacing them with more open policies is essential. Ultimately legislation will be needed, but until that time, take advantage of your administrative discretion.

2 The G7 countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

- **Be tough on China, but change your methods and goals.** US economic policy has gotten tougher on China in recent years but with little to show for it, as China is falling well below its purchasing commitments set in the US-China phase one trade agreement. The US-alone strategy is not working, so enlist the aid of allies and work through international institutions where possible. That will entail dropping unnecessary and frivolous trade disputes with allies, including rescinding steel and aluminum tariffs. It will also require changing US goals—Germany will not help the United States persuade China to buy more Boeing jets. Instead goals must be more principled: that China adhere to global rules and norms in economic policy.

NEGLECTED ISSUES

- **A global effort to identify and take out insurance against tail risks.** The people of the United States are likely to support greater global efforts on pandemics and climate change because they have seen how much damage these challenges can inflict. A lesson of this experience, however, is that it would be prudent to launch a global effort to identify other tail risks like solar flares, asteroids, and the like and understand how we can better insure ourselves against them—something that would be a global public good.

ACTIONABLE TO-DO LIST:

- Work with Congress to draft fiscal stimulus bill that includes expanded unemployment insurance, nutritional assistance, and fiscal relief for states and localities, and work with the G20 to coordinate stimulus efforts across the globe.
- Promote investment in programs that equip children to be life-long successful members of society.
- Draft a reform of US tax code and work with international bodies to coordinate effective and fair collection of corporate taxes.
- Engage with the international community to promote global governance on climate change solutions.
- Give consideration to forming a regulatory body to handle the special characteristics of competition policy in the digital economy.
- Develop and implement a new strategy on both China and immigration that will strengthen American economic growth.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

STRENGTHENING THE US ECONOMY TO FOSTER REBUILDING AND RECOVERY

To: Chair of the Council of Economic Advisers
From: Karen Dynan
October 2020

Background: Global economic activity plunged earlier in 2020 due to the fallout from the COVID-19 pandemic. While most countries have experienced some recovery, the pace at which activity is picking up has slowed and many experts believe that it could be years before conditions fully normalize. Given the immense macroeconomic and human costs associated with the situation and the political instability it generates, it is imperative that the US government does what it can to support a robust recovery in this country and abroad. The United States should also embrace the opportunity to address challenges that were holding back economic growth—at the national level, the global level, and the individual household level—even before the pandemic.

With these goals in mind, this memo lays out four key priorities for US economic policy. Some are explicitly linked to US engagement with other countries; others are focused on strengthening the US economy in ways that can foster US leadership of recovery and rebuilding around the world. The priorities do not include reducing federal budget deficits relative to those projected under current laws. Given historically low interest rates, the accumulation of federal debt is not one of the country's biggest economic challenges; instead, it is sufficient that any increase in discretionary or ongoing federal spending be accompanied by increases in federal revenue.

In keeping with the traditional and appropriate role of the Council of Economic Advisers (CEA), these recommendations are based on sound economics rather than political considerations. The CEA can be an important resource to this administration if it engages with leading economists from around the world to learn about successful policies in other countries and brings the best evidence and expert analysis to bear on policy challenges.

PRIORITY 1: Strengthen automatic fiscal stabilizers

Market participants expect that interest rates on government debt in many countries will be close to zero for years, if not decades, to come. Accordingly, central banks in the United States, Europe, Japan, and elsewhere will have substantially less ability to spur economic activity by cutting interest rates than they have had in the past few decades. Although nontraditional forms of monetary policy can fill some of that gap in recession-fighting

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capacity, fiscal policy will need to play a much larger role now and for the foreseeable future. In the United States and many other countries, fiscal stimulus during periods of economic weakness has been too small, too short-lived, and too susceptible to short-term political wrangling. The failure to pass an extension of the CARES Act in the last three months demonstrates this viscerally. Therefore, automatic fiscal stabilizers should be significantly expanded.

US leadership in forging international consensus on the importance of fiscal stabilizers and in adopting stronger stabilizers is crucial. Part of that leadership in the United States would be adopting tax and spending rules that are explicitly linked to economic conditions. For example, indexing payroll tax rates to state-level unemployment rates would be both feasible and effective. The United States would benefit directly from other governments' improving their automatic stabilizers. Consider the economic benefits to the US and the world economies if automatic stabilizers rather than premature austerity had guided fiscal policy in Japan between 1998 and 2000 and in Germany between 2010 and 2012. Global growth would have been stronger, and it would have been more balanced than what actually occurred, with US households being the consumers of last resort.

PRIORITY 2: Bring US taxation of multinational companies more in line with that of other advanced economies

Despite significant changes in US business tax rules in 2017, the United States' current tax treatment of business income remains out of line with the treatment in many other advanced economies, does not collect enough revenue to support needed government spending, and does not foster efficiency and fairness. For a number of years, many economists have advocated a combination of expensing of investment costs and eliminating the deductibility of interest expenses; that combination would treat different kinds of investments more equally and reduce financial risk. Adopting that combination would also enable an increase in the US corporate tax rate, which would bring it more in line with rates of other countries and raise needed revenue. Moreover, concerted international efforts to reduce companies' ability to shift profits to lower-taxed locations would both reduce distortions to efficiency and increase government revenue.

PRIORITY 3: Increase US infrastructure investment

Infrastructure investment in the United States now represents a smaller percentage of GDP than in most years of the past half century, and the quality of US infrastructure is declining relative to that of other countries. This stinting of investment is short-sighted from the perspective of US output and income, and it discourages foreign investment and trade in the United States. With interest rates at historically low levels, the case for a significant increase in infrastructure spending is compelling. It will be important, however, to focus additional spending on projects that yield significant returns (no "bridges to nowhere") and to fund maintenance and repair of existing capital rather than focusing solely on flashy new projects. Also, who builds US infrastructure is less important than getting what is needed built and getting value from the dollars the United States spends. Accordingly, the United States should allow competitive bidding for construction, installation, and maintenance of non-security-sensitive parts of US infrastructure; the United States should also insist that foreign governments allow the same opportunity for US firms.

PRIORITY 4: Strengthen US social programs

The consequences of the pandemic for employment, income, and well-being of American families have highlighted preexisting weaknesses in US economic and social systems. Enabling lower- and middle-income American families to thrive in the postpandemic world is necessary in moral terms and also for achieving greater social and political stability. Such stability will make the United States a more desirable partner and a more effective leader for other nations. Appropriate changes include providing more comprehensive health insurance, making other benefits more portable, increasing protections for workers, and giving children in lower-income families a better chance to succeed economically.

ACTIONABLE TO-DO LIST:

- Engage with leading economists from around the world to learn about successful policies in other countries and bring the best evidence and expert analysis to bear on US policy challenges.
- Expand automatic fiscal stabilizers and make them more effective by legislating triggers for starting and stopping that are explicitly linked to economic conditions.
- Adopt specific changes to bring the US corporate tax rate more in line with the rates of other countries and raise needed revenue.
- Increase infrastructure spending, focusing on projects that yield significant returns, including maintenance and repair of existing public capital.
- Provide more comprehensive health insurance, make other benefits more portable, increase protections for American workers, and fund programs that will give children in lower-income American families a better chance to succeed economically.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

PRIORITIES FOR 2021 ECONOMIC TALKS WITH CHINA

To: The Chair of the US Delegation for Bilateral Economic Talks with China
From: Nicholas R. Lardy
October 2020

Background: Economic negotiations with China must be a component of a consistent overall strategy to promote US interests, rather than one element of a menu of mutually inconsistent and constantly changing initiatives. The foundation of this strategy should be a comprehensive program of US economic renewal that maintains American technological leadership, rather than a defensive strategy that seeks to slow China's technological and economic rise. This strategy of addressing problems at home must include the rebuilding of crumbling infrastructure, reversing recent cuts in federal support for research and development (R&D), and a smarter immigration policy that brings to the United States talented science and technology specialists who will strengthen the US economy.

The overall strategy must recognize that regime change from the Chinese Communist Party, a crisis of the Chinese economy, or even a sharp decline in its growth trajectory are all unlikely over the time horizon of this administration. The incoming administration should assume that China's economy and its influence on the overall world economy will continue to expand.

Neither a general decoupling from China nor the promotion of regime change should be an element of this overall strategy.

PRIORITY 1: Be selective with requests

Recognize that economic negotiations with China are likely to continue to generate only modest results if the United States makes simultaneous demands for far-reaching changes in multiple Chinese economic policies. Better to start with well formulated requests on one or two high priority areas where there is at least a modicum of potential Chinese receptivity. Recently, for example, the authorities in China have themselves emphasized that most state-owned enterprises should be increasingly evaluated on their economic returns. This opens the door to potentially productive negotiations leading to a curtailment of subsidies to state-owned companies.

A corollary of this approach is that the US delegation should be relatively small: Not every government department and agency needs to be represented.

Nicholas R. Lardy is the Anthony M. Solomon Senior Fellow at the Peterson Institute for International Economics and an expert on the Chinese economy. His most recent books are *The State Strikes Back: The End of Economic Reform in China?* (2019) and *Markets over Mao: The Rise of Private Business in China* (2014).

PRIORITY 2: Work with allies

Coordinate, to the maximum extent possible, with US allies and partners. They share many of the same concerns about China's industrial policies, especially subsidies, and other unfair trading and investment practices. China is more likely to modify its policies in the economic realm if it hears a consistent message from Europe, Japan, South Korea, Canada, as well as the United States rather than facing unilateral demands from the United States. Remember that China has no allies. The United States has a huge advantage in this space; it should be leveraged to its advantage rather than being squandered by imposing tariffs on goods from Japan, South Korea, India, Canada, Mexico, Turkey, the European Union, and Australia.

PRIORITY 3: Recognize that the “tariff war” has failed

Recognize that US tariffs imposed on imports of Chinese goods have failed to achieve any of their announced objectives:

- a. The US bilateral trade balance with China has deteriorated further and the US global trade deficit has also gotten worse, in both cases for a variety of macroeconomically related reasons. In any case, the size of the US global trade position cannot be influenced by tariff policy; rather it is determined by the US domestic investment-savings imbalance.
- b. Trump administration claims to the contrary notwithstanding, tariffs have not been paid by Chinese exporters, but rather so far have imposed a tax of almost \$50 billion on US importers, most of which has been absorbed by US consumers.
- c. Tariffs have not led to a resurgence of manufacturing jobs in the United States; indeed, even before the economic downturn caused by the COVID-19 pandemic, manufacturing jobs were being lost.

PRIORITY 4: Recognize China's unstoppable expanding role

Even if “containing” China or regime change were judged to be desirable, there is little the United States can do to significantly slow China's economic rise and its increasing role in the global economy. Similarly, any regime change is likely to stem from China's internal dynamics rather than external influences. And, in any case, the United States has a long history of economic and other forms of cooperation with non-democratic regimes.

- a. China is leading the global recovery from the COVID-19 pandemic, primarily because it was successful in controlling the pandemic within three months of the initial outbreak. In contrast, the United States and several other advanced economies continue to struggle more than six months after their initial outbreaks.
 - i. China has had a V-shaped economic recovery in both the second and third quarters of 2020. The International Monetary Fund now forecasts that China's economy will expand by 2 percent and 8 percent, respectively, in 2020 and 2021.
 - ii. Thus, China's economy in 2021 will be about 10 percent larger than in 2019. The United States and almost all other economies in 2021 will be smaller than in 2019.
- b. China continues to go from strength to strength in its global trade.
 - i. Although US imposed tariffs reduced China's exports to its largest market, its total exports were up 5 percent in 2019, while global exports fell by 3 percent.

- ii. China's share of global trade is rising even more strongly in 2020, year to date, while the US share is collapsing.
- c. China has substantially liberalized access by foreign firms to its immense domestic financial market and is now an increasingly important destination for foreign portfolio investment.
 - i. Chinese regulators have allowed multiple securities, asset management, insurance, and other financial firms from the United States, Europe, and Japan to convert existing minority positions in joint ventures with Chinese partners to majority foreign-owned firms and have licensed a number of new wholly foreign-owned financial firms.
 - ii. US investors now hold well over \$1 trillion in Chinese bonds and equities, up from \$240 billion in 2007.

PRIORITY 5: Avoid a policy of “decoupling”

Recognize that the implication of the above is that a US-led general decoupling from China is likely to be a high-cost, low-benefit policy for the United States and a nonstarter for its allies and partners.

- a. Other countries have shown little interest in participating in a US-led decoupling strategy, given China's growing global economic and financial role. Their appetite for joining a US-led effort to promote regime change in China is even less. China accounted for 30 percent of global economic expansion in 2019, and its share in 2020 will almost certainly be larger. Thus, a US decoupling strategy would be a policy of economic self-isolation from a major source of global growth and trade. Non-US firms would quickly fill the void left by a unilateral US decoupling, gaining a larger and larger share of China's imports, currently running at \$2 trillion annually.
- b. A unilateral US decoupling would impose huge costs on US households and businesses that have benefited from the availability of lower-cost goods from China.
- c. Even a narrower US decoupling in technology is likely to be a high-cost strategy for the United States.
 - i. Shutting US semiconductor companies out of the China market, as the United States now seems to be doing, for example, would reduce their revenue sharply, causing capital expenditures by these firms to fall by \$13 billion and leading to the loss of 124,000 US jobs.
 - ii. More importantly, declining revenue would lead to deep cuts in R&D expenditures by US semiconductor firms, meaning the United States could lose its long-standing global leadership position in an industry that is crucial for US economic competitiveness and national security.

ACTIONABLE TO-DO LIST:

- Craft a coherent China policy to promote US interests.
- Adopt and work toward obtainable goals. These would not include slowing China's economic rise or promoting regime change.
- Coordinate with allies that share concerns on Chinese trade and investment practices, including state subsidies and protection of intellectual property.

- Focus economic negotiations on one or two high priority topics where there is at least some indication of Chinese receptivity. Avoid an omnibus approach that includes demands for far-reaching changes in multiple Chinese policies.
- Avoid weaponizing trade policy, for example through tariffs on Chinese imports, since the costs to the United States will likely exceed anticipated benefits.



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MEMORANDUM ON

RETHINKING INDUSTRIAL POLICY

To: The Director of the National Trade Council/Office of Trade and Manufacturing Policy
From: Douglas A. Irwin
October 2020

Background: Both Republicans and Democrats are openly discussing whether the United States should have an “industrial policy” to promote domestic manufacturing in critical sectors. The COVID-19 pandemic and deteriorating relationship with China have sparked concerns about the security of domestic production and its vulnerability to supply chain disruption, adding important public health and national security dimensions to the ongoing debate. The next administration will have to deal with these issues, but with even greater urgency.

In 2017, President Donald Trump created the National Trade Council—later turned into the Office of Trade and Manufacturing Policy—to advise his administration on policies to ensure a strong domestic manufacturing sector. The office—with its skeleton staff, lack of policy authority, and absence of institutional experience—does not seem to provide any real value in terms of additional information or expertise that help in administration deliberations.

PRIORITY 1: Abolish the Office of Trade and Manufacturing Policy

The new administration should rethink the structure and goals of the Office of Trade and Manufacturing Policy. Its purpose—to assist the White House in creating policies that will promote US-based manufacturing—is too narrow, and it functions ineffectively.

One option is to simply abolish the office. Just because the office was created to deal with important issues does not mean that it is best suited to addressing them. The president oversees many executive branch agencies that play a role in formulating specific industrial policies.

Alternatively, the office could serve as a coordinator of administration policy. But the National Economic Council (NEC) already exists to serve that purpose. To the extent that the functions of the office are deemed important, it could be folded into the NEC. Or, to the extent that the office serves a constructive purpose that does not duplicate what is being done elsewhere, it could be repurposed as a joint task force between the Departments of Commerce, Homeland Security, and Defense.

Douglas A. Irwin, nonresident senior fellow at the Peterson Institute for International Economics, is the John French Professor of Economics at Dartmouth College. He served on the staff of the President’s Council of Economic Advisers in 1986–87 and in the Division of International Finance at the Board of Governors of the Federal Reserve System from 1988 to 1991.

ACTIONABLE TO-DO LIST:

- Abolish the Office of Trade and Manufacturing Policy.
- Or fold it into the National Economic Council.
- Or make it a joint task force between the Departments of Commerce, Homeland Security, and Defense.

PRIORITY 2: Rethink the idea of industrial policy

Whatever is done with the office, US industrial policy requires a rethink. The Trump administration has the professed goal of reshoring American manufacturing and shrinking global supply chains to reduce dependence on foreign suppliers. Public health concerns arising from the pandemic and national security concerns arising from dependence on China for key materials have made these matters the subject of bipartisan concern.

The new administration should undertake an interagency study of the goals and feasibility of different policies to strengthen particular industries or sectors that are deemed essential to maintaining technological prowess, such as strengthening investment in research and development (R&D), or ensuring economic security, defined broadly to include public health. Such a study should not focus exclusively on the manufacturing sector, as many concerns are not with physical production but with setting regulatory standards (where the United States has yielded the initiative to an increasingly assertive China) and the digital economy. Infrastructure that is critical to the nation's economy, such as the electricity grid, as well as stockpiling of essential goods or medical supplies, might also be relevant to such a report.

The proposed study could identify specific product segments or areas where more domestic production capacity is desirable for carefully delineated public health or national security reasons. The objective should be to single out a few genuinely critical sectors where current government policy could be improved, or even where additional support might be given. The problem with America's existing industrial policies—and the nation certainly has them, belying any debate about whether the country should or should not pursue policies that support particular sectors—is that they are undertaken on an ad hoc basis across different government agencies, often at cross purposes. The proposed interagency study should attempt to provide clarity to government, business, and the public at large about these national goals and how to achieve them.

The challenge for policymakers is to identify such industries without succumbing to the notion that every industry is vital to some public objective. For example, the goal of “economic security” is so broadly defined and open-ended that virtually every domestic producer could claim the need for government support on that basis. The risk is that ill-conceived government programs will encourage corrupt behavior in which industries benefit themselves without contributing to national welfare.

Furthermore, the United States cannot and should not have as its policy goal greater self-sufficiency across a wide range of activities. The nation—and the manufacturing sector in particular—is too deeply engaged in international trade to make that advisable. Furthermore, the efficiency gains from this diversification of supply are substantial. The economic benefits from openness to trade are too great to make retrenchment desirable. Most US foreign trade is with neighboring countries and allies where there is mutual

interdependence and with whom the risk of disrupted trade is very low. (North American supply chains in automobiles, for example, are based on economic efficiency and are not a threat to national security.)

ACTIONABLE TO-DO LIST:

- Undertake an interagency study of the goals and feasibility of different policies to strengthen particular industries or sectors that are deemed essential to maintaining technological advantage, promoting national security, and ensuring public health.
- Work with allies for cooperative solutions to problems related to national security and public health, and to avoid every country seeking national self-sufficiency.

PRIORITY 3: Avoid protectionism and bad industrial policy

An interagency study, as suggested above, should also carefully examine the specific policies that might be proposed to achieve the objective of making the US economy safer and more secure. The Trump administration's policy focus has been on protecting certain American industries from foreign competition, through import tariffs, rather than promoting these industries, through incentives for R&D, investment in worker skills through labor market policies, and other forms of encouragement. This approach has been deeply problematic for both economic and diplomatic reasons.

First, protectionist policies limit imports, often without distinguishing between reliable foreign suppliers from countries that are US allies and unreliable suppliers from countries that are potential adversaries. As a result, newly imposed tariffs have harmed US relations with friendly nations whose support and cooperation the United States needs in many related areas, ranging from national security, climate change, and terrorism. Tariffs also lead to foreign retaliation against US exports, often targeting the most efficient US manufacturers and farmers, even US business service providers. Such trade wars create collateral economic damage and subvert the goal of boosting employment and growth at home.

A protectionist approach also raises domestic prices, which may help certain narrowly defined producer interests but harm other domestic industries that require competitively priced inputs. The steel industry is a case in point. The administration protected the domestic steel industry through tariffs imposed on imports under the dubious guise of national security. By raising domestic steel prices and creating spot shortages, however, these tariffs have also harmed many domestic manufacturers whose competitive position depends on cheap and readily available steel inputs. For example, the steel tariffs have hurt the domestic automobile industry, raising Ford's costs by over a billion dollars. They have hurt John Deere and Caterpillar and numerous other manufacturers (from beer kegs to bridge construction) by raising their costs of production. The products of some of these harmed companies are far more important to national security and harder to substitute than products of steel producers.

Considerable damage has been done. One study suggests that steel users will pay an additional \$5.6 billion for more expensive domestic steel. In other words, steel users will pay about \$650,000 for each job created in the steel industry. Another study calculated employment in the US steel and aluminum industries (mainly steel) might increase by 26,000 jobs over three years, while employment would decline by 433,000 jobs in the rest of the economy, owing to the damage higher steel and aluminum prices have done to downstream industries.

These trade restrictions have led to two related phenomena: lobbying for exemptions and lobbying for cascading protection. When one sector is protected, downstream sectors will pressure the government for an exemption from the tariffs on their inputs. The process of determining which users are eligible for such exemptions is fraught with politics and has the potential to be corrupted by political favoritism. If the downstream industry fails to receive an exemption, it will often lobby for protection for itself to compensate for the higher prices that it has to pay. This cascading protection can lead to further trade restrictions, further corruption, and further retaliation by trading partners.

Another problem with trade restrictions is that the achievement of one objective comes at a cost to other industries. For example, an export ban on semiconductor manufacturing equipment to prevent the leakage of high technology to China can harm the domestic industry and spur additional Chinese efforts to produce those sophisticated products at home.

In other words, protectionist policies and trade wars are not good industrial policy. If important sectors of the economy have been identified as meriting support, temporary direct subsidies or other forms of promotion assistance will not raise prices and harm downstream industries nor raise trade barriers that lead to retaliation and ill will among allies. Furthermore, should such financial support fail to achieve desired objectives, it is often easier to terminate the policy than it is to remove trade restrictions.

Government agencies are supposed to serve the public interest, but there is always a risk that private interests will capture them. Even if the next administration avoids protectionist policies, industrial promotion policies are also fraught with pitfalls. While subsidies avoid the problem of tariffs, such subsidies can be misallocated to undeserving industries for political purposes. The recent ill-advised grants to Kodak for pharmaceutical manufacturing, an initiative that came out of the existing Office of Trade and Manufacturing Policy, illustrates this point.

ACTIONABLE TO-DO LIST:

- Avoid protectionism as a seemingly easy solution to difficult problems.
- Be aware of the harmful impact of protectionism on downstream industries, as well as on consumers.
- Create safeguards to avoid policy capture by private interests.

THE UNITED STATES

OFFICE OF THE US TRADE REPRESENTATIVE

Chad P. Bown to the US Trade Representative

J. Bradford Jensen to the Deputy United States Trade Representative and Ambassador to the World Trade Organization



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

TRADE-RELATED POLICY PRIORITIES FOR THE NEXT ADMINISTRATION

To: US Trade Representative
From: Chad P. Bown
October 2020

Background: US trade policy should ideally achieve several goals, including cooperatively working with other countries to reciprocally reduce trade barriers and further economic expansion for Americans. But as the current political debate suggests, US trade policy must be seen as serving America’s workers if it is to sustain public support. The Trump administration’s current approach of unilateralism and tariffs fails along each of these dimensions, including by neglecting workers. The World Trade Organization (WTO) and China may have disappointed the administration with some adverse rulings and actions, but both the WTO and China must be handled and not ignored. Trade should be a presidential priority, and the United States Trade Representative (USTR) must reestablish and maintain bipartisan support in Congress and with the American people to promote global engagement and US leadership.

Chad P. Bown is the Reginald Jones Senior Fellow at the Peterson Institute for International Economics. With Soumaya Keynes, he cohosts *Trade Talks*, a weekly podcast on the economics of international trade policy. He has served as senior economist for international trade and investment in the White House on the Council of Economic Advisers and as a lead economist at the World Bank.

PRIORITY 1: Reset with allies and define common interests

Rebuilding trust with allies is a necessary first step to defining a common interest and action plan to ensure long-term cooperation in areas of joint concern involving China and the WTO.

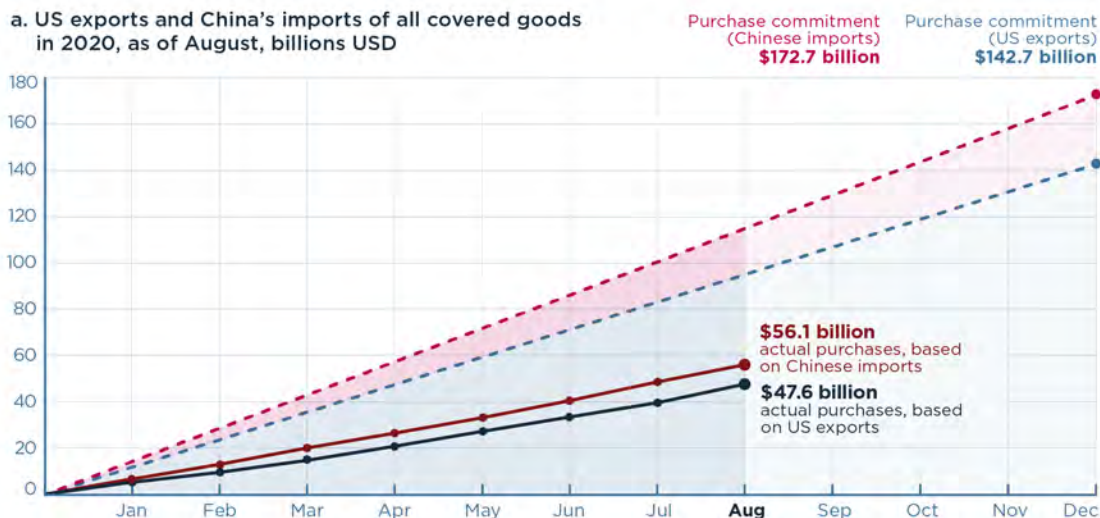
The United States must begin by removing all bilateral tariff actions with economic allies. Eliminating costly retaliation facing American exporters will require removing the US tariffs on steel and aluminum, which impose needless costs on American metal-using industries and do little to protect America’s national security. It will require negotiating a durable solution with the European Union to the long-running disputes over subsidies to Boeing and Airbus. It will involve supporting the Treasury Secretary in Organization for Economic Cooperation and Development (OECD) negotiations on multilateral tax reform and to resolve concerns over trading partners’ digital services tax regimes.

The United States should unilaterally drop the artificial targets of the purchase commitments in the US-China “phase one” agreement, as these do not encourage trade liberalization or market reform. The failure to negotiate Chinese tariff reductions means the incentives for China to fulfill its commitments arise by its state-owned enterprises, and not its private sector, increasing purchases. The targets also encourage China to divert trade away from US allies, undermining multilateral cooperation. Finally, they have not worked (see figure on next page).

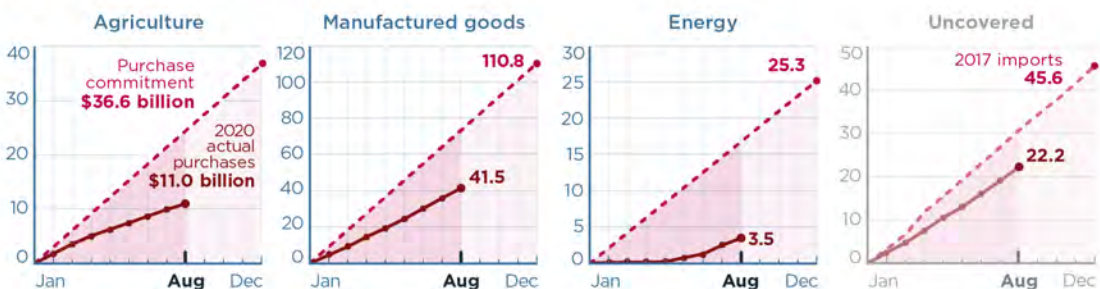
US-China phase one tracker: China's purchases of US goods

US exports and China's imports in 2020 of all goods covered by the phase one deal as of August 2020

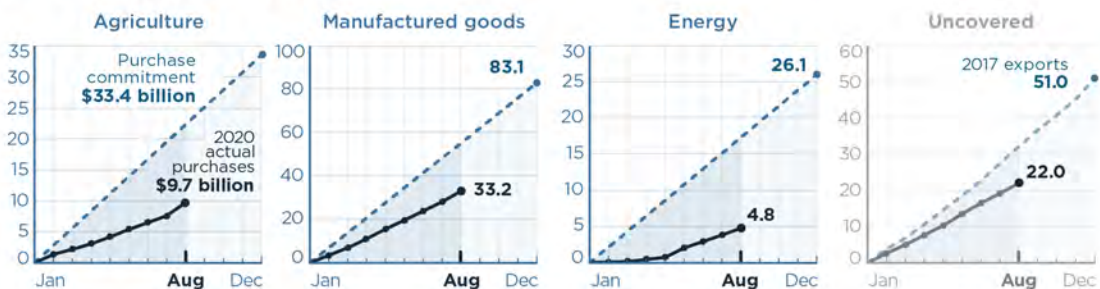
a. US exports and China's imports of all covered goods in 2020, as of August, billions USD



b. China's imports by product type, billions USD



c. US exports by product type, billions USD



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Note: Numbers may not sum to total due to rounding. "Uncovered" products refer to China's imports from the United States not addressed by Annex 6.1. Prorating the 2020 year-end target to a monthly basis is for illustrative purposes only. Nothing in the text of the agreement indicates China must meet anything other than the year-end target.

Sources: Constructed by the author with US export data from US Bureau of the Census, Chinese import data from International Trade Centre (Trademap) for 2017 and from Chinese customs for 2020, and product categories set out in Annex 6.1 of Economic and Trade Agreement between the United States of America and the People's Republic of China.

PRIORITY 2: Reengage and refocus the World Trade Organization

Ninety-five percent of the world's customers, and most of America's economic competitors, are outside of US legal borders. Despite its shortcomings, the WTO continues to provide the essential rulebook for US economic and commercial engagement with much of the rest of the world.

USTR must quickly prioritize negotiating improvements to the WTO's core functions. That includes reestablishing a working WTO dispute settlement system to replace the Appellate Body. A fair and efficacious way of resolving trade frictions is needed to reduce current uncertainty over enforcement of international rules.

USTR should also prioritize negotiations with a limited, critical mass of countries over a smaller package of essential issues. These negotiations must address industrial subsidies, agriculture subsidies, fisheries subsidies, climate-related subsidies, electronic commerce, and services. Because of the global impact of such policies, these trade areas cannot be successfully negotiated in bilateral agreements.

Such negotiations can produce rules for industrial subsidies and state-owned enterprises beginning with progress the United States announced in January 2020 under the trilateral initiative with the European Union and Japan. Agricultural and fisheries subsidies can be informed by the WTO's ongoing work program and OECD analysis. In support of rejoining the Paris Agreement on climate, USTR should also push global rulemaking to end fossil fuel subsidies and to permit appropriately designed renewable energy subsidies. Previous efforts in each area, as well as ecommerce and services, failed largely because they were each negotiated separately and in isolation.

PRIORITY 3: Help get US domestic policy right

USTR is critical to new domestic policy initiatives arising from the recession, the pandemic, and geostrategic conflict with China. The reality of cross-border supply chains and the potential costs of foreign trade retaliation means USTR plays an essential role in informing Congress and the executive branch's interagency process about the fuller ramifications of US domestic policy. In a system governed by agreed upon rules, USTR must be able to mount a successful legal defense whenever US policy is subject to international challenge. That means supporting a domestic policymaking process driven by transparency, evidence, risk assessments, and cost-benefit analysis. From its origins, US policy should be designed for other countries to emulate, not retaliate against.

USTR should present a strategic approach toward supply chains and industrial policy.

The current administration has put forward reshoring proposals that are based on the presumption that cross-border supply chains curtailed US access to critical medical supplies during the pandemic. More detailed analysis must clarify where such arguments are and are not credible, and where reducing vulnerabilities may instead require more—and not less—international diversification with reliable countries, especially regional partners such as Canada and Mexico. Coordinating to pool risk, stockpile, and understand where reserve capacity is available in the case of demand surges are important, cost-effective strategies.

The geostrategic rivalry with China is triggering other calls for an American industrial policy to support production of goods ranging from semiconductors to critical minerals. Any new US subsidy programs should be consistent not only with existing rules, but with any

new disciplines the United States is negotiating internationally. In general, future programs should identify and clarify the market failures or coordination failures that the policy needs to address. Any subsidies should be supportive of foundational and basic R&D and designed to improve industry-wide competitiveness.

PRIORITY 4: Rationalize the increasingly expansive US export control regime and make it more multilateral

Recent unilateral US export controls on high-technology goods and services to mitigate national security threats have significantly increased their trade coverage and triggered new channels of conflict even with allied governments. USTR expertise in trade, supply chains, and cooperative policymaking can help the Commerce and State Departments rationalize the most essential US export controls, while making these controls multilateral with other countries, so that any national security threat is both more likely to be mitigated and at a smaller economic cost to Americans.

ACTIONABLE TO-DO LIST:

- Remove bilateral tariff actions with economic allies.
- Remove purchase commitment targets in US-China phase one trade agreement.
- Reestablish a WTO dispute settlement system to replace the Appellate Body.
- Prioritize trade negotiations with a limited number but critical mass of countries over a smaller package of essential issues.
- Identify a strategic approach toward supply chains and industrial policy.



Rebuilding the Global Economy

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MEMORANDUM ON

IMPROVING US PERFORMANCE IN SERVICES TRADE

To: The Deputy United States Trade Representative and Ambassador to the World Trade Organization

From: J. Bradford Jensen

November 2020

Background: The United States produces roughly 30 percent of the world's services, the largest portion in the world. [China](#), the next largest producer of services, accounts for about 13 percent of global services value added. US cross-border services exports totaled \$830 billion in 2018, or 14 percent of global services exports. As a result, the United States runs a persistent *trade surplus* in services. Given the inherently local nature of many services—they often require local in-person delivery and/or provision by locally regulated entities—US trade in services through foreign affiliate sales is consistently larger than US cross-border trade in services. [Sales by foreign affiliates](#) of US services firms totaled \$1.6 trillion in 2017.

Despite its globally competitive services sector, the United States' performance is hampered by many impediments to cross-border trade, restrictions on foreign direct investment, and regulatory differences.

Policy impediments to increased services trade affect a wide range of American workers and firms. Business services (e.g., information, financial services, engineering, architecture, research and development) employ almost 25 percent of American workers. Personal services (e.g., education, health, entertainment) employ another 28 percent. In contrast, agriculture employs roughly 3 percent of [American workers](#) and the manufacturing sector employs about 8 percent of American workers. The World Trade Organization (WTO) would be a natural place to pursue services trade liberalization, but it seems unlikely that progress can be made under existing WTO frameworks.¹ The positions of major players differ significantly, are firmly entrenched, and tied to a web of other issues. Accordingly, other courses of action must be adopted.

J. Bradford Jensen, nonresident senior fellow at the Peterson Institute for International Economics, is the McCrane/Shaker Chair in International Business and professor of economics and international business at the McDonough School of Business at Georgetown University. He has been affiliated with the Peterson Institute for International Economics since 2003, serving as deputy director from 2003 to August 2007. Before joining the Institute, he served as director of the Center for Economic Studies at the US Census Bureau and on the faculty of the Heinz School of Public Policy and Management at Carnegie Mellon University.

¹ Ambassador Michael Punke [testimony](#) to House Committee on Ways and Means, Subcommittee on Trade, September 20, 2012.

PRIORITY 1: Join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership

The United States should negotiate to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the agreement the other 11 countries in the Trans-Pacific Partnership (TPP) negotiated and signed after the United States withdrew from the TPP.

The TPP, which was signed during the Obama administration but never ratified, would have been the most comprehensive trade and investment pact since the creation of the WTO in 1995. It would have eliminated a broad range of barriers to international trade and investment and established strong rules barring domestic policies that distort international trade in services and investment flows. Provisions in the TPP would have provided protections for US services firms.

Joining the CPTPP would provide US services firms better access and better protections in a region representing the third largest free trade area in the world (after the United States-Mexico-Canada area and the European Single Market). While the CPTPP suspended 22 provisions from the TPP (a number of which were important to US services firms), the CPTPP still provides important protections in a number of areas (including the chapters on cross-border trade in services, investment, financial services, temporary entry for business persons, telecommunications, electronic commerce, state-owned enterprises, intellectual property, regulatory coherence, and government procurement). To the extent it is possible for the United States to negotiate to include TPP provisions that were suspended in CPTPP, joining would be even better.

A reinvigorated CPTPP/TPP would provide an important example of a high-quality agreement on services trade (covering a significant share of global economic activity) and could provide a “competitive liberalization” impetus to services trade discussions within the WTO.

PRIORITY 2: Resuscitate the Trade in Services Agreement

The United States should try to resuscitate the Trade in Services Agreement (TiSA), which was launched in 2013 and drew 23 economies around the world into negotiations that were never completed with the adoption of an official treaty. As an initiative focused exclusively on the services sector, the TiSA would draw upon best practices from trade agreements around the world and provide rules to foster fair and open trade across the full spectrum of services industries. TiSA also intends to address new issues confronting international trade in services, including restrictions on data flows and forced data localization. It also aspires to promote the development of strong, transparent, and fair regulatory policies. The 23 economies participating in the TiSA negotiations represent nearly 70 percent of the world’s \$55 trillion services market. A reinvigorated and formalized TiSA would consolidate rules accepted by a large and diverse group of countries, laying the foundation for extending them to the multilateral system.

PRIORITY 3: Develop an international framework for privacy and data flows

The United States should press for an international framework for protection of privacy and data flows. The TiSA negotiations failed to resolve the different approaches taken by Europe and the United States on how consumer information is shared and privacy is

protected. The United States Trade Representative (USTR) should convene a forum to bring together countries that respect the rule of law (and include other major players like the state of California) to develop a framework that balances the legitimate interests of consumers and citizens who want to control the use of their personal data, with business interests in providing valuable services to consumers in exchange for the use of their data, and also with government agencies that have an interest in monitoring data flows to protect their countries against national security, terrorist, and criminal threats.

PRIORITY 4: Reform government procurement

The United States should push for greater participation in the WTO's Agreement on Government Procurement (GPA). The agreement calls on countries to allow companies around the world to compete for government contracts. Programs like "Buy American" on US government procurement contracts fail to recognize that governments abroad are important purchasers of US goods and services and may retaliate if they are unable to bid on US contracts. In fact, government spending as a share of GDP ranges from 20 percent to more than 50 percent across countries. Governments purchase not only things like steel and concrete but also a range of services, from insurance, telecommunications, data processing, engineering, architecture, design to management consulting. This is an important source of potential contracts for American services firms, yet many countries are not signatories to the WTO GPA. US leaders on both sides of the aisle have proclaimed their support for "Buy American" provisions in government services without realizing that a more robust GPA in the WTO would enable competitive US firms to get contracts in other countries. The United States and the world would benefit from making government procurement fair and open.

PRIORITY 5: Work toward mutual recognition of regulations and regulatory convergence

US policymakers should continue to work toward mutual recognition of regulations and regulatory convergence. Many services industries are (appropriately) regulated by domestic government agencies. While the objectives of this domestic regulation typically have the common goal of protecting consumers, sometimes the approaches to and methods for regulating domestic industries have evolved differently in different countries. Frequently, the different approaches yield similar outcomes. Yet, the different approaches (e.g., different licensing or accreditation standards) can prove to be an impediment to either cross-border provision or commercial presence. USTR should continue to work with like-minded countries to identify opportunities for mutual recognition in regulation or regulatory convergence/alignment where possible.

ACTIONABLE TO-DO LIST:

- Join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, which would provide US services firms better access and better protections in a region representing the third largest free trade area in the world.
- Reinvigorate and formalize the Trade in Services Agreement, which would foster fair and open trade across the full spectrum of services industries.
- Convene a forum to bring together countries that respect the rule of law (and include other major players like the state of California) to develop a framework for data flows and protecting privacy.

- Push for greater participation in the WTO's Agreement on Government Procurement to make government purchases of goods and services fair and open.
- Continue to work with like-minded countries to identify opportunities for mutual recognition in regulation or regulatory convergence/alignment where possible.

THE UNITED STATES

US DEPARTMENT OF THE TREASURY

Lawrence H. Summers to the US Secretary of the Treasury

Maurice Obstfeld to the Under Secretary of the Treasury for International Affairs

Joseph E. Gagnon to the Treasury Assistant Secretary for International Finance



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

INTERNATIONAL POLICY CHALLENGES FACING THE NEXT US TREASURY SECRETARY

To: The US Secretary of the Treasury
From: Lawrence H. Summers
November 2020

Congratulations on your nomination to be the 78th Treasury Secretary of the United States. Few of your predecessors took office at a moment of such risk or such opportunity. I suspect that, far more than is true for most Secretaries, your most significant acts will be in the international arena. This reflects in part the very limited scope the current political context provides for significant financial reform or tax legislation, and the fact that much of the financial response to COVID-19 has already been put in place by the Federal Reserve. Even more it reflects the profound deterioration in US international economic relations and international economic cooperation in recent years and the very substantial domestic and foreign risks on the horizon.

No Treasury Secretary since World War II has faced so diverse and consequential a set of international challenges ranging from maintaining financial stability to reconceptualizing macroeconomic policy and from meeting Chinese challenges to restoring the domestic underpinnings for global economic cooperation. As Tony Blair has said of progressives, “the problem is that the radical are not sensible and the sensible are not radical.” Here are some thoughts on the tasks ahead.

KEY PRIORITIES

I. Your first priority must be restoring the shared expectation among the major countries that international economic diplomacy will be consequential. A healthy global economy requires both the habit of international cooperation and the major mutual commitments at times of crisis.

There is a striking difference between the current COVID-19 crisis and the 2008 financial crisis. Even though the latter crisis was much more domestically rooted, the global component of the global response was as bold as national responses. A common commitment to major demand stimulus and reducing trade imbalances, huge new support for emerging markets from the international financial institutions, and universal commitments to avoid new protectionist measures and to scale back fossil fuel subsidies were all contained in the G20 communique issued less than 3 months into President Obama’s Administration. None of this would have happened without Secretary Geithner’s leadership from the US Treasury.

Lawrence H. Summers is the Charles W. Eliot University Professor and President Emeritus at Harvard University. He served as the 71st Secretary of the Treasury for President Clinton and the Director of the National Economic Council for President Obama. He is Vice Chair of the Board of Directors of the Peterson Institute for International Economics.

In contrast to what has happened domestically in many countries, the global economic response to COVID-19 has been almost nonexistent. Yet today's challenges require coordinated international actions on multiple fronts: (i) Agreements on the funding of COVID-19 control measures and measures to protect against future pandemics are necessary to achieve a public health foundation for the return of prosperity. (ii) Without internationally agreed measures to support demand, global growth is likely to founder even with COVID-19 progress and the US trade deficit is likely to mushroom with serious domestic political consequences. (iii) Emerging markets have suffered less from COVID-19 so far than most would have expected, but this is likely to change without substantial infusion of new funds. It says something that no African country has been to the private markets since February 2020. Only with the enthusiastic support of the United States can lending from the international financial institutions be ramped up and can the private sector be induced to play its part in relieving unsustainable debts.

You should urge the President to invite the G20 leaders to Washington during the first quarter of 2021 to forge a Compact for Inclusive Global Growth and schedule a preparatory meeting of G20 Finance Ministers and Central Bank Governors to prepare the discussion. This will both signal the new administration's recommitment of the United States to economic cooperation and provide an action-forcing deadline for crucial actions to combat the COVID-19 crisis. If the United States can organize such a meeting, forge meaningful agreement on crucial issues, and then carry through quickly on its commitments (for example, to authorize a new allocation of special drawing rights), this first G20 on your watch will signal a return of US leadership in global economic cooperation.

II. You need to forge a global consensus on the nature of current macroeconomic policy challenges, which is very different from what it has been historically. The current period of slow growth, subtarget inflation, and extremely low interest rates has now lasted longer than the high inflation of the 1970s. Yet there has been no change in orthodox thinking comparable to what high inflation ushered in with independent central banking, inflation targeting, and an emphasis on debt stabilization as the proper objective of fiscal policy.

Neither excessive inflation nor the crowding out of private investment by budget deficits is a current problem in the industrialized world, and hyper low interest rates extending out 30 years in all major countries suggest that markets do not expect them to become serious problems. Instead as figures like Janet Yellen, Mark Carney, and Mario Draghi have recognized, interest rates at the lower bound despite very large budget deficits indicate that the world's macroeconomic challenge is the effective absorption and deployment of private saving in a world of depleted private investment opportunity.

Whether or not you accept the concept of secular stagnation, super low real interest rates indicate an incipient excess supply of saving. This is the ultimate cause of excess leverage, asset bubbles, sluggish growth, and insufficient inflation. In some countries where the phenomenon is particularly pronounced because policy is oriented to discourage consumption, it is the cause of weak currencies and large trade surpluses.

Monetary policy is much less important today than it has been in the past. It can crunch credit and growth and as we saw this spring can mitigate financial panic, but it cannot push on a string and create increased demand to any large degree. This means that maintaining

demand, assuring a sustainable financial foundation for prosperity and avoiding excessive external imbalances will all depend on fiscal policy.

You will need to lead the world towards a new view of economic stabilization that emphasizes the risks of sustained underemployment, the importance of fiscal policy, the room for greater deficits in a low interest rate environment and the idea that fiscal policies can be reformed to increase demand without increasing government debt burdens. Fiscal policy is expansionary without increased deficits when (i) public investment is tax financed, (ii) income is successfully redistributed towards entities like middle-income households with higher propensities to consume, and (iii) contributory social insurance is enhanced in ways that reduce households' precautionary saving with respect to retirement, catastrophe, or children's educational needs.

It may or may not have ever been true that ultimately prosperity depends only on structural policies and not on policies to promote demand, but it surely is not true today or for the foreseeable future. If only the United States promotes demand, much of the benefit will flow to other countries' exporters as our trade deficit increases. That is why it is crucial to influence global thought on the dangers of austerity.

III. As the leader of the President's economic team, you need to establish in the public mind that your Administration's international economic policies are not acts of charity to other countries or service to American elites but are direct contributors to raising the incomes of middle-income families.

It always needs to be clear that prosperity for Americans is your first priority. The Bretton Woods Institutions and the Marshall Plan would not have been possible without the GI Bill and the Treaty of Detroit. Your credibility abroad will ultimately depend on the success of the American economy.

You should be clear at the outset that you will not spend your scarce personal capital or US political capital on the commercial agenda of US financial firms operating abroad where their success has almost no nexus with US job creation. The focus of all your international efforts on financial sector issues should be on cracking down on regulatory arbitrage and preventing regulatory competition. The competitiveness of the US financial sector is way subsidiary to the prevention of financial crisis.

You should from the first join with the French and others who insist that no highly profitable company should be able to use tax technicalities, transfer pricing, tax havens, or location in cyberspace to avoid paying a reasonable share of its reported profits in corporate taxes. It has become the goal of the United States to win a race to the bottom in corporate taxation. Your goal should be cooperative leveling up of corporate tax burdens. The Base Erosion and Profit Shifting (BEPS) framework is fine as far as it goes but this issue is as or more important than further trade liberalization and should be lifted to the highest political level.

Given the divisions in the country, the scarcity of a new Administration's political capital, and the absence of a compelling economic agenda, this is the right time to resist protectionism, to enforce existing trade agreements, and to pursue sectoral regulatory agendas in areas like finance and technology. It is not the right moment to make commitments to new trade agreements. You will likely at some point need to use the credibility of your office to resist the coalition of US businesses looking for commercial

benefit in other countries, USTR looking for projects, and the State Department, which is always eager for international agreements, always pushing for new trade agreements. Divert the energy towards regulatory and tax collaboration.

You should speak of US participation with international organizations as “cost effective forward defense of US security and economic interests.” It is cost effective because each dollar we contribute typically levers five or six foreign dollars. It is forward defense because we will be neither prosperous nor secure if the world economy is stagnating and other nations are not addressing issues like global disease and climate change. If you are successful in establishing yourself as on the side of the American middle class, you have a chance to put the US role in international institutions on a stronger footing than it has been on in a generation.

CONCLUDING THOUGHTS

Much in all of this will depend on how the US-China relationship evolves, which is beyond the scope of this memo. Broadly, your challenge will be to take the temperature down at a time when there is a bipartisan tendency to suppose that a wish list constitutes a strategy. You should seek to ensure that your Administration considers what leverage it does and does not have and what accommodations it is prepared to make as it makes demands. At the same time you should be prepared to use the need to “maintain the power of the US example” as a spur to necessary policy steps.

The reality is that in multitrillion dollar daily foreign exchange markets, you have limited capacity to influence the foreign exchange value of the US dollar. You will almost certainly find with respect to dollar talk that less is more. An oft repeated phrase will promote more financial stability than any amount of thoughtful theorizing. While I do not believe the dollar has serious peer competitors, at this point given your commitment to expansionary policy it would be unwise to appear actively devaluationist or indifferent to the dollar. Favoring a strong dollar based on a strong economy or some such seems prudent. Within the councils of the Administration it is your vital role to emphasize that if the United States overexploits the central role of the dollar in the international financial system to pursue parochial objectives it puts that central role at risk.

Finally, never forget that your credibility is a crucial national and global asset. There likely will come a time when you will need to make a reassuring statement of some sort and be believed or else there will be grave and expensive consequences. Your response to some crisis may well define your time as Secretary. Do not dissipate your credibility to pursue dubious, transient, or political agendas no matter how great the pressure.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

ECONOMIC POLICY PRIORITIES FOR THE NEXT US ADMINISTRATION

To: Under Secretary of the Treasury for International Affairs
From: Maurice Obstfeld
October 2020

Background: The United States is best served by constructive engagement with foreign allies and competitors alike. A range of global threats has potentially severe economic ramifications, justifying attention to broader efforts at international cooperation beyond purely financial issues. Skillful messaging of the goals of these initiatives can build domestic support for globalized US engagement.

PRIORITY 1: Re-establish international trust in the United States as a global leader and role model

The United States should **reaffirm its opposition to predatory trade and currency policy** within the G20¹, while embracing positive steps needed to safeguard the global commons. Specifically, the United States should reengage constructively with key multilateral initiatives and organizations including the Paris Climate Agreement, the World Health Organization (WHO), and the World Trade Organization (WTO).

ACTIONABLE TO-DO LIST:

- Join other G20 countries in the COVAX partnership formed to develop and distribute a vaccine for the COVID-19 disease, underlining the US commitment to the health and prosperity of developing countries, which ultimately contribute to that of the United States.
- Recommend that the president rescind Section 232 steel and aluminum tariffs.
 - » This action would both benefit the US and global economies, and serve to signal a sharp US shift toward a more internationally collaborative economic policy stance.
- Avoid exploiting the US dollar's global role as a sanctions instrument except in cases of relatively broad multilateral consensus.

Maurice Obstfeld, nonresident senior fellow at the Peterson Institute for International Economics, is the Class of 1958 Professor of Economics at the University of California, Berkeley, and former chief economist of the International Monetary Fund (2015–18).

¹ The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, Japan, India, Indonesia, Italy, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

- Reverse the US position that exchange-rate stability is an independent policy goal, as expressed in the G20 March 2018 finance ministers' and central bank governors' communiqués and repeated in subsequent summit statements as a result of US pressure.
- Stop deemphasizing human rights in US international economic relations.

PRIORITY 2: Adopt a multilateral approach to China

A shift is essential from the pattern of the last few years—unilateral action, coupled with coercion of third countries to support US tactics. Decoupling with China is not realistic, but at the same time, **addressing potential downsides in the economic relationship with China requires a multilateral response**, for example, by the G7² countries or a subset thereof.

ACTIONABLE TO-DO LIST:

- The United States and European Union should jointly confront China's intellectual property rights practices and industrial subsidies, push for greater market access, update the WTO framework to more effectively encompass Chinese policies that confer artificial trade advantage, strengthen WHO capabilities (including to call out probable violations of International Health Regulations), and push back on political repression in Hong Kong.

PRIORITY 3: Ensure fair tax collection from globally active businesses

The current crisis will bequeath an **unprecedented federal debt level, putting tax revenues at a premium**. At the same time, voter support for globalization will fall further without assurance that multinational enterprises are paying their fair share: As the secretary-general of the Organization for Economic Cooperation and Development (OECD) has stated, “[P]ublic tolerance of tax avoidance by companies is expected to reach an historic low in the aftermath of the COVID-19 crisis.”

ACTIONABLE TO-DO LIST:

- The United States should clearly endorse and promote completion and adoption of the two pillars of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS)—both Pillar One on international allocation of taxing rights and Pillar Two on minimal tax levels.

PRIORITY 4: Address corruption

Corruption hampers growth, drains public revenues, and undermines faith in government. These problems are especially severe in poorer countries, which will be particularly vulnerable post-COVID-19, but unfortunately, the practices of richer countries with respect to **wealth secrecy and the foreign activities of companies** can undermine anti-corruption efforts. Efforts in this area can be complementary with those that help to counteract terrorist financing.

2 The G7 countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

ACTIONABLE TO-DO LIST:

- Promote stronger implementation of the OECD Anti-Bribery Convention and lead by example through stronger adherence to the US Foreign Corrupt Practices Act.
- Fully implement transparency recommendations of the G7's Financial Action Task Force on money laundering and terrorist financing, and press US allies to do so as well.
 - » For the United States, measures would include identifying the beneficial owners of real estate and land, considering extension to financial securities, and extending and tightening due diligence requirements.
- Strengthen the US Treasury's Financial Crimes Enforcement Unit (FinCEN) with the goal of more aggressive surveillance of suspicious activity by reporting financial institutions.
 - » There is potential to leverage data analytics more effectively to support this work, as illustrated by the Decision Support System example recently developed within the International Monetary Fund (IMF).
- Strengthen engagement with the multilateral Egmont Group of Financial Intelligence Units.

PRIORITY 5: Address volatile international credit conditions

Emerging and developing countries are likely to face volatile international credit conditions in the near term as they cope with COVID-19 and slower growth globally. **Widespread debt servicing problems** could follow. Extensive debts to China pose a particular problem, though these should not be addressed by politicizing IMF/World Bank lending decisions.

ACTIONABLE TO-DO LIST:

- In the short term, support the creation of an IMF Pandemic Support Facility, as suggested by Adnan Mazerai and Matthew Fisher (PIIE Policy Brief, July 2020).
- Within the context of the IMF 16th General Review of Quotas, support expanded IMF quota resources and adjustment of emerging and developing economy quota shares in line with those countries' growing relative importance in the world economy.
- Work with the G20 and IMF to streamline restructuring or reprofiling procedures for poorer countries' private-sector sovereign debts, in cases where insolvency looks probable.
 - » This initiative would facilitate prompter and easier restructuring when necessary, while minimizing potential free riding by creditor groups.
 - » Benefits will flow to the United States through higher growth in emerging markets and developing economies (which contribute about 40 percent of global output at market exchange rates), enhanced financial stability here and abroad, and reduced risks of failed states and massive outward migrations.
 - » Consider among potential reform areas those identified in the IMF's October 2020 stocktaking paper "The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors."

PRIORITY 6: Coordinate globally on cyber risks

Cyber risks pose a Damoclean threat to global financial stability and economic activity. The United States should lead in **demanding that international financial regulators put these risks top of agenda and coordinate closely on practices and threat assessments.**

ACTIONABLE TO-DO LIST:

- The Financial Stability Board’s (FSB) consultation report “Effective Practices for Cyber Incident Response and Recovery,” presented to the G20 last April, offers a toolkit that could underlie international cooperation on a problem requiring globally coordinated preparedness, given the international financial linkages.
- Make clear US determination to retaliate strongly against state-sponsored cyber-mischief—whether by China, Russia, North Korea, Iran, or others.

An Underappreciated Issue

International payments remain slow, costly, and opaque, creating an opportunity for private actors such as Facebook to colonize the space in pursuit of their broader agendas (or for China to do the same with its digital currency, the e-RMB). The United States should help ensure that central banks fill that gap—though this requires close cooperation (e.g., a TARGET-like³ set of lending arrangements among central banks). Under several different models, central bank digital currencies could form the basis for a real-time international payments system, including for remittances, with traceable payments that would contribute to enforcing anti-money laundering and combating the financing of terrorism (AML/CFT) regulations. The move away from cash during the current pandemic provides an impetus for these developments. The February 2020 meeting of G20 finance ministers and central bank governors recognized the inadequacy of the international payment infrastructure and tasked the FSB with developing a roadmap for improving cross-border payments. The FSB’s October 2020 response notes the potential for a system based on central bank digital currencies.

3 Trans-European Automated Real-Time Gross Settlement Express Transfer.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

US TRADE DEFICIT AND INTERNATIONAL FINANCIAL POLICY

To: Incoming Treasury Assistant Secretary for International Finance
From: Joseph E. Gagnon
November 2020

Background: A prerequisite for success in your domain is to strengthen relationships with your colleagues in the Group of 7 (G7¹) advanced industrial democracies, the G20² leading economies, the International Monetary Fund (IMF), the 37-member Organization for Economic Cooperation and Development (OECD), the World Bank, and the regional development banks. The US refusal at times over the past four years to sign G7 and G20 statements is a sign of American isolation and ineffectiveness, which weakens the ability of the United States to deal with common challenges and to coordinate better economic outcomes for Americans.

Joseph E. Gagnon is senior fellow at the Peterson Institute for International Economics. He served at the US Federal Reserve and the US Treasury in a number of positions for over two decades.

PRIORITY 1: Avert currency manipulation

The most urgent task for dollar policy is to head off worrisome signs of a resurgence of currency manipulation, the practice countries use to gain unfair trade advantages by weakening their currencies and making exports cheaper and imports more expensive. Four medium-sized economies exceeded reasonable criteria for currency manipulation in 2019,³ with foreign exchange intervention totaling \$160 billion. Intervention by these and some other countries with excessive trade surpluses has jumped considerably in recent months, a trend that must not be allowed to continue.

RECOMMENDED POLICY: Countervailing currency intervention

The best way to deter currency manipulation is to embrace the policy of countervailing currency intervention (CCI) that I proposed with C. Fred Bergsten in 2017. When a country buys US dollars to keep its own currency weak, the United States can buy an equivalent amount of that country's currency to neutralize the effect. That policy would not pose a

1 The G7 countries are: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

2 The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

3 Singapore, Switzerland, Taiwan, and Thailand. See Christopher G. Collins and Joseph E. Gagnon, "Currency manipulation remained low in 2019," July 9, 2020, RealTime Economic Issues Blog, Peterson Institute for International Economics.

threat to countries that are not intervening heavily, such as China and the G7 countries. If accompanied with a significant increase in the capacity of Treasury's Exchange Stabilization Fund, simply announcing the policy should be enough to encourage manipulators to stand down without actually requiring US intervention.

Bergsten and Gagnon (2017) proposed targeting CCI only at G20 (large) economies, but that remit should be expanded to cover medium-sized economies whose manipulation has a substantial combined effect. In order to garner international support, it will be important to adhere to economically sound and objective criteria in identifying manipulators and not to allow noneconomic considerations to play a role.⁴

ACTIONABLE TO-DO LIST:

- Immediately adopt a policy of countervailing currency intervention and increase the capacity of Treasury's Exchange Stabilization Fund to deter would-be currency manipulators.

PRIORITY 2: Address chronic trade deficits through dollar policy changes, not tariffs

Further changes to dollar policy will likely be needed to address the chronic issue of US trade deficits. President Donald Trump made reducing the US trade deficit a signature issue of his 2016 campaign. His administration used tariffs as a tool to reduce imports and bring trading partners to the negotiating table to expand access for US exports. The strategy failed completely. The trade deficit has grown steadily. The economics profession has long understood that tariffs and other trade barriers have little effect on trade balances. Exchange rate policy is the key to reducing trade imbalances. Hence, responsibility for the trade deficit is placed with the Treasury Secretary and not the US Trade Representative. A long-term goal should be to keep the trade balance within a range of -2 percent to 2 percent of GDP, preferably close to 0.

Getting surplus countries in the G7 and G20 to acknowledge the harm of currency manipulation in support of large surpluses was a genuine accomplishment of the Obama administration. However, simply forswearing intervention by all countries is not the right endpoint. There are other drivers of undesirable imbalances, mainly reflecting imperfections in private financial markets, as evidenced by so many international financial crises over the years. Countries should be free, even encouraged, to intervene in ways that limit these undesirable imbalances, as endorsed by IMF Article IV.

At 2.5 percent of GDP, the trade (current account) deficit is only moderately excessive at present and not the most urgent economic problem facing the United States. But decades of neglect have allowed the US economy to travel far down an unsustainable and ultimately dangerous path. The harm from the deficit comes through several channels:

- The US net international investment position, at -69 percent of GDP, is at a level that has proved dangerous for other countries.⁵

4 Treasury's criteria include a requirement that a currency manipulator have a bilateral trade surplus with the United States. There are no economic grounds for such a criterion.

5 Data are for 2020Q2 and exclude monetary gold, which is not a claim on foreigners. Some improvement is likely in the next few quarters as US GDP recovers and the dollar reverses the rise in early 2020.

- This debt was used to support consumption not investment and is thus a burden on future generations.
 - » The burden is grossly underreported owing to measurement errors in investment income associated with foreign tax havens.
- The deficit contributes to protectionist pressures that are distorting global trade.
 - » Unlike tariffs and quotas, dollar policy directly counters the forces behind an overvalued dollar, restoring balance without reducing global trade.
- The deficit has contributed to a modest but meaningful extent in the decline of manufacturing jobs that exacerbates income inequality and disproportionately harms blue collar workers.
- Expanding exports and narrowing the trade deficit helps to increase US employment when interest rates are stuck at zero without adding to record fiscal deficits.
 - » Exchange rate policy cannot boost growth in all countries. It must be used only to narrow trade imbalances and not to maintain or enlarge them.

RECOMMENDED: Balanced dollar policy

If the US trade deficit should persist or grow over the next year or so, actions should be taken to return it gradually to zero. The most important action is a moderate buildup of US foreign exchange reserves toward levels seen in other reserve-issuing countries. The US Treasury should consult with foreign finance ministries and central banks on the speed and distribution of any reserve buildup. The aim would be a modest dollar depreciation that would set the trade balance on a slowly narrowing path. Surplus countries would be encouraged to boost domestic demand to allow for a gradual narrowing of their surpluses without endangering overall growth. The increase in US exports would return economic activity to potential sooner than otherwise, enabling an increase in public and private saving consistent with the narrowing trade deficit. The United States needs the IMF as a partner in endorsing moderate US action to narrow imbalances while discouraging retaliatory currency manipulation by other countries to support excessive trade surpluses.

ACTIONABLE TO-DO LIST:

- Adopt a “balanced dollar” policy: In consultation with foreign finance ministries and central banks, build up US foreign exchange reserves toward levels seen in other reserve-issuing countries. This will facilitate moderate dollar depreciation and narrow the trade deficit.

PRIORITY 3: Increase resources for the IMF, the World Bank, and regional development banks

With respect to the IMF, the World Bank, and the regional development banks, the United States should take the lead in increasing the resources available to combat future crises and support economic development. One area for immediate action is a new Pandemic Support Facility at the IMF. The United States should also cooperate in efforts to more fairly distribute voting power within the IMF and the development banks. This redistribution primarily involves reducing excessive voting shares of European countries and increasing the shares of emerging and developing economies, with little net effect on the US share.

Repairing relationships with European allies will help to smooth this adjustment. It is ultimately in everyone's interest to secure the legitimacy of the management structure of these international financial institutions.

ACTIONABLE TO-DO LIST:

- Support the Pandemic Support Facility at the IMF.
- Support a generalized increase in capital for the IMF, the World Bank, and the regional development banks.
- Cooperate in efforts to more fairly distribute voting power within the IMF and the development banks.

THE UNITED STATES

US FEDERAL RESERVE

David Wilcox to the Vice Chair of the Federal Reserve Board

Anna Gelpern to the Federal Reserve Vice Chair for Supervision



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

US MONETARY POLICY PRIORITIES IN THE NEAR AND MEDIUM TERMS

To: The Vice Chair of the Federal Reserve Board
From: David Wilcox
November 2020

Background: The US economy has partially recovered from a historically deep downturn, but there is still a long way to go before the recovery will be complete.¹ The overall unemployment rate remained at 6.9 percent in October 2020, and the number of jobs was still 10 million below its February level. The consequences of the economic downturn have fallen disproportionately on women, people of color, and the lower rungs of the income ladder. As of late November 2020, fiscal policymakers still appear gridlocked over when to enact additional support for the economy, how substantial that support should be, and what form it should take.

Even with the recent good news on potential vaccines, the economic recovery likely will remain incomplete through the end of 2021 at the very least, and perhaps significantly longer. Left unattended, an incomplete recovery could inflict serious damage—including but not limited to hunger, eviction from homes, and diminished attachment from the labor market—on the groups noted above who are suffering the worst of the consequences.

The Federal Reserve has played a crucial role thus far in helping to stave off even worse outcomes. Earlier in 2020, the Federal Open Market Committee (FOMC) quickly cut the short-term interest rate under its control essentially to zero and began to purchase longer-term Treasury and mortgage-backed securities in historically large quantities. In addition, the Fed established a range of emergency facilities using the authority granted to it under Section 13(3) of the Federal Reserve Act and expanded its provision of dollar liquidity to other central banks. These steps were successful in quelling the turmoil that erupted in financial markets when the pandemic crisis began.

David Wilcox, nonresident senior fellow at the Peterson Institute for International Economics, served in the Division of Research and Statistics at the Federal Reserve Board as deputy director (2001–11) and most recently as director (2011–18). In the latter role, he functioned as the chief economist of the division, a senior advisor to three successive chairs of the Federal Reserve Board, the division's lead for strategic direction, and its chief manager. He also served as assistant secretary for economic policy at the Treasury Department from 1997 to 2001 and as a senior economist at the Council of Economic Advisers from 1994 to 1995.

¹ The NBER Business Cycle Dating Committee has determined that economic activity peaked in February 2020—and thus that a recession began. They have not yet designated the month in which the recession ended. If the economy continues to gradually recover, they will probably decide that the trough occurred in April, thus making the recession the shortest on record at only two months in duration. (The shortest recession currently recognized by the NBER is the one in 1980, at six months.) If COVID-19 continues to intensify in its effect over the next few months, the economy could weaken again, and the Dating Committee could be confronted with a difficult decision as to whether what had happened was two discontinuous recessions, or one longer one interrupted by the fastest GDP growth recorded since the modern era of GDP measurement began in 1947.

As necessary and effective as these steps were, they represent the bulk of what the Fed is statutorily authorized to do in fighting recessions. The bulk, but not all. Because the consequences are so enormous, it is incumbent upon the Fed to use its tools to the utmost to deliver the best possible outcomes. Even so, the reality is that fiscal policy will have to shoulder the bulk of the responsibility from here forward to ensure that we, as a society, shield the most vulnerable from ongoing harm and speed the attainment of a full recovery.

Also, the Federal Reserve has recently concluded its “Review of Monetary Policy Strategy, Tools, and Communications,” which refines the Fed’s interpretation of the instructions given to it by Congress in the Federal Reserve Act. The revised framework helpfully includes a new set of thresholds governing the conditions that the FOMC expects to see before it will lift the federal funds rate above the effective lower bound. You and your colleagues should do everything you can to make this commitment credible, understood, and have an easing effect on policy now through communications.

In this context, there are three important steps for you to consider, each of which could help rebuild the global economy. The first step should be considered in the near term; the other two can go on the longer-term agenda but still deserve focused attention.

KEY PRIORITIES

PRIORITY 1: Strengthen the FOMC’s forward guidance about large-scale asset purchases

One piece of seemingly unfinished business from the Framework Review pertains to the guidance included in each post-meeting statement regarding future purchases of longer-term assets. Currently, the statement says that “over coming months the Federal Reserve will increase its holdings of Treasury securities and agency mortgage-backed securities at least at the current pace to sustain smooth market functioning and help foster accommodative financial conditions.”

Longer-term interest rates are low, but they are not as low as the federal funds rate, suggesting there could be room for the FOMC to provide additional impetus to aggregate demand by driving long rates lower. (As of this writing, the yield on 10year Treasury notes is in the neighborhood of 0.9 percent.) The FOMC could provide more impetus by announcing economic thresholds that it expects will have to be met before it will stop increasing the size of its portfolio. For simplicity, these thresholds could take exactly the same form as the ones already announced for the federal funds rate; or they could be closely related.² By making clear that it will scale the cumulative amount of its bond purchases according to the length of time that elapses before its inflation and employment objectives are reached, the FOMC could bolster public confidence in its determination to achieve a complete recovery as rapidly as possible.

² David Reifschneider and I advocated an approach along these lines in a [PIIE working paper](#).

PRIORITY 2: Reconsider the inflation objective in light of changed economic circumstances

The Fed came into the most recent recession with too little room to fight even a typically sized recession—let alone a historically severe one—using its conventional tool, cuts in the federal funds rate.³ The Fed found itself in this predicament despite having fostered a highly favorable macroeconomic environment, with the unemployment rate at a 50-year low and core inflation running only about ¼ percentage point below the 2 percent target. The diminishment of the Fed’s recession-fighting capability reflected the worldwide decline in the normal structure of interest rates. Many other central banks around the globe are in the same predicament.

One step the Fed conspicuously did *not* take in modifying its Statement of Longer-Run Goals was to boost the inflation target from its current level of 2 percent. Adopting a modestly higher target would eventually help the Fed to recoup a portion of its lost ability to fight recessions.⁴ Even a slight increase in the inflation objective would be difficult for any central bank to undertake unilaterally. However, you could work on two aspects of the problem. First, a coordinated move involving several globally important central banks (e.g., the European Central Bank, the Bank of Japan, and the Bank of England) all moving in concert could be easier than any bank moving alone, as my PIIE colleague Adam Posen argued. Second, the Fed and other central banks could build a rhetorical bridge to a higher inflation objective by saying that their first priority is to restore inflation to the current 2 percent objective, and once that is attained, they will revisit the question of what the optimal level of the inflation target is, in light of the further decline in the neutral rate since the 2 percent objective was adopted in 2012.

PRIORITY 3: Build out the macroprudential toolkit

Monetary policy will be stretched to the limit in coming years in terms of its ability to fight recessions. A danger is that financial stability concerns will become more acute even before central banks should curtail the amount of support for aggregate demand they are providing. The macroprudential policy toolkit is very sparse in the United States. To allow monetary policy to fight recessions to the fullest extent possible, potential financial stability concerns must be addressable using other policy tools. The precise specification of these other tools, and the identity of who should wield them, will require careful study. That program of study should get under way now. This agenda item will ultimately require extensive coordination with Congress, as well as the other regulatory agencies, depending on where the authority to exercise the new tools is lodged.

3 On the eve of the COVID-19-induced collapse, the target range for the federal funds rate extended from 1½ percent to 1¾ percent. In response to a typical post-World War II recession, usual behavior (following the so-called balanced approach rule) would have the Fed cut the funds rate by about 5 percentage points, assuming the zero lower bound on interest rates posed no impediment. A historically severe recession obviously would call for a much larger rate response in the absence of a lower bound.

4 There is no prospect of recouping *all* of the lost policy space by this means, and you and your colleagues should not try to do so, because the gap to be closed is too big.

OTHER PRIORITIES

Beyond the top priorities listed above, other issues will need your focused attention. Especially with the ongoing relevance of the effective lower bound on the funds rate being abundantly clear, the Fed and other central banks need to devote increased attention to the question of whether other monetary policy tools can be developed, with better distributional consequences than the current set of tools. More broadly, you should invest time and energy in promoting the broad rethink of the Fed's responsibility for helping to close the yawning economic inequalities that persist in our society. Related to the adoption of "average inflation targeting" under the new framework for monetary policy, the Fed will need to clarify the extent to which you and your colleagues are willing to tolerate some greater risk of higher inflation for the sake of promoting a tighter labor market and hence a more equitable distribution of economic resources. These issues are complex; if easy solutions were available, they would have been implemented already. There are not, but that does not mean that you should not pursue them.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

STRENGTHENING FINANCIAL SYSTEMS AGAINST FUTURE SHOCKS

To: The Vice Chair for Supervision of the Federal Reserve Board

From: Anna Gelpern

January 2021

Background: Financial regulators' challenge today is to fortify financial systems against future climate and public health shocks and financial crises and to prevent finance from amplifying inequality and social conflict. These risks are by their nature systemic. Prevention and resolution strategies limited to individual institutions are bound to fall short. The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Vice Chair for Supervision position at the Federal Reserve¹ in 2010 as part of a far-reaching postcrisis financial reform program explicitly concerned with systemic risk. These reforms on balance expanded the Fed's regulatory and supervisory remit but also limited its scope for emergency intervention in crises.

Policy responses to COVID-19 reaffirm the central importance of the Federal Reserve to the stability of the US and global financial systems.

Ahead of the next shock, it is essential on both economic and political grounds for the Fed to prioritize building up financial system resilience and to identify and preempt new sources of instability. During the transition and the pandemic, the Vice Chair is the one sitting US official with the mandate to implement supervisory measures to bolster resilience across institutions and the bandwidth to focus on financial stability.

PRIORITY 1: Reassess Regulatory Relief Efforts in Light of the Pandemic Experience

The pandemic experience of 2020 is an opportunity to pause, review, and reconsider recent supervisory initiatives in light of new evidence without signaling regulatory instability. In the consensus view, US commercial banks have proved resilient in the face of an unprecedented economic shock. Banks' resilience so far validates domestic and international reforms that began after the global financial crisis of 2007–09. Since 2017, however, US regulators have rolled back many of these reforms. Most of the rollbacks were in the name of reducing administrative burdens on small community banks, but some

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¹ The Board of Governors of the Federal Reserve System, referred to as the "Federal Reserve" or the "Fed."

extended to very large regional and national institutions. Regulatory relief legislation in 2018 accelerated the reversal. Capital stress tests, resolution planning, and minimum liquidity requirements have been reduced in scope and intensity for banking organizations with less than \$700 billion in assets and have been eliminated for banks with less than \$100 billion in assets. The remaining stress tests have become more transparent for the banks, but less so for the public, at least during the pandemic. Volcker Rule prohibitions on banks' proprietary trading have been relaxed. According to the International Monetary Fund's (IMF) 2020 financial sector assessment of the United States, recent measures could meaningfully reduce capital and liquidity buffers for all but the biggest global financial conglomerates.

The likely total impact of many disparate regulatory relief initiatives was hard to quantify even before COVID-19, IMF warnings notwithstanding. Ascertaining it has become more urgent since. According to the Fed's November 2020 Financial Stability Report, firm and household debts have been rising sharply since the onset of the pandemic, with risks concentrated in certain sectors and regions. The full effects of recent business disruptions, including those following a new spike in COVID-19 cases since November, would take time to appear on institutions' balance sheets. The presumption that significant cumulative regulatory rollback would produce a safe recalibration in the face of these risks is questionable and potentially dangerous.

PRIORITY 2: Develop a Comprehensive Oversight Framework for Nonbank Financial Intermediation, Including Enhanced Supervision of Both Entities and Activities

US policymakers stopped using the term "shadow banking" in 2017; financial regulators elsewhere quickly followed suit. Yet, nonbank financial intermediation has been growing rapidly in the United States and around the world, with a variety of structures using short-term debt to fund illiquid assets. The Fed's crisis management success early in the pandemic should not obscure the underlying regulatory failure that required yet another Fed intervention in entities and markets it did not regulate. The crisis revealed continued fragility in money market funds, short-term funding markets, and other parts of the nonbank financial ecosystem.

While the Fed should collaborate with functional regulators on targeted reforms, a fragmented functional approach is not enough in a world increasingly prone to large-scale exogenous shocks. Without a comprehensive framework for financial stability oversight across both institutions and markets, regulators are doomed to play whack-a-mole with Fed emergency lending on standby.

The Trump administration committed to "activities-based" financial stability oversight as an alternative to designation and enhanced supervision of systemically important financial institutions. Guidance by the Financial Stability Oversight Council (FSOC) in 2019 on the activities-based approach expressly defers to functional regulators, such as the Securities and Exchange Commission (SEC). Apart from the Fed, however, these functional regulators have limited experience in, and limited commitment to, financial stability regulation—by mandate, they do not see the big picture and are bound to miss potentially correlated amplification of shocks. The Trump administration has not implemented any new activities-based systemic risk regulations since issuing the guidance.

Despite the flaws of this approach to activities regulation, simply returning to systemic entity designations would be a bad idea. First, critics of the entity-based approach are right

to point out that it fails to capture vast amounts of financial market activity untethered from institutional balance sheets. Second, entity designation has gravitated to bank-style capital and liquidity regulation, which can be a poor fit for a diverse bunch of nonbanks. Third, by 2017, entity designation had become mired in legal challenges. While the US government might eventually win all the lawsuits, a regulatory approach that gets gummed up in court for years would cost precious time as risks build up.

Financial stability requires both entity and activity regulation. These are no more mutually exclusive than traffic lights and licensing drivers. With access to its emergency lending on the line, the Fed should press for a more holistic approach to managing systemic risk in the financial markets—even where it does not have direct supervisory authority. FSOC should coordinate the development of a comprehensive analytical framework, instead of leaving it to functional regulators and their limited tools. The Fed’s intellectual leadership can be critical in this area.²

If FSOC does not have the wherewithal to reverse its posture of deference to functional regulators, the Fed should take the initiative to design a more holistic approach to financial stability oversight. It has ample data and analytical capacity to do so, along with tools such as margin requirements to affect the supply of credit in the financial markets, oversight and operation of payment systems, and supervisory authority over the largest diversified financial conglomerates.

PRIORITY 3: Reconsider Institutional Design to Meet New Challenges and Foster Legitimacy

The structure of financial oversight in the United States is ill-equipped to handle the challenges facing it: climate, public health, social strife, and inequality, which cuts across all others.

First, paring back stress tests, Volcker Rule trading restrictions, and public reporting puts added onus on supervisors exercising discretion to determine whether institutions are operating in unsafe and unsound ways. A rule proposed in November 2020 to reduce reliance on supervisory guidance could make the exercise of discretion less transparent, whether or not it leads to more formal rulemaking on the margins. The combined effect is to shift more prudential and financial stability oversight into the realm of confidential supervision, risking capture and courting political controversy. Supervision relies on sustained engagement between the regulators and the regulated. It is hard to make intelligible and accountable to the public; guidance is one of the few tools that can help. The Fed, last seen by the public as “bailing out the banks,” is especially at risk of appearing cozy with financial institutions.

Second, FSOC and the Treasury Department’s Office of Financial Research (OFR) appear increasingly adrift while the consequences of poor coordination are becoming more dire. The fact that the US Treasury Secretary chairs FSOC adds political accountability and a measure of influence—and further politicizes financial regulation. FSOC’s recent

² The Fed Chair is a voting member of FSOC; the Vice Chair has participated in council meetings by courtesy. The current Vice Chair of the Fed also serves as Chair of the Financial Stability Board, but will be replaced by the President of the Netherlands’ central bank in December 2021.

interventions have made it harder for financial regulators to respond nimbly and flexibly to new risks. They have eliminated, blunted, and piled new obstacles in the way of using supervisory tools.

Third, the gap between US and international supervision practices for mid-sized banks, insurers, accounting standards, and operational risk, among others, has grown, partly thanks to all the regulatory relief. The United States has a history of selective adherence to international standards. It also has an impressive record of securing global standards in line with US domestic practice. In the wake of recent US withdrawal from international organizations and norms, as well as its poor performance in managing the pandemic, the United States may have to go to new lengths to convince other countries that it is a reliable partner, and persuade them to adopt standards close to its own.

Fourth and last, technology firms that deliver financial services outside the regulated financial sector will continue to challenge regulators, especially in areas such as payments and small-scale consumer lending. The line between retail and wholesale payments infrastructure will keep blurring. Increasingly diverse actors will demand access to payment systems, raising thorny questions of operational and counterparty risk, and prudential supervision, even when no deposit-taking is involved. Effective oversight for financial stability and consumer protection takes new skills, constant adaptation, and substantial resources—and may require public provision of some financial services.

The Federal Reserve has the motive and the capacity to take a leading role in managing these challenges. Its authority over bank holding companies, its place in the payment system, and its lender of last resort mandate together give the Fed unparalleled influence over the changing shape of the US financial system. While it would be preferable for FSOC to play a robust role, the Fed can perform many of its analytical and coordination tasks. If the OFR does not regain its footing quickly, merging the financial stability research function into the Federal Reserve should be on the table. Meanwhile, the Fed must place a new emphasis on public outreach and creative communication to bolster the public legitimacy of its supervisory work, as it has done on the monetary policy side.

THE UNITED STATES

US DEPARTMENT OF COMMERCE

Evan G. Greenberg to the US Secretary of Commerce

Mary E. Lovely to the Under Secretary of Commerce for International Trade

Martin Chorzempa to the Under Secretary of Commerce for Industry and Security



Rebuilding the Global Economy

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MEMORANDUM ON

US AND GLOBAL COMPETITIVENESS

To: US Secretary of Commerce

From: Evan G. Greenberg

October 2020

PRIORITY 1: Reopen the economy by putting in place and enforcing national standards to control the COVID-19 virus; lead an effort to secure global cooperation to control the virus including health protocols, surveillance, and research

This requires:

- Develop national standards and enforcement for: COVID-19 testing, digital tracing, masking, and social distancing.
- Establish global surveillance and forensic capability standards and protocols with Europe and China to control the virus and restart travel. These three regions have the influence, size, and resources to lead that effort. In spite of the anger and sensitivity surrounding China's behavior, it is in the US interest to get past the politicization of the issue and agree upon a forward-looking plan. To facilitate this effort, Chinese leaders should admit the virus outbreak began in China.

PRIORITY 2: Reestablish the rules of engagement in global commerce and the confidence in the system that comes from leadership

Market-oriented global commerce and investment—conducted according to rules that all parties have adopted—rely on the predictability and confidence that comes from leadership. Commit to upholding and advancing multilateral trade and investment agreements—a market-oriented rules-based order based on accepted norms of conduct—by adopting a two-pronged approach: advance multilateral agreements focused upon Asia and Europe and digital technology and support the long-term process to reform the World Trade Organization (WTO) by working with a coalition of the willing.

Specifically:

- Rejoin the Trans-Pacific Partnership, now reorganized and renamed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This will help advance US interests and vision of more open trade in Asia.
- Longer-term effort: Support WTO reform by working with allies—Europe, the United Kingdom, Japan, Canada, Australia, etc.
- Negotiate with trading partners on rules of engagement for technology and data flows, including intellectual property protections, technology standards, national

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security protections, and privacy. These rules should address unreasonable levels of state-supported predatory practices. Establish the predictability and rules of competition while protecting national security interests that are vital to business and investment. Mutual agreement that allows access and technology development among Europe, Japan, Korea, the United States, and others may encourage China to conform.

PRIORITY 3: Reinvigorate American competitiveness and break the tactical pattern of tit-for-tat behavior with China

- Defend US interests against predatory behavior while advancing its view of a global trading system and offering China an opportunity to join. Washington should respond to China without making it all about China. The United States doesn't need either to emulate or attack China. We need to advance and defend our interests.
- This is not to insulate US companies from competition. Rather, the US system will either include or exclude Chinese firms naturally, depending upon Beijing's desire to participate in a rules-based multilateral trading regime. As long as the United States is strong, competitive, appropriately open to competition, and willing to lead with natural confidence, others will be encouraged to follow.

PRIORITY 4: Improving labor capability through immigration and skill enhancement is a crucial part of a government industrial policy that does not pick winners and losers

- Before the pandemic, there were 10 million US jobs that the American labor market could not fill. Raising the skills of the current workforce and encouraging skill-based immigration will fill those jobs and accelerate economic growth.
- Raising labor quality requires a focused private and government partnership in educating and training workers. Instead of simply emphasizing college for everyone, which won't benefit many and doesn't produce workers with practical skills that industry needs, policymakers should support and encourage training for people with high school degrees. Take advantage of existing infrastructure—the community college system paired with local employers. Retool when necessary so that community colleges continue to be able to deliver practical career-based technical skills training.
- Large-scale immigration of both skilled and low-skilled workers is a major part of enhancing the quality as well as quantity of US labor while reducing the average age of the US working population. With expanded immigration the economy will grow faster. While immigration policy reform cannot be prioritized during the pandemic, it should be at the top of the Commerce Secretary's list when equilibrium returns.

PRIORITY 5: Invest in digital and physical infrastructure—rails, ports, and 5G digital communication

- The United States is woefully underinvested, and this inhibits productivity and growth. To incentivize capital investment by the private sector, particularly in 5G, requires a large customer, and government must be the customer. The country needs a national champion in this area of fundamental technology. The US government should work with a country like Korea to encourage a partnership between a US provider(s) and Samsung that possesses the technology the United States needs.

PRIORITY 6: Improving US competitiveness is about strengthening North America

- Supply chains are not moving to North America, and the United States needs more to move to Mexico. A meaningful portion of supply chains that are currently moving to the Asia Pacific (from China and elsewhere) could move to a solid low-cost base in North America, which is Mexico.
- And yet Mexico is going in the wrong direction politically, economically, and socially. The rule of law and institutions to administer are weak, as are the policies and personnel capabilities of the current government. North America and in turn US competitiveness would improve if Mexico reversed its policy direction and strengthened government institutions. The United States is the only country that can influence the direction of the country, and it requires a whole of government approach. The Commerce Secretary is well positioned to influence this issue.

PRIORITY 7: Promote innovation through government and private sector partnership

- The US government has a role to play in helping to finance and develop innovations in the *foundational technologies*, especially quantum, biotech, smart batteries, and others vital to US economic future.
- To be sure, this is not government funding in the *application* of technology, which should be left 100 percent to the private sector. This can be done without picking winners and losers.
- The United States is well behind in the amount it spends on research and development (R&D) and how it spends it; having the Defense Advanced Research Projects Agency (DARPA) is clearly not enough. The United States needs to return to the level of federal support for technology that the Eisenhower and Kennedy administrations successfully provided.

PRIORITY 8: Encourage businesses to decarbonize to mitigate climate change

The economy is as susceptible to climate issues as the natural world is. Putting in place policies that promote faster conversion to more carbon-neutral natural gas in the sectors of energy, utilities, and transportation, and investing in more efficient transmission capability is a key area where the Commerce Secretary can show multilateral and American leadership. Simultaneously raising the cost of carbon through cap-and-trade and fuel taxes is smart policy.

ACTIONABLE TO-DO LIST:

- Develop a national approach to containing the COVID-19 pandemic and establish global surveillance with Europe and China to control the virus and restart travel.
- Join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and support WTO reforms.
- Prioritize rules of engagement and protocols for technology and data flows in trade or other forms of binding agreement.
- Defend against predatory or aberrant behavior by China while finding places where the two countries can cooperate to their mutual benefit.
- Run a better race.

- Improve the labor force by focusing on the community college system that is already equipped to train high school graduates for practical skills that industry needs.
- Invest in digital and physical infrastructure.
- Press Mexico to “clean up its house,” thereby encouraging multinational companies to view the country as a favorable low-cost link in their supply chains and do more business with North America and the United States.
- Provide federal support for technology research and development.
- Raise the cost of carbon through cap-and-trade and fuel taxes.



Rebuilding the Global Economy

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MEMORANDUM ON

PROMOTING TRADE TO MAXIMIZE AMERICAN PROSPERITY AND INCLUSION

To: The US Under Secretary of Commerce for International Trade
From: Mary E. Lovely
November 2020

Background: International trade contributes to American prosperity, resilience, social inclusion, and sustainability. The Under Secretary of Commerce for International Trade has the tools to shape policies that promote exports, guard against unfair or predatory practices by trading partners, foster economic inclusion, protect against climate change, and harness the power of international exchange and cooperation to maximize the many economic and social benefits of trade. Concentrating on exports, for example, would allow the nation's most productive companies and farms to expand. These companies, in turn, drive opportunities for local producers.

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PRIORITY 1: Focusing on the Asia-Pacific and Mexico while ending trade wars

Given the policies of the last four years, the Under Secretary has two immediate and impactful ways to promote a healthier US economy. First, the Under Secretary has the unique opportunity to reclaim the United States' place in the Pacific region, by promoting US reentry into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the successor to the TPP, from which President Donald Trump withdrew in 2017. Regional agreements lower trade barriers for members, to the disadvantage of those outside the agreements. The United States should be inside this high-quality agreement, which creates high labor, environmental, and data standards throughout the region while opening markets for American producers. Similarly, the United States should seek to strengthen its partnership with Mexico, as strong North American supply lines promote US competitiveness with East Asian products.

Second, the Under Secretary should champion an end to tariffs implemented since 2017, as these have depressed US manufacturing job growth and placed US farms at the mercy of government payouts to compensate for lost sales overseas. Ample evidence from the last three years demonstrates that protection preserves a few jobs in favored sectors but kills far more by raising the cost of production for downstream users. Tariffs imposed unilaterally, and outside internationally accepted norms, lead to retaliation by other countries, the loss of export markets, and more job loss. The appropriate action is simple: remove tariffs that serve no further purpose. For China, the Under Secretary should clarify the objectives of US

policy, measure Chinese progress to date on protections for intellectual property, and assess the prospect for Chinese market opening in exchange for tariff reductions.

PRIORITY 2: Seeking open borders for medical supplies

The COVID-19 pandemic painfully illustrates the need for trade to contribute to American resilience. Resilience does not come from producing domestically everything that might possibly be needed, but rather from a considered mix of preparedness, which would include some stockpiling, along with the creation of diversified and trusted international partnerships. COVID-19 has taught us some hard lessons in the dangers of disrupted availability of medical supplies and medicines.

In this context, information is power. Getting adequate supplies where they are most needed requires timely and accurate information on stocks and prices. As PIIE Reginald Jones Senior Fellow [Chad P. Bown](#) has noted, an international market information system exists for food stocks (which likely prevented export controls on food supplies) but does not exist for medical supplies and medicines. The Under Secretary should work with foreign partners to create and maintain such an international market information system.

In addition, trade provides resilience only if borders remain open during times of crisis. Rather than being overly dependent on one supplier, [new analysis by Simon Evenett](#) shows that remarkably few nations have concentrated sourcing patterns for medical supplies. This diversification mitigates risk because it is rare for all suppliers to be similarly affected by a disaster—if access is provided when needed. The Under Secretary should promote a plurilateral agreement with trusted trade partners that ensures mutual aid and maintenance of open borders in times of public health crises.

PRIORITY 3: Using trade to promote inclusion

Trade can promote social inclusion. Changes in the global economy cause disruption and dislocation in the United States, straining the social fabric. Yet, it is impossible to fully insulate American workers from these changes while ensuring a vital and growing economy. While labor, tax, and education policies seek to improve conditions for American workers, trade policy can also play a useful role. First, the Under Secretary must ensure that laws protecting US workers from unfair trade are fully enforced. But the United States must go farther. Only by working with allies, notably the European Union and Japan, can the United States tackle the problems caused by predatory state subsidies, overcapacity, and intellectual property theft.

The Under Secretary should also work within the administration to extend export opportunities to more workers in more regions. The pandemic offers ample evidence that economy activity can flourish outside American cities and coasts. By promoting robust rural broadband provision and actively seeking opportunities for services exports from remote locations, the Under Secretary can open new opportunities for more American workers.

PRIORITY 4: Reducing the carbon footprint

Lastly, trade must contribute to sustainable growth. Already, American companies are creating new products and services for a low-carbon future. Strong domestic demand for green products is the best way to ensure US producers achieve sufficient scale to be globally competitive. The Under Secretary must help keep foreign markets open to US green producers by articulating the risks of broad “Buy America” provisions—which invite other

countries to lock US products out of their government procurements. He or she should also raise awareness of the cost of failing to enact policies to mitigate climate change—which will lead directly to adoption of border taxes by major US trading partners.

The Under Secretary also has the tools to convene American logistics experts to identify the most promising avenues for reducing the carbon footprint of international trade, including new transport modes, streamlined border procedures, and improved labeling.

The Under Secretary should be an important voice within the next administration—promoting policies that harness international exchange for the benefit of the American people.

ACTIONABLE TO-DO LIST:

- Champion an end to US tariffs implemented since 2017.
- Clarify the objectives of US policy toward China, measure Chinese progress to date on protections for intellectual property, and assess the prospect for Chinese market opening in exchange for tariff reductions.
- Promote US reentry into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).
- Work with foreign partners to create and maintain an international market information system for medical supplies and medicines, similar to the one that exists for food stocks.
- Promote a plurilateral agreement with trusted trade partners that ensures mutual aid and maintenance of open borders in times of public health crises.
- Work with US allies, notably the European Union and Japan, to tackle the problems caused by predatory state subsidies, overcapacity, and intellectual property theft.
- Work within the administration to extend export opportunities to more American workers in more regions across the country.
- Help keep foreign markets open to US green producers by articulating the risks of broad “Buy America” provisions.
- Raise awareness of the cost of failing to enact policies to mitigate climate change.
- Convene American logistics experts to identify the most promising avenues for reducing the carbon footprint of international trade, including new transport modes, streamlined border procedures, and improved labeling.



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MEMORANDUM ON

PROTECTING INNOVATION AND NATIONAL SECURITY

To: Under Secretary of Commerce for Industry and Security
From: Martin Chorzempa
October 2020

Background: Export controls designed to protect US national security, innovation, and intellectual property are one of the most powerful tools available for economic statecraft, but they must be used carefully. If they are overused, they encourage firms to move their research, development, and production overseas to avoid controls, the risk of which is greater than ever because of globalized supply chains and attractive alternative locations for research.

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Nevertheless, export controls, when implemented properly, especially with respect to China, can be a useful tool to maintain US leadership and capacity for innovation in key technologies and keep China and other competitors reliant on US technology. Such an outcome serves US interests far better than “decoupling” from China in a way that would threaten to deprive US firms of Chinese talent, investment, and markets.

Below are recommendations for employing export controls that can help rebuild the US and global economies after the COVID-19 pandemic.

PRIORITY 1: Adapt export controls to a world connected by globalized supply chains and many centers for R&D

The United States dominated the global innovation landscape with over two-thirds of global research and development (R&D) spending in the 1960s; today’s competitive environment has diminished that share to less than a third (figure 1).

Figure 1
United States no longer dominates global research and development (R&D)

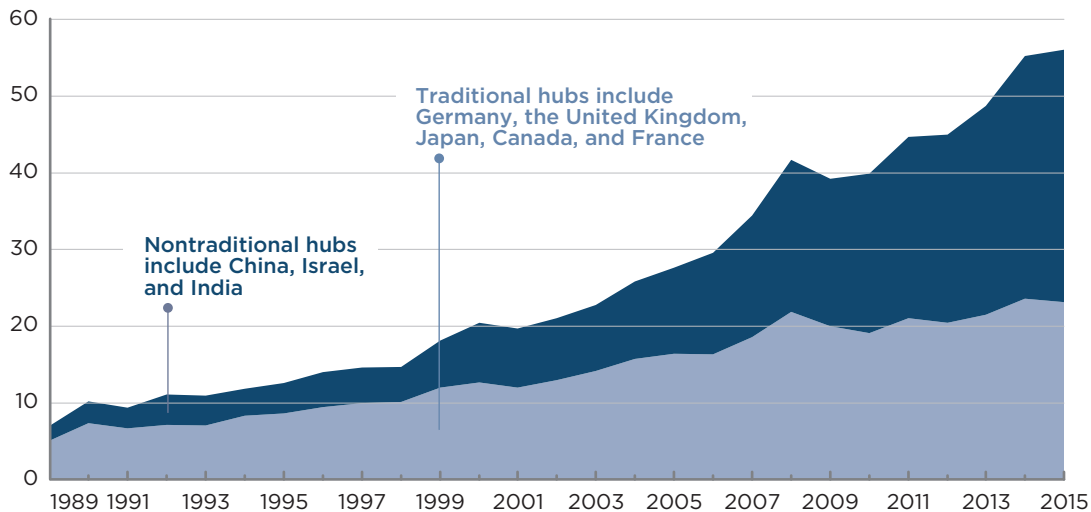


share of R&D spending

Source: Congressional Research Service.

Even US multinational firms increasingly perform R&D in countries like China and India that are not traditional US allies, and thus less likely to go along with US export controls (figure 2).

Figure 2
US-based multinational firms increasingly fund R&D outside US-allied countries
(billions of US dollars)



Source: Lee G. Branstetter, Britta Glennon, and J. Bradford Jensen, 2019, “The IT Revolution and the Globalization of R&D,” *Innovation Policy and the Economy* 19: 1-37.

Since firms already have well-developed, competitive innovation ecosystems abroad, unilateral controls—or even those shared only among US security allies—are more likely to backfire, giving other jurisdictions the investment and jobs.¹

No US policy can reverse this shift. The Commerce Department’s Bureau of Industry and Security (BIS), which oversees issues of technology and national security, must adjust to this new reality in which controls have both less leverage and higher potential costs. Export controls and licensing procedures that put an undue burden on US exporters incentivize them to move abroad to avoid losing revenues that they need to remain internationally competitive. Since top talent increasingly comes from outside the United States as well, export policy should ensure that US firms maintain the ability to hire the best international talent by not overusing deemed export restrictions.

ACTIONABLE TO-DO LIST:

- Cut down on existing and new unilateral controls in categories like commodified products.
- Facilitate deemed export licenses when benefits of international talent outweigh risks of technological leakage.

¹ Lee G. Branstetter, Britta Glennon, and J. Bradford Jensen, 2019, *The Rise of Global Innovation by US Multinationals Poses Risks and Opportunities*, PIIE Policy Brief 19-9, Washington: Peterson Institute for International Economics.

PRIORITY 2: Use “small yard, high fence”² as the guiding principle for export restrictions

Controls will be more effective with a “higher fence.” The BIS’s limited resources should be focused on rigorously enforcing controls on the most critical technologies and goods. More narrow controls are more likely to secure compliance from allied countries and also gain their buy-in to adopt similar controls. The process of determining what should be inside the fence will identify areas crucial to keep cutting-edge US technological out of the hands of strategic rivals, thus potentially restricting access to key building blocks like semiconductor manufacturing equipment (SME) or design tools when such actions could effectively block import substituting industrial policy or prevent countries and firms from profiting from stolen intellectual property. At the same time, limiting the scope would relax outdated or ineffective restrictions, like those on most products that are far from the cutting edge or on widely available commodity products.

ACTIONABLE TO-DO LIST:

- Launch a small-yard initiative that continues and intensifies the Obama-era export control reforms to loosen or eliminate outdated controls or those on low priority products.
- Beef up enforcement and monitoring on high priority technologies and products.

PRIORITY 3: Build situation-specific coalitions with allies to control key technologies

The COVID-19 epidemic has put China in a negative light around the world, a political shift that has expanded support for multilateral controls that would not have passed even a year ago. The United States should capitalize on this trend and strengthen existing fora like the Wassenaar Arrangement, a multilateral agreement on technology controls established in the 1990s. But Washington should also build smaller coalitions of the willing with key suppliers of goods like semiconductors, where interests align in blocking import substituting industrial policy that aims to supplant foreign suppliers. All it would take to put controls on the majority of global SME exports is for Japan and the Netherlands, both US securities allies, to join US controls. If Korea and Taiwan joined, just under two-thirds of the global export market would be covered, according to forthcoming research from my PIIE colleague Chad P. Bown.

ACTIONABLE TO-DO LIST:

- Form informal working level commissions with allies of key exporters of strategic technologies to coordinate national export control policy where the Wassenaar Arrangement is too large or slow to fit the need.
- Work with the European Union to coordinate US entity listings and new controls with the drive for autonomous controls on cyber-surveillance.

² Originally formulated by former Secretary of Defense Robert Gates.

PRIORITY 4: Incentivize Chinese dependence on US technology and inputs well into the future by using the entity list more judiciously

The unprecedented rise in entity listings and rule changes that place restrictions without a clear path to removal through behavior changes has disrupted US-China relations, encouraging Chinese leaders and businesses to see the United States as an unreliable technology supplier. In the past, for example with ZTE, the Chinese company accused by the United States of selling banned technology to Iran and North Korea, the rationale for the company being added to the list was more clearly defined, as were the behavioral changes or deals that could get it removed.

The latest export control policy has put American firms at a competitive disadvantage in the Chinese market and incentivized China to double down on self-sufficiency. Both US and foreign firms have reported privately that Chinese buyers, even those not in sensitive sectors, are requiring certification that their supply chains are outside the reach of US export controls. China's concerns are encouraging foreign firms to eliminate American participation in global supply chains. Any security advantage from this change in policy has come with a cost. The United States is reducing its ability to understand Chinese capabilities and weakened its control over technology access that occurs when Chinese firms rely on US technology.

ACTIONABLE TO-DO LIST:

- Be careful about using the entity list as a symbolic gesture against firms over which the United States lacks leverage.
- Provide clear paths to exit from the entity list for firms on it to incentivize changes in behavior.
- Use licensing to gather data on China's technology capabilities, rather than denials that force self-sufficiency.

THE UNITED STATES

US DEPARTMENT OF STATE

Marcus Noland to the Under Secretary of State for Economic Growth, Energy, and the Environment

Jeffrey J. Schott to the Assistant Secretary of State for Economic and Business Affairs

Cullen Hendrix to the Assistant Secretaries for the Bureaus of Energy Resources and Oceans and International Environmental and Scientific Affairs



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

REINVIGORATING US PARTICIPATION IN BILATERAL, REGIONAL, PLURILATERAL, AND GLOBAL ALLIANCES

To: The Under Secretary of State for Economic Growth, Energy, and the Environment
From: Marcus Noland
November 2020

Background: The position of Under Secretary of State for Economic Growth, Energy, and the Environment has existed in some form since 1946. Historically, the Under Secretary has been a voice for an open international economic system, articulating the foreign policy implications of international economic policy in the interagency process, often sharing the lead on specific policy initiatives or negotiations with other cabinet departments in areas of specific functional expertise. Recent examples of the payoffs to Americans from a cooperative approach to international economic policy include coordinated action through the Group of Twenty (G20) to recover from the global financial crisis and the expansion of the Information Technology Agreement, which eliminated tariffs on \$1.3 trillion in annual global exports of information and communication technology products to the benefit of American firms and consumers, achieved during the Obama-Biden administration.

Starting in January 2021, your highest policy priority will be to reinvigorate US participation in bilateral, regional, plurilateral, and global alliances to address critical economic issues.

KEY PRIORITIES

PRIORITY 1: Fighting the COVID-19 Pandemic

The most immediate challenge facing the world economy is the global COVID-19 pandemic. The global nature of the pandemic necessitates a multifaceted international solution: No one will be truly safe until everyone is safe.

Hopes have been buoyed in recent weeks by announcements of effective vaccines. But the world faces an emerging “vaccine famine.” In famines, people do not die because there is not enough food to go around in a physical sense; they die because they are too poor to purchase adequate supplies. Vaccine nationalism, in which a limited number of producer countries impose export bans or purchase huge stocks for their citizens, will leave vast swaths of the world’s population exposed to the virus.

The world needs a transparent, enforceable international agreement to produce and distribute vaccines in an equitable and rational way. Such a goal is most likely to be achieved by the US government working through existing international organizations such as the World Health Organization (WHO). The COVAX partnership, the World Trade

Marcus Noland is executive vice president and director of studies of the Peterson Institute for International Economics. From 2009 through 2012, he served as the Institute’s deputy director. He was previously a senior economist at the Council of Economic Advisers in the Executive Office of the President of the United States.

Organization, and international development banks such as the World Bank will also have roles to play.

Start by annulling the Trump administration's notification to withdraw from the WHO. Recent surveys by Pew Research, the Chicago Council on Foreign Relations, and the Eurasia Group document that a majority of Americans support the WHO and international cooperation to end the pandemic. Such cooperation is not only the right strategy, it is a politically popular one as well.

PRIORITY 2: Cooperating on Climate Change

Much of the Climate 21 Project agenda involves domestic reforms outside the direct purview of the State Department. But global warming can be solved—and the US and other economies' domestic commitments sustained—only through cooperative interstate action. President-elect Joseph Biden has promised to get the United States back into the Paris Agreement under the United Nations Framework Convention on Climate Change, but more work remains to be done.

While the Paris Agreement may well be inadequate, the UN process is the only credible venue, and the existing accord should be regarded as a stepping-stone and not a final outcome. US withdrawal from the Paris Agreement while other governments such as China and Japan committed to carbon neutrality has terribly damaged the US image abroad, disincentivized reforms domestically, and set back any global reduction in greenhouse emissions.

Your key responsibility will be to manage diplomatically the inevitable imposition of border taxes, as countries try to maintain a level playing field for domestic and foreign producers facing different carbon taxes or abatement schemes in different jurisdictions. The good news is that the polls show a clear majority of the US public supports US participation in the Paris Agreement. The Biden administration will need to sustain and build that popular goodwill if the Senate remains in more climate change-skeptical Republican hands, and other countries respond to our slower approach to decarbonization.

PRIORITY 3: Joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership

The United States abandoned the Trans-Pacific Partnership negotiations in 2017. The other 11 Asia-Pacific countries moved on without the United States, forming the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). More recently, 15 Asian countries—including China—joined together to form the Regional Comprehensive Economic Partnership (RCEP). Refusal to engage with the most dynamic part of the world economy has left the United States isolated. Together with the Office of the United States Trade Representative (USTR), you need to explore US accession to CPTPP.

Ironically, when the United States withdrew from the TPP negotiations, the remaining participants dropped some of the provisions that Democrats in Congress had found most problematic, including lengthy periods for pharmaceutical patents and investor-state dispute settlement terms, which some regarded as tilting excessively toward producer or investor interests. The final CPTPP agreement is more akin to the USMCA, which passed the US Congress with bipartisan support and should be more palatable to Democratic members of Congress today.

While it will not be politically easy for a Biden administration to embrace CPTPP, the United States needs to join to ensure that it takes the lead in setting the future rules of commerce in this critical region, which may well eventually be extended to the global level. Remaining outside CPTPP creates an opening for China to play that role instead of the United States.

Such concerns are underscored by the recent conclusion of the RCEP agreement covering nearly one-third of the world's economy. China's centrality in that agreement means that trade and supply chains are likely to increasingly be diverted away from the United States.

PRIORITY 4: Revitalizing the US-China Dialogue

The US-China relationship is the most important bilateral relationship in the world. Since the Clinton administration, every US administration has had a regular, ongoing high-level dialogue with China on economic issues. The Trump administration's "phase one" bilateral trade pact with China was misguided, targeting the bilateral trade balance. Those targets are not being met, and achieving those targets through managed trade will mean strengthening the role of the state and the Chinese Communist Party in the economy—not what the United States wants to see. The United States has real economic challenges with China, including subsidies and intellectual property rights protection, but the Trump approach does not address them. Moreover, the focus on managed trade diverts attention from other issues, including cybersecurity, North Korea, and climate change, where China-US cooperation should be possible (and is desirable). You should lead your administration's effort to take corrective action and revitalize a high-level dialogue.

PRIORITY 5: Combating Corruption

Traditionally the United States has led the world in anticorruption and transparency actions, pioneering the Foreign Corrupt Practices Act (FCPA), which bars bribery by US firms. Extending that work at the global level not only is good for economic efficiency but also levels the playing field for US firms competing abroad.

In 2017, the United States withdrew from the [Extractive Industries Transparency Initiative \(EITI\)](#), an international effort to reduce corruption and bring improved governance to extractive industries such as oil and mining, where problems in developing countries have been endemic. These difficulties are not just an economic concern but, by encouraging instability in these natural resource producers, represent a national security challenge as well. You should work with your counterpart at the Department of the Interior to get the United States back into the EITI.

Similarly, you should work with your counterpart at the Department of Justice to communicate to foreign counterparts that the United States stands fully behind the FCPA and similar international anticorruption efforts through the Organization for Economic Cooperation and Development.

PRIORITY 6: Preserving the Good Friday Agreement to Maintain Trade Ties with the United Kingdom

Lastly, the United Kingdom will want to have a close economic relationship with the United States post-Brexit. Communicate to your British counterpart that a Brexit outcome that damages the Good Friday Agreement will not form an appropriate foundation for such a close relationship. Yes, the [President-elect and the Speaker of the House](#) have been quite

clear on the principle, but it is important that this be restated at the senior working level. You can consider offering to assist the United Kingdom in applying for membership in CPTPP or even USMCA as a means to incentivize the preservation of the Good Friday Agreement and make a positive move for economic relations with key allies without pushing for direct trade initiatives unlikely to be supported early in the administration.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

STATE DEPARTMENT PRIORITIES FOR REBUILDING THE GLOBAL ECONOMY

To: Assistant Secretary of State for Economic and Business Affairs
From: Jeffrey J. Schott
October 2020

Background: Rebuilding the global economy will require coordinated initiatives between the United States and its major allies and trading partners in areas such as trade, climate, energy, and global health where the State Department has core responsibilities for the formulation and execution of US policy. In each of these areas, cooperation with key allies in Europe and the Pacific Basin is critical to achieve results that serve US strategic and economic interests. In some important areas, however, the United States also will need to work cooperatively with China, particularly to mitigate climate change and the COVID-19 pandemic.

PRIORITY ACTIONS

PRIORITY 1: Restore US leadership in international economic initiatives on trade, climate, and health

Without US leadership, these transnational challenges will likely fester and lead to conflict. US officials should rejoin the Paris Climate Agreement and the World Health Organization. US policy also should promote an immediate action agenda in the World Trade Organization (WTO) to develop reforms that help ensure access to vaccines and therapeutics essential for fighting the COVID-19 pandemic.

ACTIONABLE TO-DO LIST:

- Lead efforts to reform each institution to advance new initiatives that improve and better coordinate international actions against global warming and the COVID-19 pandemic and ensure that all major countries commit substantial resources to those results over the next five years.
- Advance new international initiatives to promote investment in clean energy resources vital to meeting the carbon abatement commitments of rich and poor countries alike.
- Support WTO reforms that facilitate the distribution of medicines and equipment needed to fight the pandemic.

Jeffrey J. Schott is senior fellow at the Peterson Institute for International Economics and a member of the State Department's Advisory Committee on International Economic Policy. He also previously cochaired the Trade and Environment Policy Advisory Committee for the US Trade Representative. Schott is coauthor of *Economic Sanctions Reconsidered* (3rd edition, 2007) and coeditor of *Trans-Pacific Partnership: An Assessment* (2016).

PRIORITY 2: Reinforce and rebuild frayed economic relations with key allies in Europe and Asia

US credibility as a reliable partner has been shaken by protectionist measures against its allies for dubious national security reasons, and in response to demands to rebalance and restructure bilateral trade pacts. The United States has also disabled the WTO dispute settlement system and threatened to abandon the WTO altogether.

ACTIONABLE TO-DO LIST:

- Eliminate Section 232 import controls applied to trade with US allies.
- Reengage in talks to reform WTO dispute procedures by the WTO ministerial scheduled for June 2021, which in turn will facilitate negotiations to update and modernize WTO obligations.

PRIORITY 3: Revisit US participation in the comprehensive Trans-Pacific Partnership (TPP) that the Trump administration rejected in its first days

The United States should offer to reengage with its original partners and others in the negotiation of a new economic pact, updating the current Comprehensive and Progressive Agreement for a Trans-Pacific Partnership (CPTPP) that is the successor to the TPP. The United Kingdom is already interested in joining the pact and should be encouraged to do so as a complement to ongoing US-UK trade talks. The European Union is hesitant for fear of undercutting the WTO process but could be convinced to join the United States if it commits to using the results to bolster multilateral negotiations in the WTO. US participation in such talks would close the door to relaxing current CPTPP standards or granting broad exceptions to accommodate Chinese participation, a development that could occur in the absence of US reengagement in the pact.

ACTIONABLE TO-DO LIST:

- Negotiate a revised CPTPP to:
 - » broaden obligations on labor, environment, and digital trade; and
 - » introduce standards for using economic measures for national security reasons.

PRIORITY 4: Support Taiwan by encouraging its economic integration through accession to a revised CPTPP

Taiwan has been aligning many of its laws and regulations to CPTPP requirements and lowering trade barriers to facilitate prospective CPTPP accession. This regional approach to trade is preferable to a bilateral US-Taiwan pact and will provide a bigger boost to economic growth in Taiwan. In the near term, the United States and Taiwan could pursue policies to expand regional trade and investment, drawing on prior bilateral trade facilitation talks.

PRIORITY 5: Renegotiate the Joint Comprehensive Plan of Action (JCPOA)

The United States should negotiate revisions to the JCPOA with Iran and the other P5+1 countries (China, France, Germany, Russia, and the United Kingdom) to update and improve the terms of the 2015 pact constraining Iran's development of weapons of mass destruction. Since the US withdrawal from the pact in May 2018, Iran's program has moved forward despite the continued heavy costs imposed by US sanctions. US allies would support US proposals to improve the disciplines that constrain the pace of Iran's weapons development

with rigorous international monitoring of Iranian facilities. A revised, comprehensive, and enforceable agreement would also lower the risk of military actions in the Persian Gulf that could disrupt the production and trade of energy from this region.

WHAT ISSUES REQUIRE ATTENTION AFTER YEARS OF NEGLECT?

1. Formal dialogue between China and the United States

The United States should reopen a high-level strategic economic dialogue with Chinese leaders to coordinate policies in areas where the two countries need to work together (e.g., response to pandemics, using economic leverage to constrain the nuclear programs of Iran and North Korea, combatting global warming, and developing guidelines to deter commercial cybersecurity). Such discussions also could improve working relationships that have been badly frayed over the past four years and reduce policy misunderstandings that can provoke unintended economic and military confrontations. Importantly, the dialogue could be valuable in managing the aftershocks of the US-China phase one trade deal after it runs its course or requires revision.

2. Escalating tensions between South Korea and Japan

The State Department needs to take a more active role in de-escalating frictions between South Korea and Japan that threaten US economic and security interests in the region. Recognizing that these disputes have deep historical roots, US officials nevertheless should intercede to prevent those political disputes from undercutting intelligence sharing and disrupting vital supply chains. There is no credible rationale for discriminating against the traded goods of allied countries for national security reasons; in this regard, the United States should lead by example and drop its own Section 232 steel restrictions applied to both countries on national security grounds. Longstanding problems should not impair urgently needed bilateral cooperation in the face of common security threats in the region.

3. US involvement in APEC

The United States should participate more actively in the 21-member Asia-Pacific Economic Cooperation (APEC) forum to promote joint trade, investment, and climate initiatives of the member countries as a complement to broader efforts in the WTO, Paris Climate Agreement, and regional integration pacts. Doing so would also better secure Taiwan's integration in regional supply chains and new trade accords. In addition, the United States should give priority to supporting the accession of new APEC members such as Colombia and Costa Rica to deepen their integration in Asia-Pacific supply chains.

4. Coordination with allies on US economic sanctions

The United States should revisit how and when to use economic sanctions to deter or punish abusive foreign practices. At present, State and Treasury have more than 30 active sanctions programs targeting Iran, Russia, North Korea, Cuba, and Venezuela, among others, for abuses of human rights, nuclear proliferation, support for terrorism, military adventurism, and attacks on democratic processes. In many instances, these sanctions punish but do not deter continuing abuses. Too often, US sanctions target individuals or entities that can readily evade or avoid economic pain. Unilateral US measures often simply divert trade and investment to non-US companies, underscoring the need for coordinated policies with allies akin to the near common sanctions regime that forced Iran to roll back its nuclear weapons development in 2015.

ACTIONABLE TO-DO LIST:

- Reopen a high-level strategic economic dialogue with Chinese leaders.
- Help de-escalate destabilizing tensions between South Korea and Japan.
- Use the APEC forum to promote cooperation on regional trade, investment, and climate initiatives.
- Revise how economic sanctions are deployed so that US actions are better coordinated with its allies:
 - » making sanctions more effective and less disruptive to US trade and investment interests at home and abroad; and
 - » ensuring that financial channels remain open to fund humanitarian assistance.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

STATE DEPARTMENT PRIORITIES FOR REBUILDING THE GLOBAL ECONOMY

To: The Assistant Secretaries for the Bureaus of Energy Resources and Oceans and International Environmental and Scientific Affairs

From: Cullen Hendrix

October 2020

Background: The United States must reassume its position of global leadership in addressing climate change, ensuring sustainable energy security at home and abroad, governing the world's shared oceans, and helping fragile states address the challenges of global environmental change. The State Department can lead the way on these issues in four concrete ways:

PRIORITY 1: Rejoin and revitalize the Paris Climate Agreement

In 2019, the Trump administration formally announced the United States would withdraw from the 2015 Paris Agreement under the UN Framework Convention on Climate Change. This withdrawal badly damaged the United States' soft power abroad and actively discouraged the transition to renewable energy systems at home and the job creation and export potential that would come therewith. Rejoining the most recent comprehensive global compact to combat climate change would help facilitate that transition and reestablish US leadership in multilateral efforts to combat and adapt to climate change. But the United States should go further, using its diplomatic leverage and technical assistance to help developing and middle-income economies meet their Nationally Determined Contributions with technical assistance, technology transfer, and financing.

PRIORITY 2: Achieve sustainable energy security

As a matter of both national security and environmental responsibility, the United States must transition to a sustainable energy security that promotes decarbonization at home and abroad, further integrates the North American energy market, and promotes good natural resource governance. Doing so would consist of the following steps:

ACTIONABLE TO-DO LIST:

- **Press for decarbonization targets in future trade negotiations.** Trade negotiations have grown longer and more complex over time, as they have moved beyond tariff barriers to address a host of regulatory issues related to market access, harmonization of standards, labor rights, environmental issues, intellectual property, and health and safety. To this list, the State Department should add successful progress toward Nationally Determined Contribution targets as an element of future trade negotiations.

Cullen S. Hendrix, nonresident senior fellow at the Peterson Institute for International Economics, is professor and director of sustainability initiatives at the Korbel School of International Studies, University of Denver.

- **Promote the adoption of a carbon border tax adjustment on energy consumption's contribution to imported goods and services.** Broader carbon taxes, especially progressive ones graduated by partner income level, may greatly perverse incentives to further concentrate carbon-intensive production methods in developing countries and discourage carbon leapfrogging in their energy systems. By imposing a border adjustment tax on the carbon intensity of the energy component of finished products, rather than the carbon intensity of the entire product, the United States can encourage partners to decarbonize their energy systems.
- **Further North American energy grid integration.** Despite significant trade integration and vast renewable potential, the North American electricity grid and market is comparatively lightly integrated. Prior to 2018, prospects were looking positive. However, under President Andrés Manuel López Obrador, Mexico is winding back power company privatizations and threatening the kind of competition that would facilitate broader two-way renewable energy trade. The current administration's focus on trade-related issues of particular relevance to swing states has meant that this issue has not received front-burner attention. The State Department should pressure regional partners to increase two-way energy trade and integration, and reinstate energy market liberalizations in Mexico.
- **Reengage and reinforce the Extractive Industries Transparency Initiative (EITI).** The EITI is a groundbreaking multistakeholder initiative to prevent corruption, conflict, human rights violations, and environmental degradation while promoting good governance around extractive industries. The United States had been working toward compliance since 2012, until the Trump administration backed away from the initiative in 2017, ending meetings with industry and stakeholder groups domestically and stepping back from technical assistance that had been committed to Myanmar in 2013 at the G8.¹ These acts are not only inconsistent with broader whole-of-government efforts to promote good governance abroad but may actually undermine the competitiveness of US firms. As transparency becomes a broader norm, working with more transparent companies translates to more sustainable and peaceful domestic politics in host communities. If US companies are perceived as less transparent than their Europe-, Canada- and Australia-based counterparts, they may lose business. Re-dedicating the US government to EITI will be a good first step, but it can and will need to go further and press for increasing transparency in the production and trade of the 35 critical minerals identified by the [United States Geological Survey](#) in 2018.

PRIORITY 3: Reassert leadership in the maritime domain

In parallel with efforts to revitalize stewardship of the atmospheric commons, the United States should also rededicate its efforts to promoting effective governance of the high seas. This would consist of four initiatives:

ACTIONABLE TO-DO LIST:

- **Renew the push for ratification of the United Nations Convention for the Law of the Sea (UNCLOS).** Under former Secretary Hillary Clinton, the State Department pressed hard for the United States to ratify this convention, which US negotiators had a

¹ The G8 consisted of the highly industrialized countries of Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States. Russia was removed in 2014, and the group is now known as the G7.

large role in creating. Ratifying UNCLOS would give the United States legal precedent to pursue claims on the US continental shelf, expand offshore mineral exploration activities, and establish (or prevent the establishment of) legal precedents that might harm the competitiveness of US firms and preclude investment in US maritime “territory.”

- **Strengthen the Agreement on Port State Measures (PSMA).** The PSMA is the first binding international agreement to combat illegal, unreported, and unregulated (IUU) fishing, which harms the US fishing industry, undermines sustainable fisheries management, and is even implicated in human rights abuses and narcotics smuggling. Rather than focusing US efforts on ensuring reciprocal trade in seafood products, the State Department should, in partnership with the National Oceanic and Atmospheric Administration, press more trading partners to join the agreement.
- **Resolve disputes with allies over the Arctic.** Increasing Russian power projection into the Arctic domain will require a unified response from the United States and its allies, most principally Canada, in the region. Resolving the languishing disputes with Canada over the Beaufort Sea and legal demarcation of the Northwest Passage will allow the two partners to coordinate more effectively around shared economic and national security interests in the polar region.
- **Expand extent and capacity of regional fisheries management organizations (RFMOs).** The United States is a major player in most of the RFMOs that facilitate cooperation and catch targets for many of the world’s most commercially important fisheries. However, these institutions need to be reformed to include currently overlooked species like sharks and deep-sea fish, as well as be reformed to include better dispute resolution mechanisms to prevent fisheries conflicts that may spark broader political and military confrontations.

PRIORITY 4: Address environmental security and state fragility

As the key agency responsible for implementing the Global Fragility Act of 2019, the State Department is tasked with advancing diplomatic and political efforts, drafting and executing strategy implementation, and guiding security efforts to address the root causes of violence and state fragility. While these efforts are headed by the Bureau of Conflict and Stabilization Operations, the increasing role of environmental factors in armed conflicts—and the specter of even larger impacts under climate change—implies a need to integrate concerns related to energy, agriculture, and the environment into efforts to build partner-country resilience. Though the five focus countries of the act have yet to be identified, they will most likely be ones where environmental governance is poor to nonexistent, and competition over access to or control of resources is a major source of instability.

ACTIONABLE TO-DO LIST:

- **Require State Department fragility assessments to assess environmental security threats, both those emanating from first-order effects of the changing natural environment and those emanating from the second-order effects of climate change adaptation- and mitigation-related efforts.** The effects of the latter will have particularly important security implications for major legacy hydrocarbon producers and countries that invested heavily in energy exploration and infrastructure during the 21st century commodity boom (2002–14), and countries with large, exportable endowments of “transition metals,” like aluminum, copper, rare earths, lithium, and

cobalt, that will underpin transitions to more sustainable energy systems. Doing so would be a best practice that should be adopted across State, the Department of Defense, and the United States Agency for International Development.

- **Regional combatant commands should develop environmental security priorities and game plan specific scenarios.** Because many threats associated with climate change and the environment are both complex and actorless in nature, conventional security approaches based around actor deterrence and/or compellence are likely to be insufficient. Developing priorities around and game planning for complex, climate-related natural disaster–driven emergencies should be a priority across the whole foreign policy community.

THE UNITED STATES

US CONGRESSIONAL COMMITTEES

Gary Clyde Hufbauer to the Chairs and Ranking Members of House and Senate Subcommittees on Trade

C. Fred Bergsten to the Chairs and Ranking Members of the Senate Foreign Relations Committee and House Foreign Affairs Committee

Edwin M. Truman to the Chairs and Ranking Members of the Senate Foreign Relations Committee, House Financial Services Committee, and House Foreign Affairs Committee



Rebuilding the Global Economy

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MEMORANDUM ON

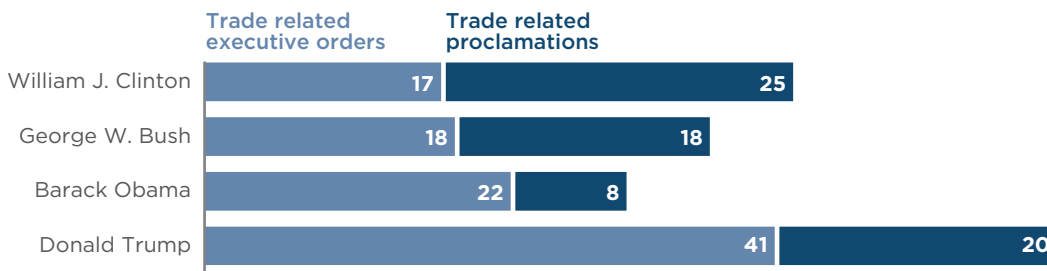
TRADE POLICY PRIORITIES FOR 2021

To: Chairs and Ranking Members of House and Senate Subcommittees on Trade
From: Gary Clyde Hufbauer
October 2020

Background: Article I section 8 of the Constitution assigns Congress the power to regulate commerce with foreign nations. Over the past century, however, Congress has enacted more than a dozen statutes that delegate its constitutional power to the president. Recent presidential abuses of trade statutes through President Donald Trump’s unilateral trade actions, invoking executive orders and presidential proclamations, which outnumber those of any previous president in recent history, indicate it is time to redress executive overreach in foreign commerce and involve Congress more closely in trade policy decisions.

Gary Clyde Hufbauer, nonresident senior fellow, was the Reginald Jones Senior Fellow at the Peterson Institute for International Economics from 1992 to January 2018. He has coauthored numerous books on international trade, investment, and tax issues.

Number of executive orders and presidential proclamations issued during the first term



Source: Federal Register.

PRIORITY 1: Reclaim congressional oversight of trade policy

- Amending individual statutes like Section 232 of the 1962 Trade Act, Section 301 of the 1974 Trade Act, and the International Emergency Economic Powers Act of 1977 would be a lengthy process. Instead, Congress should enact an **umbrella oversight law**.

PRIORITY 2: Raise the American profile in the Asia-Pacific region

- The United States should increase its presence in the Asia-Pacific region to participate in the region’s fast-growing economies and to provide an alternative to Chinese domination.

PRIORITY 3: Engage with the World Trade Organization (WTO) and address new issues

- The WTO provides the framework for US trade relations with more than a hundred countries that do not have bilateral agreements with the United States. While the old WTO rulebook remains in place, the dysfunctional WTO Appellate Body means there is no practical method to resolve disputes. Meanwhile negotiations to update the rulebook are largely frozen as 164 members search for elusive common ground.

ACTIONABLE TO-DO LIST:

- Pass the Trade Security Act of 2019 ([S.365](#)) and/or the Global Trade Accountability Act of 2019 ([H.R.723](#)) to enact an oversight law specifying the following:
 - » Presidential trade actions taken under the delegated powers of existing statutes must be ratified by Congress within a short period of time. Unless ratified by majority vote in both houses, the presidential actions would lapse.
 - » The president must consult with trade subcommittees before issuing new executive orders, even for national emergency or national security trade restrictions.
 - » Tariffs implemented by executive order during the past four years must be ratified by Congress. If ratification is not forthcoming within 90 days, those tariffs should expire.
- Renew Trade Promotion Authority (which expires on July 1, 2021) and close an existing loophole from past renewals to ensure that congressional notification and approval is required for all trade agreements that necessitate US regulatory and/or legislative changes, not just agreements with legislative changes.
- Use the renewed Trade Promotion Authority to:
 - » work with Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) countries to enumerate amendments that would allow the United States to join the pact;
 - » allow the United Kingdom to join the US-Mexico-Canada agreement (USMCA);
 - » indicate congressional priorities for countries to target for trade agreements;
 - » call on trade agreement partners to establish meaningful labor, environmental, and human rights standards; and
 - » provide a “bill of particulars” for WTO Appellate Body reform.
- Work with WTO member countries to establish “clubs” within the WTO framework for subsets of members that can agree on rules in different domains, i.e. on fishery subsidies, business services, ecommerce, carbon emissions, technology transfers, or state-owned enterprises.



Rebuilding the Global Economy

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MEMORANDUM ON

FOREIGN POLICY ASPECTS OF INTERNATIONAL ECONOMIC RELATIONS

To: The Chairs and Ranking Members of the Senate Foreign Relations Committee and House Foreign Affairs Committee

From: C. Fred Bergsten

November 2020

OVERVIEW

International economic cooperation and US global economic leadership, key pillars of world peace and security, have eroded badly in recent years. Traditional American alliances have been weakened by economic conflicts. China poses the first real challenge to US global economic supremacy in more than a century. Multilateral institutions that the United States created and nurtured, in some cases for decades, have been ignored or abandoned. US foreign policy, along with American prosperity and economic stability, have been severely jeopardized as a result.

In addition, the executive branch has repeatedly abused and even violated authorities that Congress has delegated to it to conduct foreign economic policy. Spurious “national security” excuses have been used to justify restrictions on imports from some of the United States’ closest allies. The administration has threatened to withdraw unilaterally from trade agreements approved by Congress. International trade and investment have become so central to US foreign policy that the entire legislative framework for US international economic policy needs urgent review and reform.

MAJOR PRIORITIES

The Committees should pursue the following priorities:

PRIORITY 1: Hold hearings and commission research and reports on all the topics cited above. Leaders should make speeches to help revive a constructive national narrative on open trade and international economic cooperation.

PRIORITY 2: Focus on the importance of global economic leadership to America’s overall role in the world and national security. The foreign policy dimension of that leadership must be recognized and respected if the leadership is to be restored.

PRIORITY 3: Insist that future administrations respect and support the international economic institutions, such as the World Trade Organization and World Health

C. Fred Bergsten is nonresident senior fellow and director emeritus at the Peterson Institute for International Economics, of which he was founding director from its creation in 1981 through 2012.

Organization, that the United States has created and nurtured over many decades. Strong support for the rule of law must be maintained and indeed strengthened.

PRIORITY 4: Highlight the economic as well as security challenges posed by China and fashion a new policy that combines tough competition and negotiation with conditional cooperation on issues of global importance, such as climate change and cybersecurity, where agreement between the United States and China is necessary if meaningful progress is to be made.

MAJOR POLICIES THAT SHOULD BE REVERSED

The Committees should also urge a cessation or reversal of several recent policies including:

- **Reverse the withdrawal from the Paris Agreement on climate change and the World Health Organization (WHO)**, and the evisceration of other international institutions such as the World Trade Organization (WTO).
- **Cease actions that risk moving toward a new cold war** and unrealistic “decoupling” with China.
- **End the growing abuses of trade laws** by clarifying and revising the key statutes and interpretations to avoid arbitrary and capricious invoking of national security and other domestic concerns to justify protectionism.

The Congress must play a central role in reviving a constructive US leadership role in the world economy and thus in rebuilding global prosperity and stability. Your committee can initiate a proactive strategy in these directions.

ACTIONABLE TO-DO LIST:

- Promote resolutions urging the immediate restoration of cooperative economic relations with political allies, especially Europe and Canada and Japan.
- Promptly schedule a series of hearings on the need for the United States to resume effective leadership of the world economy, modified to meet the realities of the 21st century.
- Promptly schedule a series of hearings on China to assess the interaction of US security, economic, human rights, and other interests with that country.
- Work with the committees primarily responsible for trade policy to fashion new legislation to restore an effective congressional role in the conduct of US foreign economic policy.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

PRIORITIES ON FOREIGN AFFAIRS AND INTERNATIONAL FINANCIAL INSTITUTIONS FOR THE 117TH US CONGRESS

To: The Chairs and Ranking Members of the Senate Foreign Relations Committee, House Financial Services Committee, and House Foreign Affairs Committee

From: Edwin M. Truman

November 2020

Background: US foreign affairs programs underpin US soft (nonmilitary) power, which is in decline as these programs have been underfunded. In FY2020, the United States spent \$57 billion on international programs, activities, and institutions. Spending on the major international financial institutions (IFIs) was \$1.4 billion. They include the International Monetary Fund (IMF), the World Bank Group, and the other multilateral development banks (MDBs). These institutions are crucial magnifiers of US policies toward the problems and priorities of the global economy and financial system. Through them the United States leverages financing from other countries to address US priorities and mobilize international public opinion to support those policies. Unfortunately, new IMF financial commitments during the first eight months of the global coronavirus pandemic lag behind its commitments during the first eight months of the 2008–10 global financial crisis (see figure).

Edwin M. Truman, nonresident senior fellow at the Peterson Institute for International Economics, served as assistant secretary of the US Treasury for International Affairs from December 1998 to January 2001 and returned as counselor to the secretary March–May 2009. He directed the Division of International Finance of the Board of Governors of the Federal Reserve System from 1977 to 1998. From 1983 to 1998, he was one of three economists on the staff of the Federal Open Market Committee.

Increase in IMF financial commitments (billions of US dollars)



Source: International Monetary Fund.

KEY PRIORITIES

In the 117th Congress, US priorities for the IFIs should focus primarily on the global coronavirus pandemic and its economic aftermath. Congressional committees should view all administration proposals through the lens of whether they will aid in limiting the spread

and reemergence of the COVID-19 virus and/or help countries recover from the economic shock from the pandemic. I recommend the following four priorities:

- 1 Originate legislation to authorize the US Treasury to lend up to \$75 billion to the IMF over the next two years to provide the Fund temporarily with the financial resources to support its members in recovering from the pandemic. The United States, with one exception in the late 1970s, has not participated in coordinated bilateral lending to the IMF. The pandemic demands another exception. At \$75 billion, US participation in such an arrangement would be larger than that of any other current bilateral lender to the Fund, as is appropriate for the United States. This special authorization should expire on December 31, 2023.
- 2 Originate legislation to authorize the US Treasury to make an advance commitment of \$4 billion to the 20th replenishment of the World Bank's International Development Association 20 (IDA20), which focuses on the world's poorest countries, to enable it to continue to operate smoothly and to augment its lending to eligible members during the pandemic and its aftermath.¹ More than half of IDA borrowers are in Sub-Saharan Africa. A period of low growth and economic contraction known as the "lost decade of the 1980s" was centered in Latin America. The "lost decade of the 2020s" will be centered in Africa unless countries act now to prevent it. A US commitment to IDA20 will help relax the constraint on spending IDA19 funds.
- 3 Engage with the administration to ensure an early completion of the 16th General Review of IMF Quotas, which is to end by December 2023. Quotas are set according to each country's size as a portion of the world economy, and they determine the maximum amount of financial resources a member is obliged to provide to the IMF. The principal issues are (a) the size of the overall increase in quotas, which should at least replace existing bilateral lending commitments to the Fund, and (b) the redistribution of IMF quota shares to give greater representation to dynamic emerging-market countries, as well as other developing-country members, while reducing the shares of European members, which are a combined 32.4 percent, and preserving the US share, which is 17.4 percent.
- 4 Encourage the administration to apply to join the Asian Infrastructure Investment Bank (AIIB), which China established in 2015 as a financing vehicle to support infrastructure in Asia and beyond. Both the Obama and Trump administrations have been wary of the initiative, viewing it as a tool of Chinese ambitions. But 103 countries are already members or prospective members of the AIIB, including all the other major advanced countries except Japan, which shares US concerns. The AIIB also has had a good track record of adhering to international standards in lending, unlike the China Development Bank and Chinese policy banks. US membership would help to limit China's use of the AIIB to achieve its narrow political objectives and upgrade China's other international lending activities. Former officials in the administrations of both parties agree that the decision by the Obama administration not to join the AIIB was a strategic mistake.

POLICIES TO REVERSE

Congressional activity on the IFIs has been counterproductive in several respects during most of the past several congresses. Congress could improve the effectiveness US policies by reversing past tendencies.

¹ This would be a one-third increase in the \$3 billion US commitment to IDA19.

- 1 Congressional committees should recognize that the IFIs and other international organizations such as the Organization for Economic Cooperation and Development (OECD)² and the World Health Organization will not always align with US objectives in implementing their policies. On balance, they have been effective in advancing US policy objectives. Congress should refrain from criticizing and seeking to penalize IFIs for actions that the United States does not approve and praise actions that advance US objectives.
- 2 Congressional committees should seek to better coordinate congressional action and oversight of US bilateral and multilateral assistance especially to countries in Africa and should encourage the executive branch to contain its own turf battles. The distribution of US economic assistance is seriously biased toward achieving narrow political objectives and away from economic objectives that are essential to reinforcing US political objectives.
- 3 US policies toward IFIs involve many diverse objectives ranging from humanitarian assistance to strategic geopolitical aims. The credibility of US use of IFI tools to achieve US objectives is undercut by the fact that the United States is currently almost \$3 billion in arrears in its financial commitments to the IFIs. Almost two-thirds of that amount involves commitments to the Multilateral Debt Reduction Initiative (MDRI) for IDA and the African Development Bank. The MDRI arrears problem is of the United States' own making. The time has come to resolve it.

ACTIONABLE TO-DO LIST:

- Originate legislation to authorize the US Treasury to lend up to \$75 billion to the IMF over the next two years to provide the Fund temporarily with the financial resources to support its members in recovering from the pandemic.
- Originate legislation to authorize the US Treasury to make an advance commitment of \$4 billion to the 20th replenishment of the World Bank's International Development Association.
- Engage with the administration to ensure an early completion of the 16th General Review of IMF Quotas, which is to end by December 2023.
- Encourage the administration to apply to join the Asian Infrastructure Investment Bank.
- Refrain from criticizing and seeking to penalize IFIs for actions that the United States does not approve and praise actions that advance US objectives.
- Better coordinate congressional action and oversight of US bilateral and multilateral assistance especially to countries in Africa and encourage the administration to do the same.
- Resolve the problem of arrears in US financial commitments to the Multilateral Debt Reduction Initiative (MDRI) for the International Development Association and the African Development Bank.

2 The administration's budget for FY2021 proposed defunding the OECD.

EUROPE

Olivier Blanchard to the President of the European Central Bank

Simeon Djankov to the President of the European Bank for Reconstruction and Development

Jacob Funk Kirkegaard to the European Commission Executive Vice President for a Europe fit for the Digital Age and Commissioner for Competition

Robert Z. Lawrence to the European Commissioner for Trade

Jean Pisani-Ferry to the President of the European Commission

Ángel Ubide to the European Commissioner for Economic and Financial Affairs

Nicolas Véron to the European Commissioner for Financial Services Policy

Reinhilde Veugelers to the European Commissioner for Innovation



Rebuilding the Global Economy

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MEMORANDUM ON

ACHIEVING THE RIGHT FISCAL-MONETARY POLICY MIX IN THE EURO AREA

To: The President of the European Central Bank
From: Olivier J. Blanchard
November 2020

Background: This memo must start with a note of congratulation. While the European Central Bank (ECB) has not achieved its inflation target (and I shall come back to it below), it has stabilized financial markets and helped sustain economic activity in the euro area. This achievement was true during the financial and the euro crisis, and it has been true in the COVID-19 crisis as well.

In the process of doing so, the ECB has introduced many new programs and tools. Its balance sheet has increased by a factor of 9 since 2000, and by 40 percent since the start of the COVID-19 crisis (see figure). It is time to take stock, which is the purpose of this memo.

Olivier Blanchard is the C. Fred Bergsten Senior Fellow at the Peterson Institute for International Economics and the Robert M. Solow Professor of Economics emeritus at MIT. He was economic counselor and director of the Research Department at the International Monetary Fund.

Central bank assets in the euro area since 1999 (11-19 countries)

millions of euros, weekly, not seasonally adjusted



Source European Central Bank, Central Bank Assets for Euro Area (11-19 Countries) [ECBASSETSW], retrieved from FRED, Federal Reserve Bank of St. Louis, <https://fred.stlouisfed.org/series/ECBASSETSW>, November 23, 2020.

To do so, one must distinguish between three different economic environments.

Call the first “dislocation,” times when financial markets experience sudden outflows, when investors suddenly leave or enter markets, leading to large disruptions and large price movements. Europe experienced them as recently as the spring of 2020. At this point, it no longer does.

Call the second “secular stagnation,” i.e., times when r^* , the neutral real safe rate, is so low that, in combination with low inflation, it limits the central bank’s ability to rely on the policy rate as the main tool of monetary policy. The ECB has been in this environment now for more than a decade.

Call the third “normal times,” or perhaps more accurately “olden times,” times when the neutral rate, and by implication the nominal rate, is sufficiently high on average that there are few constraints on moving the policy rate. According to both forecasts and market prices, this will not happen any time soon.

Take the first: The ECB did well in fighting dislocation. It negotiated swap lines with the US Federal Reserve, provided generous liquidity to both markets and institutions, and quickly got markets to stabilize. It is ready to do it if it happens again.

Take the third: For the time being, Europe does not have to worry about what to do in “normal times”: There will be time to rethink and possibly remove policy tools if and when normal times return.

This leaves monetary policy under secular stagnation, which I shall focus on in the rest of the memo.

KEY PRIORITIES

PRIORITY 1: A greater emphasis on fiscal policy

Under secular stagnation, the central issue is the right monetary-fiscal mix. In “normal times,” the allocation is simple. Fiscal policy should focus on fiscal objectives and leave the macro stabilization mostly to monetary policy. Under secular stagnation, the answer is not so simple. Monetary policy cannot do the job alone, and this limitation has indeed been reflected in the ECB’s inability to achieve its target inflation for so long. Both fiscal and monetary policies are needed for macro stabilization, and the mix is a complex one.

Faced with a negative output gap, too little fiscal help forces the central bank to go beyond its comfort zone to sustain activity, forces it to decrease spreads perhaps too much, and in the process take on risks, not only financial but political as well. Too much fiscal help, on the other hand, can raise issues of debt sustainability, worry markets, increase spreads, and make the central bank’s job harder.

Fiscal and monetary policies must thus find the sweet spot, not an easy thing to do. I believe that in the COVID-19 crisis, the European national fiscal authorities and the ECB together have roughly found it. The risks to both the ECB and the national bank balance sheets have remained limited. And, given the low rates and the low spreads, debt sustainability risks have also remained very low. Let me, however, raise three issues, which I see as important:

The first involves semantics. “Market stabilization” and “improving the transmission mechanism” were good descriptions of what the ECB did in the dislocation phase. Preventing a self-fulfilling run on Italian bonds earlier in 2020 was clearly the right policy

to follow. These terms are not, however, an honest description of what the ECB is doing today. With security holdings of close to three trillion euros, the ECB is doing more than stabilizing markets; it is decreasing spreads. Being honest about what the ECB is doing will improve the discussion.

The second deals with the division of labor between fiscal and monetary policies.

Decreasing spreads is the right thing to do. If the policy rate cannot be decreased further, and activity remains weak and inflation too low, there are good second-best arguments for decreasing spreads beyond what the market would achieve, even if this leads to some distortions. The issue, however, is when it should stop being the job of the ECB and become the job of fiscal policy. The ECB's liquidity programs are all carrots and no sticks. If a government started misbehaving, the ECB would be faced with very difficult decisions, and possibly with balance sheet problems. A lighter European Stability Mechanism/Outright Monetary Transactions (ESM/OMT) arrangement, with very limited conditionality but still the means to force an adjustment if it were needed, may be a better way to provide sovereign lending at lower rates and reduce the ECB exposure. Europe cannot move to such an arrangement today, as markets would likely react badly, but European authorities should think about whether such a transition should take place over time.

The third points to the need for major institutional changes in fiscal policy, a change in fiscal rules, a move toward more fiscal union, and the need for a fiscal partner for the ECB. These are not the ECB's responsibility, but they are of the essence if the ECB is to do its job correctly. Achieving the right mix between monetary and fiscal policies in the current environment is difficult when 19 fiscal authorities are involved. Having one formal fiscal partner would help. EU fiscal rules have been suspended, and euro area governments have been willing to aggressively use fiscal policy, but rules cannot be suspended forever. They must be rewritten to consider the new realities. A bigger role for the ESM along the lines above requires movement toward more fiscal union. It is appropriate for the ECB to push explicitly for such reforms, indicating that if they do not take place, it might be forced to take excessive risks, which is in nobody's interest.

PRIORITY 2: Not the right time for higher inflation targeting

Let me turn to several other issues, which I view as less fundamental but are the subject of much attention and will be discussed in the ECB's strategy review.

There is nearly universal agreement among economists that, in general, central banks should have a dual mandate, output gap stabilization and stable inflation. But the ECB's single mandate may de facto not be so bad: Stabilizing inflation at target will in general deliver a decent output performance. Furthermore, the reality is that the ECB cares about both the output gap and inflation. If inflation were at 2 percent and, for some reason, the euro output gap remained large and negative, I am sure the ECB would maintain an expansionary stand. So, for the time being, given the difficulty of achieving a Treaty change, I would leave this issue aside and let sleeping dogs lie.

What about an increase in the target inflation rate? Relative to the debate and the many papers written before the financial crisis, what have we learned? On the one hand, we have learned that the probability of being at the zero lower bound was much higher than had been estimated; that the underlying reason was not just bad shocks, but a decrease in the neutral rate, r^* , relative to the past. On the other hand, we have learned that a central

bank can set somewhat negative interest rates, which relaxes the zero lower bound. The Phillips curve has become not only flatter but more so on the downside, decreasing the risk of a catastrophic deflationary spiral. And low inflation has made inflation less salient and inflation expectations stickier, a useful development for monetary policy.

So, while, in the abstract, the ECB would probably be in a better place with a higher inflation target, this is also not the time to push it. We should clearly move from the “below but close to 2 percent” to a straight “2 percent,” but not go further at this point. The credibility of the current target is already low, the credibility of a higher one would be even less so. As opposed to what the US Federal Reserve said, I would, however, leave the door open to revisiting the issue when inflation is back at 2 percent.

What about following the Fed and adopting average inflation targeting, or even considering a stronger version, price-level targeting? From an opportunistic viewpoint, given the context, this was a potentially good move on the part of the Fed as it could increase inflation expectations and decrease real rates (it turned out not to...which says something more general about the ability of monetary policy to manage expectations). The relevant issue, however, is whether it is a good rule in general. If it is symmetric, it will not be credible: No central bank will trigger a recession based on the argument that inflation is fine today but has been too high in the past. Thus, it must be asymmetric, perhaps along the lines of the proposal by former Fed chairman Ben Bernanke. If so, I believe it must be less fuzzy than the Fed has described. Fuzziness about length of time over which the average is computed, and what this means about the inflation rate the central bank will tolerate, will confuse investors and complicate policy. It will be more hindrance than help. If the central bank goes down that path, I believe that yield curve control, à la Bank of Japan, is a better way of sending the right signal. The ECB should explore it further.

I have not talked about how much monetary policy should be concerned with income distribution or global warming. It was intentional. In the ECB's role as the financial market supervisor, considering global warming risks on the portfolio of financial institutions is obviously desirable. Going beyond this would be unwise, except when the choice of alternative monetary policy tools has clear implications for either income distribution or the nature of growth. Realistically, the ECB can have at most a marginal effect on these evolutions, and having too many targets will come at the cost of not fulfilling its primary mandate as best as it can.



Rebuilding the Global Economy

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MEMORANDUM ON

REIGNITING INTEGRATION IN EUROPE

To: The President of the European Bank for Reconstruction and Development

From: Simeon Djankov

October 2020

Background: The European Bank for Reconstruction and Development (EBRD), established in 1991 to assist in the economic revival of Central and Eastern Europe, has been essential to transforming postcommunist countries into market economies. In recent years, the European Council has turned toward the European Investment Bank (EIB) as the main vehicle of choice for project finance and equity investments in the European Union and the EU neighborhood (the Balkans, the Caucasus, and Ukraine). This development leaves the EBRD as “the US bank” in the postcommunist region, with the United States serving as the largest shareholder with 10 percent of ownership.¹

A more assertive use/support of EBRD by the United States would benefit the European Union too, as the EBRD and EIB can align the transatlantic interests in stemming Russian and Chinese influence in the region—for example, by pushing back Russian ambitions in Serbia and Ukraine, stopping China’s growing influence through the Belt and Road Initiative (BRI) in Central Asia, and furthering the integration of Albania, North Macedonia, Montenegro, Kosovo, Bosnia, and Serbia into the European Union.

Further convergence and integration in the region could lead to higher economic growth of perhaps 1.5 to 2 percentage points, driven by a larger effect in Ukraine (plus 3 to 4 percentage points annual growth) and the Balkans (2 to 3 percentage points). Neighboring countries would benefit as well, especially Bulgaria and Romania. The effect on global growth is small.

PRIORITY 1: Transforming Ukraine’s economy for successful integration into Europe

The integration of Ukraine into Europe has stalled after a(nother) promising start under President Volodymyr Zelensky, who took office in 2019. The country of 45 million people is on the watershed between Europe and Russia, with successive governments leaning in one direction or the other. EBRD has helped the transformation of the banking, agricultural, energy, and export-oriented metal sectors in other post-Soviet economies and has the

Simeon Djankov, senior fellow at the Peterson Institute for International Economics, was deputy prime minister and minister of finance of Bulgaria from 2009 to 2013, chairman of the Board of the European Bank for Reconstruction and Development in 2012–13, and chief economist of the finance and private sector vice presidency of the World Bank, as well as senior director for development economics.

¹ Japan is the second largest shareholder, with 9 percent, France, Germany, Italy, and the United Kingdom have 8.6 percent each. The European Union altogether has 63 percent shareholding. The countries of operation have a combined 14 percent shareholding.

expertise to assist with this transformation in Ukraine. In 2020, EBRD has a portfolio of €4 billion in Ukraine, of which €2.5 billion is disbursed. However, in comparison, this is only half of EBRD's active portfolio in Turkey.

The first task for EBRD in Ukraine is to wrest control of some companies from the hands of Russia-dependent oligarchs. Many such companies, in particular in the agriculture and energy sectors, are majority state-owned, but with separation of ownership and control work for the benefit of oligarchs. EBRD can invest minority stakes in these companies and make their governance more transparent by active participation on their boards.

The second task is to invest in rail and road infrastructure in Ukraine, reorienting the main trading routes toward the European Union, through Poland. At present much of the existing infrastructure leads toward Russia, making exports to EU countries more expensive.

The third task is to create a path toward the eventual reintegration of eastern Ukraine into the economy. This preparation involves drawing reconstruction plans, as well as finalizing land reform. The 2019 land reform supported by the European Union and US Agency for International Development went halfway toward providing conditions for title transfers and the creation of private farms. The heavy machinery sector in the east has been largely destroyed due to the hostilities and a new source of manufacturing jobs has to be developed.

PRIORITY 2: Assisting the remaining Balkan countries with joining the European Union

The next task is assisting the Balkan states in joining the European Union. There are three tiers of countries in descending order of readiness: Albania and Northern Macedonia received invitations in 2019 and are waiting for a date of entry into the European Union; Montenegro and Kosovo have taken significant steps but issues of corruption and drug trafficking in the case of Kosovo have held back their negotiations. Serbia and Bosnia are further behind, with a stated goal of accession but little practical progress. Opening up their economies to international competition is a point of contention with the EU negotiators, as is the unstable macroeconomic environment. The Serbian population supports EU accession and if other Balkan countries go ahead, the Russian influence in the country through Serbian President Aleksandar Vučić and his most vocal supporter Prime Minister Viktor Orban of Hungary will not be sufficient to stop integration.

PRIORITY 3: Saving Central Asia from temptations to embrace China's opaque Belt and Road Initiative

The objections of the United States to the BRI project—manifested in the insistence of making public the contracts to show the terms of financing by Chinese state-owned banks—has necessitated a pivot away for Central Asian leaders from openly embracing BRI. However, countries in the region are weighing the costs and benefits of dealing with China and will move away only if offered alternative sources of investment and growth. EBRD can be a catalyst for such investment, if directed by its main shareholders (the United States and the European Union). In the next two years, EBRD can double its exposure to Central Asia, which currently accounts for 9.5 percent of the investment portfolio.

To achieve this goal, EBRD would align with the International Monetary Fund (IMF), the World Bank, and other multinational institutions, and not just with the United States, in terms of principles for multilateral development lending. This alignment, manifested in

the form of investments in the infrastructure of the Central Asian economies, would be a significant antidote to BRI projects. At present the World Bank and the IMF are promoting transparency in BRI debt obligations through the debt service suspension initiative.

PRIORITY 4: Staying out of Russia and Turkey

Russia and Turkey have jointly accounted for about a quarter of overall EBRD financing over the past decade. However, due to sanctions on Russia since 2014 and instability in Turkey's macroeconomy, their share in EBRD investment has fallen. The issue is also political, since both President Vladimir Putin and President Recep Tayyip Erdogan's policies do not adhere to some articles in the EBRD charter (on promoting democracy and free media). Accordingly, EBRD may do well to focus its investment elsewhere. Staying out of these two economies would free up to \$8 billion on the EBRD balance sheet. These funds can be reallocated to Ukraine, the Balkans, and Central Asia. In the long run, Russia and Turkey can be treated as EBRD financing members rather than as clients, just like the Czech Republic switched its profile in 2007. This evolution is similar to the discussion of graduation from the World Bank of China and other middle-income economies.

ACTIONABLE TO-DO LIST:

- Wrest control of some companies in Ukraine from the hands of Russia-dependent oligarchs.
- Invest in rail and road infrastructure in Ukraine.
- Create a path toward the eventual reintegration of eastern Ukraine into the economy, including drawing reconstruction plans and finalizing land reform.
- Assist the remaining Balkan states with joining the European Union.
- Double EBRD investments in Central Asia, particularly in infrastructure, to pull leaders there away from embracing China's Belt and Road Initiative.
- Stay out of Russia and Turkey and free up to \$8 billion on the EBRD balance sheet, which can be reallocated to Ukraine, the Balkans, and Central Asia. In the long run, treat Russia and Turkey as EBRD financing members rather than as clients.



Rebuilding the Global Economy

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MEMORANDUM ON

COPING WITH TECHNOLOGY INNOVATIONS IN EUROPE

To: The European Commission Executive Vice-President for a Europe fit for the Digital Age and Commissioner for Competition
From: Jacob Funk Kirkegaard
December 2020

Background: Current technological innovation has driven Europe and the United States to rely on online platforms for intermediating commercial transactions. That trend is in turn spreading the application of artificial intelligence and machine learning algorithms, and greatly increasing the value of big data accumulation. As a result, it is crucial that EU competition authorities focus on their core mission to combat market distortions in the digital, data, and state-linked entities realms. The threat of autocratic economic power from digital corporations is Europe-wide, and, in fact, international, and must be addressed with that scope in mind. The European Union is leading in terms of action and thinking when it comes to regulating the digital economy. The United States and other advanced economies should be encouraged to emulate and catch up rather than to see Europe's digital regulatory action as a threat.

Jacob Funk Kirkegaard is nonresident senior fellow with the Peterson Institute for International Economics and resident senior fellow with the German Marshall Fund of the United States (GMF) in the GMF's Brussels office.

KEY PRIORITIES

PRIORITY 1: Regulate digital platforms as gatekeepers

The pandemic lockdowns have promoted the online business model of digital platforms. COVID-19 has consequently accelerated the already high corporate concentration in many digitized sectors, further raising concerns that these large incumbent firms exploit their privileged position to the detriment of other suppliers. In response, the European Commission recently published its new Digital Markets Act (DMA), identifying large online platforms as “gatekeepers” and subjecting them to obligations and prohibitions aimed at ensuring a level playing field between them and the many third parties relying on their platforms. The DMA comes with biting enforcement powers, including as a last resort the breakup of a gatekeeper firm. The Commission has tasked itself with enforcing the DMA and must do so in a timely and vigilant manner. Suspected abuse of dominant positions should be preemptively sanctioned to avoid market facts on the ground becoming settled ahead of binding conclusions reached only after lengthy judicial review processes. Given that US federal and state governments, as well as US congressional committees, have recently launched similar investigations of gatekeeper firms, a preference, though no requirement, exists for the European Commission to implement the DMA in a collaborative way with the incoming Biden administration.

PRIORITY 2: Limit how long digital companies can hold exclusive rights to harvested big data

Digital platforms have privileged access to large amounts of harvested data on consumers' behavior in the digital marketplace, their physical movements, and other personal preference information. This uneven access to big data is a growing market distortion.

The European Commission should ensure that big data datasets above a certain threshold size¹ are made available as anonymized data to the public, including to competing firms. The collecting digital platform should have only a limited time window of exclusivity. Recent [EU proposals](#) to facilitate “voluntary data sharing” are unlikely to suffice. The value of big data datasets to digital collectors should be temporary, in the same way that time-limited patent protections are, trading off the private benefits of incentivizing collection and innovation against the public interest in wide access to the information collected (and made subject to scrutiny).

Implementing similar mandatory data sharing practices must also be extended beyond the currently dominant digital platforms, as the rollout of 5G broadband cellular networks and the Internet of Things will expedite the collection of valuable big data datasets across all economic sectors. This prospect highlights the fact that mandatory data sharing is not aimed exclusively at successful US digital platform businesses. Therefore, Europe should offer to collaborate with US regulators, encouraging US oversight and regulation in a European direction. This cooperative approach is in the EU's interest and preferable to the delayed or diminished adoption of nascent US federal regulation on data harvesting. The goal should be to avoid feeding industry claims that this effort is about creating European national champions when it is actually about competition and public access.

PRIORITY 3: Address competitive distortions from Chinese and other state-subsidized FDI and tender bids

Authoritarian government influence over Chinese businesses in critical industries creates potential national security concerns, and the continued growth of outward investment by China's still often state-supported economy raises important competition policy and state aid challenges in Europe. Chinese state-linked private entities or state-owned enterprises (SOEs) can enjoy preferential access to state-owned bank financing, enabling them to outbid other interested parties in target acquisitions, or to offer below-market pricing in tender bids. This issue also exists in other countries with rising state-involvement in outward economic activities, but China's size and autocratic polity makes it rightly the focus of attention.

The European Commission should implement state aid regulations compelling inward investors relying on state-linked financial resources to a priori prove that they do not enjoy a distortive nonmarket financial benefit. Failure to do so should result in acquisitions or tender bids being blocked. This initiative should be pursued with the goal of a multilateral

¹ The threshold for “importance” of a big data dataset will depend on the sector. There is likely to be an overall simple size threshold beyond a certain level of terabytes of data, consumers or consumer transactions included, at which eventual dissemination is in the public interest. However, big data datasets specific to some sectors or particular market segments might be smaller but cover a far larger share of recent relevant transactions. Hence the well-known competition policy issue of determining what the relevant market is for legal analysis will resurface in this type of data sharing mechanism. It seems likely that case law will be important in settling the relevant data share or intensity for eventual public dissemination over time.

solution within the World Trade Organization (WTO), and rapid cooperation with the United States and other allies on a plurilateral approach should be the immediate next step towards that goal.

PRIORITY 4: Refocus the priorities for the Directorate-General for Competition and the Commissioners' Group on a Europe Fit for the Digital Age

The Executive Vice-President for a Europe fit for the Digital Age should accept that completing long-term “legacy projects,” like the Single Market in Services or rooting out excessive state aid in the EU banking sector, are now of secondary importance to digital-related competition issues. The Vice-President should further refrain from thrusting the Directorate-General for Competition into domestic tax and industrial policy matters. These are truly legacy issues that have little to do with the future development of the European economy as compared to the rapidly evolving transnational digital issues. The legacy issues remain a political time-sink for little gain. Thus, the Vice-President should specifically desist from the following activities:

1 Stop the creation of European champions to allegedly better compete globally

The merging of European firms into larger entities, which gives them a larger global presence but also the potential to dominate some EU member state markets, must continue to be resisted. Such European champions invariably consist of firms located in the two or three largest member states, which then tend to exploit their market power in smaller members. In general, given the size of the EU trade surplus, merging European businesses into larger units for competitive reasons is superfluous. European “industrial policy” might be warranted in special circumstances only in sectors with no existing EU productive capacity that also pass a critical standard for positive spillovers on productivity and unemployment.

2 Stop the pursuit of low tax EU jurisdictions via state aid litigation

The European Court of Justice’s recent annulment (currently under appeal by the Commission) of the state aid case against Ireland and Apple signals the legal difficulty of proving that governments bestow discretionary tax benefits on individual firms. The case reveals that European state aid regulations are ineffective in compelling member states to levy, and firms to pay, higher corporate taxes, even in seemingly obvious cases. In any event, deciding corporate tax rates and a possible common corporate tax base in Europe is a job for European legislators, not the Commission. Conditional on constructive engagement by the Biden administration, the potential agreement of a reform of the global corporate tax framework in the multilateral Organization for Economic Cooperation and Development’s base erosion and profit sharing (BEPS) process may address most of these concerns, including preempting national digital services taxes. The Directorate-General for Competition should leave this to the relevant political authorities.



Rebuilding the Global Economy

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MEMORANDUM ON

THE FUTURE OF EUROPEAN TRADE POLICY

To: The European Commissioner for Trade

From: Robert Z. Lawrence

December 2020

Background: The announced intention of President-elect Joe Biden to strengthen US alliances and participate in international institutions offers an opportunity for the European Union to set its global trading strategy on a new path by reinvigorating the US-EU trade relationship, revitalizing the World Trade Organization (WTO), and implementing a coordinated response to the systemic problems presented by Chinese policies.

The European Commissioner for Trade should not, however, naively expect that the new administration will place trade policies at the top of its agenda and automatically eliminate the bilateral conflicts caused by the Trump administration. Nonetheless, the European Union has an opening to encourage the Biden team to move in that direction.

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KEY PRIORITIES

PRIORITY 1: Restore the US-EU trade relationship

The European Union should try to rapidly restore the status quo ante-Trump on a group of issues, consistent with broader Biden administration goals, rather than seeking big wins that challenge US principles.

- A standstill agreement on authorized retaliations in the Boeing-Airbus subsidy cases could permit the United States and the European Union to negotiate an agreement patterned after the Organization for Economic Cooperation and Development (OECD) code for export subsidies that would allow subsidies for aircraft development but within defined limits. An exception would be no limits on subsidies for green fuels and technologies for aircraft.
- The US-EU frictions over steel and aluminum should concentrate on problems of excess capacity rather than alleged national security concerns between allies. The administration should be ready to remove steel and aluminum national security tariffs on EU products and simultaneously announce new steel and aluminum procurement plans for infrastructure and clean energy programs. In return, the European Union should eliminate its retaliatory tariffs and increase its NATO contributions. Both sides should use the WTO subsidies code to challenge practices leading to excess capacity emanating from China and other countries.
- Europe and the United States should relaunch their initiative to cooperate on regulations and standards, including mutual recognition of those deemed to be

equivalent, with emphasis on transportation, health, and renewable energy. The new EU-US Trade and Technology Council should be equipped to deal with challenges in quantum computing, 5G and 6G broadband cellular networks, artificial intelligence (AI), big data analytics, biotechnology, and nanotechnology.

- Setting compatible standards should also involve international standard-setting bodies, with a goal of opposing efforts by China and others to use standard setting to gain a competitive advantage. Agreements to bolster supply chains in health and strategic minerals should also be negotiated, with the goal of preserving open trade rather than self-sufficiency. Bilateral understandings on rules for ecommerce can pave the way for new agreements on data use, cybersecurity, nonlocalization, and privacy rules.
- Both parties should avoid taxes on internet transactions by agreeing to OECD rules. In light of the incoming Biden administration's proposals for minimum taxes on corporations and a US return to the OECD negotiations on base erosion and profit shifting (BEPS), France should postpone its planned digital tax measures.
- Implementing climate policies should not violate WTO rules. Border adjustments could be justified by GATT Article XX as necessary to protect "human, animal or plant life." But such adjustments would not be necessary if countries apply market-based climate policies such as taxes or tradable CO₂-emissions permits. Under the principle of national treatment, foreign firms could be given offsetting credits for permits they have purchased or taxes they have paid in their home countries.
- Any overly ambitious goal such as the Transatlantic Trade and Investment Partnership (TTIP) should be placed on the back burner.

PRIORITY 2: Revitalize the WTO with Appellate Body reform, plurilateral agreements, and new rules

The European Union should lead efforts to reform the WTO to strengthen its role in dispute settlement and rules setting. A first step would be persuading the United States to join the consensus in appointing Ngozi Okonjo-Iweala as the next WTO Director-General.

- **Reform the Appellate Body (AB).** The European Union has led by establishing a temporary alternative to the AB, but the impasse over the US refusal to fill vacancies at the AB remains unresolved, making an effective alliance to challenge unfair foreign practices difficult to achieve. The Biden administration should therefore accept reform proposals responsive to US concerns over AB overreach, intrusion in administration of trade remedies, and inefficiency.
- **Allow plurilateral agreements.** The WTO should be a forum with a variable geometry that can accommodate the wishes of members who seek deeper trade agreements that not all members wish to join. Members should all have the right to negotiate and join such agreements, but to prevent free riding, these agreements should not automatically be extended to all members on a most favored nation basis. The European Union should help launch plurilateral agreements on issues that are standard in US and EU regional agreements, such as investment, services, ecommerce, and labor standards. Agreements on environmental goods, pharmaceuticals, and medical supplies should also be pursued.
- **Reform safeguards.** Safeguard protections, which allow countries to impose temporary trade barriers when injury can be proven, can play a vital role as a buffer that prevents finger-pointing about unfair trading practices. Both the United States and the European Union have been unable to implement safeguards that can survive WTO challenge,

however. A new more workable safeguards agreement would eliminate ambiguous language and allow selective responses in cases where injury is caused by imports from one country.

- **Reform subsidies.** Some of the groundwork for expanded WTO rules on subsidies has been laid out in the agreement reached by the European Union, the United States, and Japan. After resolving their remaining differences, this agreement should form the basis of an expanded WTO subsidies negotiation. If these negotiations fail, an enhanced plurilateral subsidies agreement can be negotiated.

PRIORITY 3: Coordinate policies toward China

A joint US-EU approach to China should steer realistically between the extreme decoupling sought by the Trump administration and the inadequate responses to harmful Chinese practices in the past. Efforts to prevent China's rise are likely to fail and prove counterproductive. Similarly, China is very unlikely to abandon its successful state-led system. In addition, China will continue to increase in importance as a market for many foreign firms and to be a key participant in global value chains. Although excessive Western dependence on China raises risks of opening opportunities for technological and trade blackmail, mutual interdependence is a better cement for peaceful interactions than acrimonious efforts at extreme separation.

- China's trading partners should use improved WTO rules and a restored Appellate Body to challenge China's practices of violating intellectual property rights, forcing technology transfers, employing poorly disclosed subsidies, and generating excess capacity in international markets.
- China's market remains largely closed to foreign investors in key areas, despite long inconclusive negotiations over bilateral investment treaties. A joint US-EU policy should deny China foreign investment and technology acquisition opportunities in industries and technologies in which they do not provide reciprocal benefits to foreign firms.
- Where there are genuine national security and strategic threats, the European Union should also work with other countries to strengthen procurement restrictions and implement coordinated export controls on sales of products and technologies to China. The European Union should promote the selective approach it used with Huawei, which involved avoiding purchases of network products that pose national security risks but buying other products that do not.

NOTES OF CAUTION

Both the United States and the European Union will need to bolster domestic support for trade policy. President-elect Biden will be hindered by the legacy of the unilateral measures undertaken by the Trump administration that gained considerable support domestically. Before rolling back tariffs, he will need to point to offsetting benefits. The EU challenge is achieving a unified strategy to resist China's efforts to employ tariffs and incentives (infrastructure projects) to dilute common EU policies. The European Union also needs to monitor the actions of the Biden administration and be willing to challenge US "Buy American" measures that are not WTO-consistent. The same would apply to proposed US tax policies, especially those that discriminate in favor of domestic manufacturing production.



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MEMORANDUM ON

CONCRETE INITIATIVES FOR A MORE OUTWARD-LOOKING, GEOPOLITICAL EUROPE

To: The President of the European Commission
From: Jean Pisani-Ferry
December 2020

Background: In the Political Guidelines you presented to the European Parliament immediately after your designation in July 2019, you set the goal of making an “ambitious, strategic and assertive Europe” capable of acting to “uphold and update the rules-based global order.” Europe, you added, regards multilateralism as its “guiding principle in the world.” A year later, in your State of the Union speech, you said that you want the European Union to “lead reforms of the WTO [World Trade Organization] and WHO [World Health Organization]” and behave strategically. The rebuilding of the global economy is definitely a key tenet of your agenda—even more so for the post-COVID-19 world.

Europe, however, is not wired for your agenda. First, it has for many decades been obsessed with internal issues: the single market, monetary union, enlargement, the euro crisis, and Brexit. Because agreements between member states are so hard to reach and sustain, its politics remain fundamentally inward-looking. Second, the European Union is not used to behaving strategically. Because it is itself a rules-based entity, its natural habitat is a world of rules sheltered from the interference of geopolitics.

You are right: Europe should continue fighting for what it believes in. In the years to come there won't be that many defenders of the rules-based international order among the great powers, and the European Union will need to speak up in the name of all those who want to resist the weaponization of international relations. At the same time, it would be foolish not to adapt to a new context of power and sovereignty.

Words have changed already: You have called for a “Geopolitical Commission” and European Council president Charles Michel regards “strategic autonomy” as goal number one for the present generation. But these concepts are understood differently in different European capitals. Your task now is to spell out what they mean in policy terms.

The changeover in Washington, DC will test your capacity to translate broad notions into concrete policy decisions. President Donald Trump's adversarial attitude toward the European Union's policy philosophy and stated priorities gave you no choice but to remain on the defensive. His peculiar behavior also made it tempting for European allies to postpone hard choices. President-elect Joseph Biden will be a friendlier partner but a much more demanding one. He will also be speaking for a nation that has changed: You

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should underestimate neither the shift in attitudes that has taken place in the United States vis-à-vis the international order nor the implications of the growing rivalry with China. You should brace for testing moments.

Challenges will continue emerging on many fronts. Here are seven important priorities.

KEY PRIORITIES

PRIORITY 1: Define and implement a China strategy

The European Union belatedly gave up its predominantly mercantilist perspective to wake up to the magnitude of the challenges that China represents. But still disparate responses to issues posed by Chinese telecommunications giant Huawei and, despite strengthened coordination mechanisms, the lack of a truly common foreign investment screening policy indicate that Europe is still at pains defining its stance and adapting its toolbox. Although the European Union shares many of the American concerns about Beijing's behavior, its priority and strategy cannot be identical to those of the United States: Unlike the United States, the European Union does not regard China as a geopolitical rival; but it does regard China's stance as a potentially lethal threat to its own perspective on international relations—and therefore to its own identity. To engage effectively with both the United States and China, Europe needs to be much clearer about its own aims and means.

PRIORITY 2: Engage the United States, China, and other players on global trade reform

The European Union has traditionally been a staunch defender of the WTO and its Appellate Body. But long-standing US grievances culminating in aggressive bullying by the Trump administration have changed the debate, and it is now accepted that the global trading regime needs reform. As the Commission has undisputed authority on trade matters, you are well placed to play a leading role in WTO reform. But you need to forge a new pan-European consensus on trade matters in spite of opinion having grown more skeptical of globalization, more fearful of China, and more distrustful of the United States. Successful global trade reform requires building up domestic support for your agenda.

PRIORITY 3: Take responsibility for the international dimension of your climate strategy

You are committed to radically enhancing the European Union's climate objectives for 2030 and beyond. Even if other major countries step up their effort, Europe is most likely to be far ahead of others on the path to decarbonization. To avoid carbon leakages, the extension of the cap-and-trade system should be accompanied by an efficient and trade-friendly border adjustment mechanism. But its introduction will be delicate, as the initiative could well be captured by protectionist lobbies and elicit adverse reactions from trading partners. Your responsibilities will be to (1) design a template for mechanisms that reduce distortions and do not create obstacles to trade; (2) convince trading partners that it won't be used for beggar-thy-neighbor purposes; (3) help build a climate coalition with similarly minded countries, possibly including the United States; and (4) address the adverse spillover effects of the European strategy on neighboring fossil fuel producers.

PRIORITY 4: Push hard for fair taxation of multinational companies

At a time when citizens care more about inequality, tax avoidance on a massive scale heightens grievances against globalization. The Organization for Economic Cooperation and Development's Base Erosion and Profit Sharing (BEPS) initiative has paved the way for

a redefinition of taxing rights that does not single out the digital sector but addresses the problem at the root. Even if some of the EU member states benefit from the current situation, you should push for a speedy agreement with the United States and other participants in the BEPS initiative. It should be clear that any acceptable solution will imply that Europe also cedes certain taxing rights on its own multinationals to trading partners from advanced and emerging-market economies. In the short term, a minimal tax (BEPS Pillar 2) is a priority.

PRIORITY 5: Turn the euro into a full-fledged international currency

The emergence of a multipolar monetary regime is a distinct possibility in the medium term. The question is if the euro will be part of it. It is time to break with the European Union's stated neutrality on the international role of its currency and to decide what to do about two major weaknesses that hamper its offshore adoption. The first is the lack of a common safe asset; the postpandemic context and the launch of the NextGenerationEU program provide a basis to rethink the issue. The second has to do with lingering doubts over the ability of the European Central Bank (ECB) to extend swap lines to partner central banks in times of liquidity stress; it can be remedied only if the ECB is given assurances that facilitating the use of the euro in third countries or for key commodities is part of its mandate and that it will be backed by the European Union if corresponding risks materialize.

PRIORITY 6: Complete the economic homework

The never-ending completion of Economic and Monetary Union may not appear to be a priority from an international perspective. But you should not forget that the European Union remains a surplus economy in a world of excess savings. Outdated fiscal rules and the lack of a common fiscal capacity risk being obstacles to an effective use of fiscal policy and the global coordination advocated by Lawrence Summers in his [memo](#) to the US Treasury secretary. Moreover, scars left by the pandemic crisis risk bringing the euro area's persistent frailties back to the fore. You may be hesitating because the task of reforming the euro policy system is a hard one. But the remarkable response to the COVID-19 shock engineered by the ECB and through the Recovery and Resilience Facility provides a strong basis for reform action.

PRIORITY 7: Defend the system, not your privileges

As reforms of voting rights lag behind economic realities, the EU member states are increasingly overrepresented in several international organizations, starting with the Bretton Woods institutions. This situation contributes to aggravate the emerging world's distrust of the prevailing system of global governance. Europe cannot at the same time defend the system and defend its privileges. It must end rearguard battles and offer emerging-market and developing partners a clear quid pro quo: The more ownership of the system they demonstrate, the faster Europe will contribute to the rebalancing of voting rights.

The arrival of a new US president who is committed to changing the course of US international economic policy is an opportunity for developing a new global agenda between the United States and the European Union. However, on China, trade, climate, taxation, and currencies, views will get closer but are unlikely to converge entirely. Your responsibility is to ensure that by the time the European Union starts speaking to the new US administration, it has settled on priorities, potential concessions, and red lines. In the current world context, successful partnership can no longer be based on ambiguities.



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MEMORANDUM TO

THE EUROPEAN COMMISSION ON REFORMING EUROPE'S ECONOMIC POLICY TO HANDLE PANDEMIC SHOCK

To: The European Commissioner for Economic and Financial Affairs
From: Ángel Ubide
December 2020

Background: The overriding objective of the European Commissioner for Economic and Financial Affairs must be to avoid permanent economic consequences from the pandemic shock. This goal entails unambiguously supporting the efforts of EU member states to maintain an expansionary fiscal policy at least until the 2019 level of GDP is restored, while ensuring that the economic policies adopted to cushion the shock do not widen intra-euro area economic divergences. As the shock fades, it is paramount that the commissioner lead the reform to strengthen the economic policy framework in order to better meet the needs of the European economy in the current context of low growth, inflation, and interest rates.

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senior fellow at the
Peterson Institute from
2009 to February 2016,
is managing director
at Citadel.

KEY PRIORITIES

a. Reform the Stability and Growth Pact (SGP) to adapt to the reality of persistent low r^ and low inflation*

The secular decline in neutral interest rates and very low levels of inflation have left fiscal policy as the main macroeconomic policy tool to respond to recessions. Therefore, “sound fiscal policy” is no longer equivalent to deficit reduction: Deficits and debt ratios now have to be instruments, not objectives, of policy. Furthermore, deficits and debt ratios have increased as a result of the necessary fiscal expansion required to successfully manage the COVID-19 shock. The combination of these two factors make the Stability and Growth Pact targets set before 1999 obsolete in two senses: The SGP targets of 3 percent deficit and 60 percent debt-to-GDP ratio have become unrealistic, and the focus on debt and deficit levels, rather than on the uses of fiscal policy, is counterproductive. Therefore, the Stability and Growth Pact must refocus the assessment and design of fiscal policies on three new objectives: (1) avoiding past errors of premature tightening and instead supporting the European Central Bank’s efforts to reduce unemployment and increase inflation to its target; (2) improving *the quality* of fiscal policies, instead of prioritizing the reduction of deficits at all costs; and (3) protecting public investment by developing fiscal golden rules.

b. Successfully deploy the Recovery and Resilience Facility

The Recovery and Resilience Facility, and the associated Recovery and Resilience Plans, provide unique opportunities to improve the growth potential of European economies, in

addition to fostering the EU objectives of enhancing economic fairness and mitigating the impact of climate change. These tools allow the Commission to demonstrate the power of common fiscal efforts in Europe. These plans involve a large deployment of resources, which must achieve the right combination of near-term demand support and long-term productivity growth increases. The Commission must carefully manage these plans to avoid a deployment that is misguided by an excessive focus on spending too fast on projects that might be suboptimal or face capacity constraints. Countries should also be able to keep the option to request the loans at a later stage as needed, and the European Central Bank should stay away from pushing for a full take-up of loans at the outset.

c. Develop the European Union's own resources

The European Council decision to launch the Next Generation EU (NGEU) program included a request to the European Commission to present proposals for new EU own resources that could be used to repay NGEU borrowing. These new resources—for example, creating an EU tranche of the value-added tax—will stabilize the European Union's borrowing ability and allow it to create revenues better suited to tax bases that are mobile or pan-European. A better revenue base should also correct the current political distortion whereby countries try to minimize their contributions to the European Union's resources without internalizing the spillback benefits of the spending programs that they finance.

d. Build a euro area safe asset

The debt issuance associated with the Recovery Fund, combined with new EU own resources, set the stage for the creation of a true euro area safe asset. Making this new asset succeed at scale will reduce the cost of capital for European households and businesses and boost potential growth. This safe asset is also a necessary condition for completing the European banking and capital markets union and for boosting the international role of the euro. The next step should be making the Recovery Fund a permanent facility and catalyzing the creation of an EU debt management office.

KEY PAST PRIORITIES THAT SHOULD BE ABANDONED

The European Union should abandon the excessive focus on “risk reduction” that has been so detrimental to growth in the past decade. The endless debates on reducing sovereign exposures and debt restructuring mechanisms have kept financial conditions excessively tight over the last decade and diverted attention from the key priority of creating a euro area safe asset.

KEY PRIORITIES THAT HAVE BEEN IGNORED AND SHOULD NOW BE PURSUED

a. Develop a euro area countercyclical fiscal capacity

The economic architecture of the euro area is incomplete, as it lacks an instrument to achieve the optimal fiscal stance for the euro area as a whole. The Stability and Growth Pact is asymmetric, with detailed mechanisms to force countries to tighten fiscal policies but a complete lack of mechanisms to force them to loosen fiscal policies. Developing a euro area fiscal capacity should become a priority, especially in an environment where fiscal policy must be the leading economic policy for aggregate demand management. For example, some of the new EU own resources could become tools for countercyclical stabilization.

b. Boost the international role of the euro

The euro area accounts for about a third of global GDP, and yet the euro is a much smaller share of global foreign exchange reserves and international transactions. Developing the international role of the euro, for which the creation of a euro area safe asset is a necessary condition, is a priority that would have large positive economic and geopolitical benefits for the European Union, including sharing the low financing costs generated by the US dollar's so-called exorbitant privilege and boosting the effectiveness and reach of the euro's global payment system.



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MEMORANDUM ON

BUILDING UP THE EUROPEAN UNION'S CONTRIBUTION TO INTERNATIONAL FINANCIAL REGULATION AND OVERSIGHT

To: The European Commissioner for Financial Services Policy
From: Nicolas Véron
December 2020

Background: The Commissioner for Financial Services Policy¹ should define and promote a vision for a sustainable global financial regulatory and supervisory order, based on the lessons from the previous major international financial crisis in 2007-09 and its aftermath. As a member of President Ursula von der Leyen's "geopolitical Commission," the Commissioner should lead in setting the international agenda and build global credibility by driving the corresponding "domestic" (i.e., EU) reforms at home. This memo focuses on the international aspects.

KEY PRIORITIES

PRIORITY 1: Create a robust and enforceable international institutional architecture for the oversight of firms that are critical to global financial infrastructure and system integrity

The ongoing (and ostensibly unstoppable) shift to a more multipolar financial system implies that the current setup, based on informal global coordination, will be increasingly unfit for the oversight of a limited number of internationally critical firms. The category includes critical financial information providers and gatekeepers such as audit networks, ratings agencies, trade repositories, some actors that may be emerging from the use of new technologies such as distributed ledgers, and perhaps internationally critical clearing houses. Banks, being ultimately tied to their currency areas and monetary policies, should not be included within that scope.

Such internationally critical firms should come under binding (i.e., treaty-based) supranational legal and supervisory regimes, ensuring a common basis for trust and cross-border activity. Whether the geographical scope of such regimes should be fully global (e.g., leveraging the existing framework of the Bank for International Settlements) or plurilateral (e.g., bringing together the home jurisdictions of a critical mass of major international financial centers and firms) must be assessed on a case-by-case basis.

Nicolas Véron

is senior fellow at the Peterson Institute for International Economics (PIIE) and at Bruegel, the Brussels-based economic policy think tank he helped cofound in 2002–04. He is host of PIIE's Financial Statements virtual event series. Véron has held various positions in the public and private sectors, including as corporate adviser to France's labor minister (1997–2000), chief financial officer of the publicly listed internet company MultiMania/Lycos France (2000–2002), and independent financial services consultant. He is an independent nonexecutive director of the Repository and Derivatives Services arm of DTCC (the Depository Trust and Clearing Corporation), a global financial infrastructure company.

¹ The full official title is Commissioner for Financial Stability, Financial Services and Capital Markets Union.

PRIORITY 2: Streamline European representation in existing international financial regulatory bodies to enhance their global acceptance, not least by non-Western and emerging jurisdictions

The European Union and especially the euro area are indefensibly overrepresented in bodies such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), not to mention the shareholding structure of the Bank for International Settlements. That representational imbalance is slowly undermining the legitimacy and effectiveness of these bodies, and the way European countries “hog the seats” reflects poorly on them too. You may attempt to negotiate their rebalancing against something useful, but the truth is that even a unilateral reduction of European overrepresentation would be in the European interest so that these bodies can retain and further develop their international relevance and authoritativeness.

To illustrate the point, the European Union represents 36 percent of the BCBS jurisdictions, 29 percent of BCBS members, 26 percent of FSB members, and 32 percent of members of the FSB Steering Committee. The corresponding figures for the United States are respectively 4, 9, 5, and 13 percent; and for China (including Hong Kong), 7, 7, 7, and 3 percent.

The BCBS is a particularly glaring case since supervisory policy is no longer set at the national level in the euro area, and thus the individual full membership thereof of no fewer than seven euro area countries (in addition to the European Central Bank and Single Supervisory Mechanism) has lost any justification other than inertia and incumbency.

In the same vein, you could also promote symbolically significant relocations of currently Europe-based organizations, e.g., the FSB secretariat, to suitable alternative locations in Asia such as Singapore or Tokyo.

PRIORITY 3: Lead by example by making the European Union fully compliant with relevant international standards

The existing European lapses of compliance have more downsides, in terms of loss of credibility for the global standard-setting bodies and loss of European influence within these, than upsides in terms of better European regulatory outcomes. In fact, full compliance would arguably be an improvement to the European regulatory framework irrespective of the positive international spillovers. The scope for this includes full compliance with the Basel III global accord as set by the BCBS and phasing out the lingering EU “carveouts” from International Financial Reporting Standards.

You should also foster effective and consistent global implementation of new standards, such as critical data elements for over-the-counter derivatives as defined under the Committee on Payments and Markets Infrastructure and the International Organization of Securities Commission.

PRIORITY 4: Create a seamlessly integrated euro area financial system by completing the banking union and capital markets union

This is of course your number one “domestic” (intra-EU) policy priority, but it also has positive global implications. It is the central condition for strengthening the international role of the euro and hedging against the risk of abusive weaponization by the United States of the dollar’s dominance, e.g., with financial sanctions. Fortunately, the agreement reached in 2020 on the NextGenerationEU recovery plan establishes Union bonds as a new bedrock

for the European financial system and an acceptable instrument for risk sharing. As the consequences of this new reality gradually sink in over the next years, they can be expected to alleviate the political obstacles to completing the banking union, which itself is the key to fulfilling the vision of the capital markets union.

PRIORITY 5: Establish a credible policy framework for Anti-Money Laundering (AML) supervision in the European Union

You should prioritize this issue of EU reform because policy momentum has been (sadly) created by the revelation since 2018 of major shortcomings of the existing framework, which is based on national implementation of the European Union's five successive AML directives. You should accelerate proposals for an integrated system in which a new European AML supervisor is empowered to directly supervise (and impose financial penalties on) firms it deems most risky, while being incentivized to redelegate to the national level AML supervision of firms and sectors it deems lower-risk in line with the EU principle of subsidiarity.

Constructive cooperation with the United States and China would help on all these matters, but you should not be shy about global initiative and leadership. The United States is likely to be absorbed by domestic priorities for the foreseeable future, and in China (including Hong Kong) policy processes are likewise dominated by domestic stability concerns. There is a strong alignment between the European Union's commitment to a sustainable international order for financial services and the aspirations of other jurisdictions such as Australia, Canada, Japan, Singapore, Switzerland, and the United Kingdom, to name only the most significant from a global financial system standpoint. Even on matters where unanimity is out of reach, the European Union is best placed to catalyze critical mass coalitions that could move joint projects and actions forward.



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MEMORANDUM ON

EUROPE'S RECOVERY THROUGH INVESTMENT IN SCIENCE, TECHNOLOGY, AND INNOVATION

To: The European Commissioner for Innovation
From: Reinhilde Veugelers
December 2020

Background: A science, technology, and innovation machine in full gear will ensure a prosperous post-COVID-19 EU economy that provides well-paid jobs and a healthy, safe, and clean environment for all of its citizens. The European Union's efforts in these areas, however, have not responded fast enough to societal challenges in the past.

The gap in research and development (R&D) in the European Union is not due to deficiencies in its incumbent innovators in classic sectors of strength—like automobiles and pharmaceuticals—but because it is missing leading innovators in new digital technology sectors, especially in digital services sectors. These sectors are increasingly important in the corporate global technology landscape. Because of advantages of large scale and user bases, digital R&D has become concentrated, with a few winners taking all, especially in digital services. Europe enjoys a buzzing digital startup scene but lacks leading big technology firms, especially the critical gatekeepers, where the United States and China dominate. Despite rapid technological change, there is relatively little turbulence in these gatekeeper positions. Europe may thus continue to miss pole positions in future races for returns from new digital innovations.

The question is whether the European Union will be able to lead in new races to come, post-COVID-19. These races will be mostly in digital technologies but, and perhaps more importantly for Europe, also in green and health technologies. The nondigital races in manufacturing and services will be centered on the integration of new digital technologies, including advanced digital services, the Internet of Things, and artificial intelligence. As a result, network-based supply processes will profoundly reshape traditional value chains. If European firms are unable to develop and integrate new digital technology-intensive services into the evolving paradigms of supply, they will not win the races of the future, even in sectors where they currently lead, like automobiles and health.

While these challenges are sizeable and urgent, particularly in light of climate change, the powers of the European Commission to address them are being undermined. First, Brexit is costing a pivotal part of the European Union's science, technology, and innovation capacity. But even within the EU27, there is an increasing divergence between countries on the importance of supporting this capacity at the European level. Skepticism is rising on the

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value added of EU policy instruments in science, technology, and innovation, as witnessed by the fights over the size and distribution of the next EU budget for these activities (“Horizon Europe”).

Europe's challenges are occurring just as China is rising as a science, technology, and innovation powerhouse, and US technology giants continue to dominate pivotal digital platforms. The apparent success of Chinese state-controlled or sponsored business and policy models and the rise of protectionism, including in EU member states, have spilled over to the EU level. The latest tendency in European Commission rhetoric is to brand “Europe First” with a “strategic autonomy” label and rephrase its innovation policy objectives toward “technology sovereignty.” This is not the right response and in fact will set Europe farther back.

KEY PRIORITIES

PRIORITY 1: Ensure a stronger EU science, technology, and innovation motor

The EU science, technology, and innovation motor has to be in full power for sustainable rebuilding. The EU policy agenda should therefore ensure a strong science and technology knowledge base, promote entrepreneurship, and provide space for innovative companies to grow and earn appropriate returns from their innovative investments on world markets.

The classic approach of the past, deploying the single market and competition policy as major EU instruments, has failed to put the European Union at the frontier of the digital transformation. History has also shown that throwing money at selected “winners” has not been effective. Europe may need a new version of industrial policy, but the new version should not pick specific technologies, sectors, or EU champion firms. A better approach would target broadly defined missions within a strong general forward-looking policy framework.

Such a framework should ensure an adequate ecosystem for the birth and development of technologically advanced platforms bringing together stakeholders along all stages of the value chain, from research to final consumption. This goal requires full use of the EU single market of customers and competitors. It does not require major overhauls of single market regulation and competition rules or more protective, closed “EU First” inspired reforms. More forceful forward-looking enforcement is needed based on a perspective of dynamic efficiency, one that assesses not only the impact of government interventions on the current working of markets but also their impact on the science, technology, and innovation motor. Irrespective of corporate nationality, enforcement should detect and redress potential abuse of dominant corporate positions in the new digitally powered platforms. Harm should be assessed not only in the short run but also in the long run without jeopardizing any static and dynamic efficiencies that derive from large size.

The more directed/targeted approach should not simply provide public funds for selected “winners.” Rather the approach should be to develop a target-specific horizontal policy, i.e., creating framework conditions and removing barriers to the development of collaborations, networks, and ecosystems in target areas. These target areas should reflect broad policy objectives rather than selected sectors, technologies, or firms. The targets should cover early-stage emerging ecosystems with identified market and system failures that impede development of identified EU strengths. Targets within biopharma and health technologies as well as green technologies (including renewable energy technologies) would be good

examples. Such target-specific horizontal policies should not protect and subsidize a select “few,” shielding them from EU internal and global competition. Spending public money in these areas should be broad, program-based, and supportive of these ecosystems. Subsidies should be temporary, with selection based on competition and monitoring and evaluation focused on whether milestones are being met, while ensuring a level playing field for competing emerging ecosystems.

Past efforts might provide some inspiration. In the early 1980s, European Commissioner Etienne Davignon launched ESPRIT (European Strategic Programme for Research and Development in Information Technologies) to make the European microelectronics industry competitive against US and Japanese companies. This initiative brought together public and private forces from member states. At the EU level, public resources were pooled to support research (with the first Framework Programme). On the single market and the competition policy side, the initiative allowed EU firms to cooperate in precompetitive research and a regulatory agenda with common standard setting. ESPRIT delivered some success in 3G, though it is unfortunately not a perfect example. Eventually, the initiative settled in complacency, shielding EU firms from the global competitive scene, which resulted in the European Union missing out on the next waves of digital technologies.

PRIORITY 2: Strengthen the European Union's position in the global technology landscape

How to address the European Union's position in global competition and the global configurations of technology platforms and value chains? How to respond to the call for more “technology sovereignty” and “strategic autonomy”? In a technology space that needs to be global, self-sufficiency is elusive and inefficient. Rather than embracing autarky, the European Union should keep an open perspective and defend a *global* technology space that is a fair level playing field.

The process of selecting and supporting key technology platforms should avoid protectionist pitfalls, in which current incumbents are shielded from the global creative destruction process, whether in the European Union or abroad. The EU single market should remain open to the import of frontier technologies and best practices, wherever they are initially developed. To meet this objective, it is important to continue the work at the World Trade Organization (WTO) on trade facilitation measures. Foreign investors should have adequate access to the single market, within the boundaries of the EU framework for screening foreign direct investments.

A technology sovereignty policy should guarantee the highest possible access for EU citizens to the best that technology offers now and in future. Such a policy should ensure that the global technology space operates with open access to key technologies and lets EU firms build the world's leading technology positions or partner in global value chains that yield value from unique technology positions. Assuring technology sovereignty should entail fining or regulating firms that block access to and/or abuse their monopoly positions in these value chains and technologies, whatever nationality they have.

Regulatory authorities should not only invoke sanctions and regulations to avoid European firms being blocked from key technologies or components by other countries but also prevent dependence on single suppliers and components by diversifying and encouraging technologies that are modular and flexible (like 3D printing, bioengineering). It will be important to shape and use the multilateral WTO to achieve a fair level playing field. Europe

needs a strong position at the multilateral table, a *force incontournable* in international coalitions to discourage nationalist-focused technology strategies. For this, it should lead by example. It also requires a unified voice representing a strong EU internal market, strong interconnected EU companies, and a strong EU science, technology, and innovation machine.

ACTIONABLE TO-DO LIST

- Implement the European Union's regulatory and competition policy framework such that it ensures that EU firms are able to build world's leading technology positions or at least become crucial technology partners in global value chains that yield benefits from these unique technology positions.
- Take the lead in multilateral negotiations to ensure that the global technology space is a fair, level playing field, operating with open access to key technologies, where the European Union leads by example.
- Prevent technology dependence by diversifying and mastering modular, flexible technologies.

INTERNATIONAL ORGANIZATIONS

Caroline Atkinson to the Secretary-General of the Organization for Economic Cooperation and Development

Mark Carney to the Chair of the Financial Stability Board

Monica de Bolle to the President of the Inter-American Development Bank

Pinelopi (Penny) Koujianou Goldberg to the President of the World Bank

Anabel González to the Director-General of the World Trade Organization

José De Gregorio to the Managing Director of the International Monetary Fund

Patrick Honohan to the Chair of the Financial Stability Board

Olivier Jeanne to the General Manager of the Bank for International Settlements

Charles D. Lake II to the Leaders of the Parties to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)

Adnan Mazarei to the Executive Secretary of the United Nations Economic Commission for Africa

Peter Orszag to the International Monetary and Financial Committee



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

THE OECD'S ROLE IN BUILDING CONSENSUS ON GLOBAL GOALS AND POLICY ACTION

To: The Secretary-General of the Organization for Economic Cooperation and Development

From: Caroline Atkinson

December 2020

Background: The Organization for Economic Cooperation and Development's (OECD)¹ particular strength among multilateral institutions is its combination of intellectual focus with deep knowledge and convening power across a broad range of countries and topics. It does not have the power to disburse money, conditional on policies. But through its research and publications, and standard setting, it has established metrics and norms that influence country policies across many areas. Some examples include: the Program for International Student Assessment (PISA) that since 1997 has conducted periodic studies in 79 countries, both OECD and non-OECD members, of student academic attainment at 15 years of age and that is widely used to judge the effectiveness of national education policies; the export credit arrangement, a negotiated framework that limits export subsidies, fostering a level playing field, for example on coal-fired power plants; and the anti-bribery convention, begun in 1999 and strengthened in 2009 and now being reviewed again, which for the first time focused on the firms that offer—rather than receive—bribes as a way to curb corruption, making it a crime in signatory countries for companies to offer bribes to foreign officials for business-related purposes.

The OECD's work can bridge microeconomic and macroeconomic policy, bringing together micro expertise on key sectoral and social issues—critical for rebuilding the global economy—with a macroeconomic lens. Its convening power, through committees of national policy experts, coupled with connection to the G20 summit process, supports consensus on global goals and policy action, including through setting norms and standards.

Caroline Atkinson

is a senior advisor at RockCreek and a member of the executive committee of the board of directors of the Peterson Institute for International Economics.

¹ The members of the OECD are Australia, Austria, Belgium, Canada, Chile, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

KEY PRIORITY: Maintain and build credibility with G20 countries

An overarching priority of the Secretary-General must be to maintain and build credibility with major G20 countries, many of whom are not among the OECD's 37 members.² Work should be focused on the following five topics where global coordination is essential and micro-macro coordination is important. The OECD's close relationships with country officials, through its committee structure, combined with its role at the G20, will be particularly important in the first two areas: global taxation of capital and digital technology. The OECD can be the primary forum for agreement on important decisions where major economies come together. In these areas, the OECD is the primary international forum.

OTHER PRIORITIES

1. TAXATION: Work with OECD and G20 members towards fair cross-border taxation of capital to buttress political support for global investment and trade

- The OECD's work on aligning and reforming international taxation of capital, base erosion and profit shifting (BEPS), has made important advances through the G20. But it is at a critical phase, with political consensus fracturing over how to tax digital technology companies.
- This contentious issue—politically appealing to European and other nations without large tech companies but at odds with the underlying notion of taxing profits where the capital that generates them is domiciled—risks jeopardizing broader progress on BEPS.
- The OECD should work with the new Biden administration to see if there is an approach that will address Europe's concerns about untaxed revenues without discriminating against American digital companies.
- At the same time, the OECD should shift focus back to winning broad support, including in the countries where multinational companies (MNCs) are domiciled, for clear and conceptually simple steps to make it much harder for these companies to avoid taxation.
- The OECD should work with OECD and G20 nations on both sides of the BEPS issue: the major economies where large MNCs are headquartered and the smaller countries that have used low (and often specially negotiated) tax rates to attract MNCs—including, for example, EU members such as Ireland, the Netherlands, and Luxembourg as well as Singapore in Asia.
- Key tools to reduce base shifting and tax avoidance include: minimum profit taxes enacted in home countries that reduce the attractiveness of tax havens, and better information exchange among tax authorities and standards for company transparency.

2. DIGITAL TECHNOLOGY: Advise governments on regulatory standards to address concerns about digitization, while exploiting potential gains

Technological innovation holds a key to promoting global growth. But geopolitical divisions between the United States and China, growing protectionism, and concern about the conduct and impact of large—mainly US—technology companies threaten to undermine the smooth operation of the internet and inhibit digital trade and innovation. There is a gap

² The members of the G20 that are not OECD members are Argentina, Brazil, China, the European Union, India, Indonesia, Russia, Saudi Arabia, and South Africa. G20 members who are also OECD members are Australia, Canada, France, Germany, Italy, Japan, Korea, Mexico, Turkey, the United Kingdom, and the United States.

to be filled on developing agreement around technology standards and “rules of the road.” The OECD should use its considerable expertise and public voice on science, technology, and innovation to advise governments and the international community on how best to exploit potential gains from digitization—in sectors from finance to transit to manufacturing to government services—while also developing and adhering to appropriate regulatory standards. Growing internet access should spur global growth and efficiency, and spread the benefits of digital technology.

3. CLIMATE: Provide the analysis and standard setting that can help political leaders fulfill promises to “build back green”

The institution should take a two-pronged approach: economic analysis of macroeconomic tools, notably pricing, that aim at transforming economies while also protecting growth, and building and disseminating microeconomic expertise on the role of regulation, public and private investment, and financing. The OECD has the ability to gather data and conduct research across borders, to consult with business (through the 50-year-old Business and Industry Advisory Committee, BIAC) and to present policy-based findings at all levels of government, including to the heads of G20 governments.

4. HEALTH: Provide the research on the best reforms of national health systems

Ill-equipped global and national health systems contributed to the devastating economic impact of COVID-19 around the world. Reform is essential to rebuild a more resilient global economy and revive trade, international travel, and tourism. OECD research can support best practice national reforms—in particular of public health systems and practices but also of efficient and cost-conscious service delivery. Globally, the OECD should help the G20 fill the gap in pandemic preparedness and response that cannot be met by today’s health bodies. Scientific and medical expertise, whether of the World Health Organization or more specialized agencies such as the Gavi vaccine alliance or the Global Fund, needs to be bolstered by economic and policy expertise, as well as by easy access to those at the heart of government, especially at a time of crisis.

5. PRODUCTIVITY: Analyze detailed data on businesses, education, and training to shed light on the effect of policy actions on productivity

Political support in major advanced economies for rebuilding global economic and trade links rests on improving employment opportunities and living standards. A return to the faster productivity growth of earlier decades is essential. The OECD should reinvigorate its growth and productivity project to understand why productivity slowed down and what measures—including education and training to build human capital—would help to revive it. The OECD’s access to detailed data on business formation and regulation, its work on competition policy, and the cross-country studies of education and training to build human capital should be used to shed light on policy actions that promote—or inhibit—productivity growth and equitable distribution.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

BUILDING A FINANCIAL SYSTEM TO SUPPORT THE TRANSITION TO NET ZERO FOR THE FINANCIAL STABILITY BOARD (FSB)

To: Chair of the Financial Stability Board

**From: Mark Carney, UN Special Envoy for Climate Action and Finance
December 2020**

The Financial Stability Board (FSB) has been a paragon for international cooperation to solve issues that transcend national borders. Established in 2009, it develops regulatory, supervisory, and other financial sector policies that promote stability in the global financial system. With its clear mission and strong political backing, diverse membership, deep expertise, and consensus-based approach to policy reform, the FSB has been able to agree to a wide range of reforms needed to increase the resilience of the global financial sector. Its efforts helped ensure that the financial system was able to support the world's economies during the current health and economic crises.

But FSB members know that they can never rest on their laurels. Complacency is the enemy of financial stability. There are new vulnerabilities—in market-based finance, in cyber and operational risks—and there is an existential risk whose very resolution could threaten financial stability if we do not prepare now: climate change.

The catastrophic impacts of climate change will be felt beyond the traditional horizons of most banks, investors, and financial policymakers, imposing costs on future generations that the current one has no incentive to fix. Once climate change becomes a clear and present danger, it could be too late to stabilize, as global temperature rises.

The FSB was an early mover in recognizing the risks of climate change for the financial sector. In 2015, in response to a call from G20 leaders, it established the Task Force for Climate-related Disclosures (TCFD) to develop recommendations for voluntary disclosures of material, decision-useful, climate-related financial risks. Today, the TCFD is the gold standard for such reporting and the basis for newly announced mandatory reporting regimes around the world, including in the United Kingdom, the European Union, and New Zealand.

In November, the FSB's report on the *Implications of Climate Change for Financial Stability* provided an important contribution in furthering the discourse on climate-related financial risks. Indeed, this work highlights the considerable variation in how financial institutions and their supervising authorities are addressing climate-related risks and the need for more urgent action.

Mark Carney, is Finance Adviser to the UK Prime Minister for the 2020 United Nations Climate Change Conference (COP 26) and UN Special Envoy for Climate Action and Finance; he is also a Former Governor, Bank of England; Former Governor, Bank of Canada.

With the climate ambition of countries around the world dramatically increasing, climate transition risk is moving from concept to reality. The FSB should use the run-up to COP26 next year to focus on delivering globally consistent standards for climate-related reporting, building climate risk management capabilities in the financial sector, and developing consensus on forward-looking metrics for net zero transition in the financial sector. These building blocks will minimize transition risks, build resilience, and promote financial stability as the world tackles this fundamental challenge.

PRIORITY 1: Create consensus around and embed a globally consistent framework for climate-related reporting

Following on from the success of the TCFD, the FSB is well placed to support further integration of its recommendations into more established disclosure frameworks. The time has come to move from voluntary, market-led disclosure to establishing pathways to mandatory climate disclosure for the largest companies in the largest jurisdictions.

The FSB can help ensure that there is no divergence between competing standards and that the international community can agree on minimum baseline standards, which can be adapted for local jurisdictions. This coordination is especially important, as it will help make any disclosures decision-useful and comparable for users of the information and efficient for companies who disclose the information.

The International Financial Reporting Standards (IFRS) Foundation is a mechanism by which to achieve this. Its role in overseeing the International Accounting Standards Board (IASB) and accountancy standards, as well as the depth of its existing standards in over 140 countries, ensures that it is well placed to take the TCFD recommendations forward in a manner that can achieve global consensus.

ACTIONABLE TO-DO LIST:

The FSB should consider:

- Endorsing the IFRS Foundation’s proposal to establish climate-related disclosure standards through a new Sustainability Standards Board under the Foundation’s remit, via the FSB’s upcoming public statement on the TCFD.
- Publishing a statement to encourage jurisdictions to use the TCFD as the basis for setting domestic requirements on climate disclosure.
- Publishing a report for the G20 based on the Italian Presidency’s request for the FSB to work with other financial sector bodies to “explore ways to promote globally comparable, high-quality, and auditable standards of disclosure in sustainability reporting based on the TCFD recommendations, as well as a better alignment of the climate-related financial disclosure frameworks at the global level, so as to enhance coordination of relevant regulatory and supervisory approaches.”

PRIORITY 2: Improve climate risk measurement and management

The effects of climate change are already being felt through two channels: physical risks and transition risks.

Physical risks arise from damage to property, land, and infrastructure from catastrophic weather-related events such as heat waves, hurricanes, floods, and rising sea level. Over the last three decades, the number of extreme weather events tripled. Inflation-adjusted

insurance losses increased fivefold. Uninsured losses from extreme weather increased seven-fold over the same period.

These physical risks can affect the banking sector as well. For example, extreme weather events can cause significant losses for homeowners, reducing their ability to repay their loans and damaging the value of their property. The average annual loss on residential mortgages in the United Kingdom from flood risk is expected to more than double by 2050 in a 4°C world. Smaller lenders with geographic concentrations would be more at risk.

Transition risks arise from changes in climate policy, technology, and market sentiment as the world adjusts to a net-zero economy. These risks will affect every sector. Depending on the speed and predictability of the adjustment, banks may find themselves with large, unexpected losses through credit exposures to companies that are not viable in a net-zero economy, leading to stranded assets, reduced earnings, and business disruption. More than 100 oil and gas companies in North America filed for bankruptcy this year. And the world's largest listed oil companies collectively wiped out almost \$90 billion from the value of their oil and gas assets in the last nine months.

Managing climate-related financial risks requires that disclosure go beyond the static (a company's carbon footprint today) to the strategic (their plans to manage down their emissions). Risk management means assessing such forward-looking disclosures to judge the resilience of firms' strategies to the transition.

The financial stability risks from climate change are still not being adequately identified, addressed, or priced. This leaves the financial system vulnerable to climate change and the necessary transition of the global economy to net zero. The scale and threat of the challenge here calls for an ambitious program of work, with the FSB well placed to galvanize action among international and national authorities.

ACTIONABLE TO-DO LIST:

The FSB should consider:

- Integrating climate risks into its guidance and frameworks. Publishing guidance on addressing climate risks for financial institutions would help meet the urgent need to raise expectations globally for risk assessment and encourage the necessary investment in the financial system's collective capability.
- Identifying new areas, tools, and frameworks to embed climate considerations in the global financial system.
- Catalyzing agreement among G20 regulators to set expectations on firms' climate risk management and stress test their systems against different climate outcomes set out in the reference scenarios published by the Network for Greening the Financial System (NGFS), a group of nearly 80 central banks and supervisors committed to addressing these risks.
- Joining other international standard setters as an observer on the NGFS.
- Endorsing the use of the NGFS scenarios as a way for companies and financial institutions across the economy to assess their resilience.

PRIORITY 3: Develop the metrics for the financial sector to disclose its alignment with net zero

The financial community needs to measure and disclose how its activity is aligned to net zero. Banks will need to disclose how their lending aligns with net-zero goals. And investors should be disclosing how closely their portfolios are aligned with the transition to net zero.

In recent months, some of the world's largest global banks committed to net zero by 2050 on a *scope three* basis, which means bringing all their financed emissions in line with net zero. They now need to work out a robust measurement framework and disclose the results.

Some of the world's largest and most influential investors are making this commitment. The members of the Net Zero Asset Owner Alliance, with over \$5 trillion in assets under management, have committed to manage down their carbon footprints by up to 29%, preferably on a scope three basis (including direct and all indirect emissions), by 2025 and to be at net zero by 2050. This metrics-based approach will likely become increasingly common. The recently launched Net Zero Asset Managers Initiative, representing \$9 trillion in assets under management, also committed to working with clients to achieve target-based net-zero goals by 2050. And Climate Action 100+—a group of over 500 institutional investors controlling almost \$50 trillion of assets—recently demanded that the world's 161 highest-emitting companies (representing 80% of industrial emissions) publish strategies to reach net zero by 2050.

Investors will need to agree how best to demonstrate how clients' investments are aligned to climate targets. One of the most important tasks over the next 12 months will be to determine the best approaches for managing transition risks and opportunities. Any measure of alignment to net zero needs to be:

- forward looking, giving appropriate credit to efforts by companies to decarbonize
- anchored in real-world climate targets
- dynamic, to show progress over time and accommodate new technologies.

These criteria encourage engagement with companies across the economy that are seeking to decarbonize. Existing climate-related metrics serve useful roles, but they are not best suited to measuring a whole-economy transition. Carbon footprints and CO₂ emissions per dollar invested are not forward looking. Environmental, social, and corporate governance (ESG) metrics are inconsistent and poorly correlated, and their “E” is not benchmarked to net zero. And taxonomies, while useful for measuring the percentage of assets invested in certain activities, capture only a small proportion of business activity, cannot chart progress through the 50 shades of green, and are not yet dynamic enough to account for new technology developments.

There are, however, ways to measure alignment, including:

- the percentage of assets that are net zero-aligned (“Paris aligned”)
- transition progress versus scientifically determined transition pathways by sector
- calculations of a “degree warming metric” to assess the quality of transition plans relative to the Paris goals in a given portfolio.

The challenge for the industry is to work on a framework that will help it measure alignment and to disclose this information to people whose money they manage.

ACTIONABLE TO-DO LIST:

The FSB should consider:

- Charging the TCFD with including forward-looking metrics for investors and banks in their recommendations framework.
- Taking stock of the landscape of how banks and investors are measuring the alignment of their lending and investments and providing guidance on those that are particularly relevant to mitigating risks to financial stability.
- Identifying the data gaps that exist to accurately measure alignment of lending and investment with the transition.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

THE HEALTH, ECONOMIC, AND POLITICAL CHALLENGES FACING LATIN AMERICA

To: President of the Inter-American Development Bank (IADB)
From: Monica de Bolle
December 2020

Background: The COVID-19 pandemic struck Latin America in late February 2020. Governments in the region had time to adopt public health strategies, economic rescue plans, and policies to protect millions of informal and vulnerable workers throughout the region, but institutional weakness hampered their efforts.

As a result, the impact in Latin America has been widespread and tragic. By mid-December, the region's five largest economies combined (Brazil, Mexico, Colombia, Peru, and Argentina) registered 12 million cases of COVID-19 and hundreds of thousands of deaths—25 percent of the global death toll of 1.6 million people. Brazil alone is the second country in the world (after the United States) with the most deaths. More than 180,000 people have perished in the past 10 months. The numbers may be even greater because of underreporting, lack of testing capacity, and the absence of systematic contact tracing protocols.

The disease has devastated the region's economies, which have suffered steep declines in GDP, rampant unemployment, and a humanitarian crisis falling disproportionately on the poor, who lack minimal access to health services and economic support from local governments.

Significant challenges loom on all fronts. Some countries face a potential loss of external financing and debt constraints, compounding the failure to respond adequately to the health and economic crisis. In other, better managed countries, access to financial markets has receded but is unlikely to disappear completely over the medium term, demonstrating better performance than has been the case during some crises of the past. The fact that some of Latin America's major economies have managed fiscal constraints relatively well while allowing a humanitarian crisis to unfold uncontrollably underscores how some countries have been more preoccupied with austerity than with saving lives.

KEY PRIORITIES

- **Control the spread of the coronavirus.** No sustained economic recovery can occur in the absence of measures to control the epidemic. Action is needed to bring down the viral transmission rate, or the effective R, below the threshold of 1, meaning that one

Monica de Bolle, senior fellow at the Peterson Institute for International Economics, is former director for Latin American studies and emerging markets at the School of Advanced International Studies at Johns Hopkins University and also a former director of the Brazilian think tank Institute for Economic Policy Research.

infected person will contaminate no more than one other person. As some countries have shown, this result can be achieved by a combination of strict social distancing measures, widespread testing, and contact tracing. Unless brought under control, the pandemic will continue to ravage the vulnerable population, exacerbating already very high inequality and poverty levels in the region.

- **Develop immunization strategies.** Most countries in the region have delayed their immunization strategies and/or have severely limited vaccine portfolios, resulting in inadequate coverage to their populations. In some countries, politicization of vaccines is hampering the ability to develop immunization strategies. For example, in Brazil, the federal government has rejected the Coronavac vaccine, one of the two currently in clinical trials in the country, because it is being developed in the state of São Paulo—the president and the governor of the state are political opponents. In all countries, vaccine shortages are likely to further exacerbate inequality, as the rich gain access to immunizations, while the poor remain at the back of the line. Advising countries on how to minimize these problems is a top priority.
- **Continue providing income support to the poor.** To address the disproportionate toll on the poor, countries should consider continuing temporary cash transfer programs to support the lower income segment of the population. These programs need to be consistent with countries' fiscal constraints, some of which are very tight. As a result, some countries in the region may only be able to launch very limited income support programs, while others may have room to be more ambitious.
- **Stem bankruptcies and unemployment among small and medium enterprises.** The small and medium enterprise (SME) segment in Latin America has not received any significant financial support from governments. As a result, bankruptcies are widespread, and unemployment will likely continue to rise. To address these problems, the Inter-American Development Bank should provide advice and technical assistance to governments, particularly on how to rely on their existing public banks for SME support.
- **Reform badly neglected government services.** Many countries in Latin America need to modernize and reform the delivery of government services, which suffered years of neglect before the pandemic. The Bank should work with governments on a realistic reform agenda that takes into account the effects of the ongoing health crisis and the need for gradual fiscal adjustment over the next several years.
- **Fund social protection programs and health systems within fiscal constraints.** The IADB should help countries enhance social protection and provide adequate financing to health systems, particularly the public health systems that several countries in the region have adopted. In view of the rigid fiscal constraints facing most countries, it may be necessary to raise tax revenues to fund these policies after the recession. The Bank should work individually with governments to find solutions that will help them navigate the current crisis without increasing the risk of a future fiscal collapse and should collaborate with other institutions assisting in the region, such as the International Monetary Fund.
- **Plan for added social protection for a future labor market that may not return to the pre-pandemic status quo.** On the social protection front, some countries may need to do more to support informal workers and those who rely solely on daily incomes. Such programs do not need to be very costly: For example, by spending about 1.5 percent of GDP per year, countries like Brazil may be able to provide as much as one

minimum wage per child between 0 and 6 years of age in low-income households. Rising unemployment, and particularly the challenge of long-term unemployment, may require broader insurance mechanisms and programs to qualify part of the affected population for different jobs, especially if labor markets do not go back to the pre-pandemic status quo.

LONG-TERM CHALLENGES

- **Political instability, corruption, and social unrest.** Latin America's economy was already fragile before the pandemic struck, leaving little room for public sector fiscal stimulus. Political systems are largely fragmented, and institutional weakness, particularly widespread corruption, is rampant throughout the region. In late 2019, protests erupted in many countries, driven by widespread discontent over income inequality and lack of social mobility. Chile and Colombia, two countries that had promoted significant reforms over past decades, did not experience a leap forward in productivity growth or social mobility, sparking civil unrest. Reforms in these countries also failed to provide political stability.
- **Corruption and misallocation of resources, particularly with influx of Chinese investment.** China's influence in Latin America will likely continue to grow as countries face the challenges of rebuilding their economies with limited access to financial markets. While Chinese investments are welcome, concerns over transparency and a pileup of new debt in a region mired by corruption will require the Bank's role in advising governments on how best to allocate resources.
- **Reviving relations with the United States.** The United States remains one of the region's main trading partners, but US foreign policy has largely ignored Latin America over the past several administrations. The United States should strengthen relations with governments in the region, particularly in the areas of trade and fighting climate change.

ACTIONABLE TO-DO LIST

The IADB can assist Latin American governments through specific actions:

- Provide governments with advice and technical assistance to help small and medium enterprises avoid bankruptcy.
- Work with governments to develop a reform agenda for badly neglected government services.
- Advise governments on how to avoid future fiscal collapse while funding social protection programs and health systems.
- Advise governments on how best to allocate resources, particularly as Chinese investment and risk of a pileup of new debt grows in the region.



Rebuilding the Global Economy

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MEMORANDUM ON

INTERNATIONAL POLICY ADVICE FOR THE WORLD BANK

To: The President of the World Bank

From: Pinelopi (Penny) Koujianou Goldberg

November 2020

Background: The World Bank has always been a complex institution trying to balance the diverse needs and priorities of its member countries and its shareholders. As the last quarter of 2020 approaches, the World Bank faces global challenges (pandemic, increasing poverty, climate change) amidst a gradually deglobalizing world. Tensions between two of its major shareholders, the United States and China, have cast doubt on the future of global trade and multilateral cooperation. The runup to the 2020 US presidential election has added to this uncertainty, though regardless of the outcome, there does appear to be bipartisan support for turning inward, cutting ties to China, and reshoring economic activities.

The current policy environment in combination with the pandemic—and against the backdrop of rising automation—makes it unlikely that policymakers can rely on the export-led model of growth and development that many international institutions have advocated in the past. The increasing use of robots makes developing countries' traditional comparative advantage in low-skilled manufacturing less relevant, while newly imposed protectionist measures in high-income countries may discourage imports from low-wage countries in the future. With trade and immigration tensions rising, cooperation among member countries and shareholders will become more difficult, making effective decisions even more arduous. Accordingly, it is best to adopt a pragmatic approach prioritizing those issues where progress can be achieved.

PRIORITY 1: Provide country-specific advice on the impact of trade tensions

The trade tensions between the United States and China are forcing many low- and middle-income countries to reach a new understanding of how the new trade climate will affect their economies. They are struggling to figure out what policies would help them reap benefits from the potential reallocation of global trade. The most affected countries are those in Southeast Asia (Vietnam, Thailand, Malaysia, Indonesia) as well as Mexico. Many of these nations have enjoyed a fruitful relationship with the World Bank in the past and would benefit from its advice. The World Bank could play a leading role in developing a research and policy agenda focused on the effects of the trade tensions tailored specifically to these countries.

Pinelopi (Penny) Koujianou Goldberg, nonresident senior fellow at the Peterson Institute for International Economics, is the Elihu Professor of Economics at Yale University. She was chief economist of the World Bank Group between November 2018 and March 2020.

PRIORITY 2: Rethink the World Bank's relationship with China

Some of the biggest successes of the World Bank have been in East Asia, China in particular, where policymakers credit the World Bank for useful advice and guidance and a significant, if only indirect, role in their development. It is unfortunate that the World Bank is caught in the middle of escalating tensions between China and the rest of the world, especially the United States. While managing the relationship with China is tricky, the World Bank must not pull out from the one region where its institutional impact has been consequential in the past. China still seeks engagement with international institutions and is receptive to advice on how to navigate the current tensions. By remaining engaged with China, the World Bank has an opportunity to influence future developments rather than being a frustrated bystander.

Given that China is now an upper-middle-income country, its relationship with the World Bank must be based on something other than lending. The general principle guiding interactions with China should be to push for reforms that are beneficial to both China and the rest of the world. Three specific areas of potentially fruitful engagement should be pursued. The first is climate change. As incomes in China are rising, its citizens are increasingly concerned about the environment, and leadership is interested in implementing policies consistent with the ideal of ecological civilization. The second area is intellectual property rights, where China has realized that further progress and growth require protection of the intellectual property of foreign as well as its own domestic firms. The third area concerns reforms of the social safety net in China, an area where China has sought World Bank advice in the past.

China's *Belt and Road Initiative* (BRI), an ambitious infrastructure investment project throughout the region and beyond, has been a source of contention with the World Bank. Concerns have focused on the sustainability of the projects and the amount of debt incurred by recipient countries. But constant attacks on the BRI by World Bank officials and in research papers are counterproductive and call the World Bank's objectivity into question. Many countries in which BRI-related investments have taken place view them as beneficial to their economies, their rising debt notwithstanding. A more impactful strategy for the World Bank would be to continue pushing for debt transparency while offering countries attractive alternatives to Chinese loans. To this end, it is important to consider investments that are attractive to recipient countries and not just to World Bank shareholders. Driving China out of its role of investing in developing countries without offering a realistic alternative will not work in the long run.

PRIORITY 3: Return to being an advocate for trade

A recent review of World Bank policy briefs and reports for the 2019 *World Development Report* on global value chains revealed that the words "trade policy" have all but disappeared from the advice the World Bank has given to countries in the past 10 years. A constructive starting point would be to acknowledge that open trade and foreign direct investment remain important for growth and poverty reduction, especially in small, low-income countries, and to revitalize the rich research and policy agenda that the World Bank once had in this area.

PRIORITY 4: Broaden the World Bank's role to include facilitating regional integration

A more general and challenging question is how countries should navigate the backlash against multilateralism and the World Bank's role in this process. Independent of the outcome of the US elections, a resurgence of support for multilateralism is unlikely any time soon. A pragmatic alternative is to pursue regional economic integration and—when the necessary conditions are present—potentially also plurilateral agreements spanning multiple regions. Such an approach would require a major change of mindset at the World Bank, but it could be a game changer that increases the World Bank's impact in the developing world.

Despite existing regional trade agreements and regional value chains, many countries remain suspect of trade with neighboring countries, viewing potential trading partners as competitors rather than potential markets. The prevailing thinking in many countries, especially in Southeast Asia, is based on traditional models of comparative advantage emphasizing differences in factor endowments, rather than on modern theories highlighting economies of scale and product differentiation. Put differently, the vision of the role of trade in development seems to look to the recent experience of China, ignoring alternative growth trajectories that were established in EU countries post World War II. Given that a repeat of the Chinese (or, more generally, East Asian) experience is highly unlikely in the present environment, the current mindset needs to change. The World Bank could play an active role in educating countries on the benefits of regional cooperation and integration and in promoting regional trade agreements. This approach would not come easily to the World Bank. The current setup—with country offices and country directors who are rewarded based on the performance of country-specific programs—encourages a focus on countries, not regions. But this focus can be debilitating when one deals with low-income, resource-starved countries.

Regional cooperation could make a big difference in many areas. The African Continental Free Trade Area (AfCFTA) is a step in the right direction, but much more needs to be done. As countries consider regional trade integration, they often perceive tradeoffs—for example, policymakers in Kenya feel they may have to weigh cost and benefits between more trade with the United States versus more trade with their neighbors within the AfCFTA. Advising countries on such issues is imperative. Beyond trade agreements, trade facilitation could lower the costs of crossing borders, which are significant in Africa. The World Bank already has an active program and excellent track record in this area.

Regional cooperation is also required in infrastructure investments to increase connectivity in Africa. Establishing and implementing an effective competition policy is necessary to curtail the market power of local monopolies, particularly in digital initiatives with cross-border implications—for example, spectrum allocation as 3G or 4G networks are rolled out. Individual countries can often make little progress in these areas on their own. They could achieve much more under a regional umbrella.

ACTIONABLE TO-DO LIST:

- Research the effects of US-China trade tensions on specific countries, especially those most affected in Southeast Asia and Mexico.

- Engage with China as more than a lender, specifically provide advice on:
 - » policies relevant to combating climate change,
 - » protecting intellectual property rights,
 - » reforming China's social safety net, and
 - » ensuring greater debt transparency for BRI investments.

- Educate developing countries on the benefits of regional trade agreements and provide advice on how best to weigh perceived costs and benefits of more trade with the United States versus with regional trading partners.



Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

PRIORITIES TO REVITALIZE THE WORLD TRADE ORGANIZATION

To: The Next Director-General of the World Trade Organization
From: Anabel González
November 2020

Background: Of the challenges facing the World Trade Organization (WTO), no priority is more pressing than revitalizing the organization to help counter the COVID-19 pandemic and rebuild the world economy. The WTO needs reform, but a reform agenda should not delay action on these broader health and economic objectives.

As of this writing, the WTO faces an impasse over the selection of its next Director-General. The choice may not be settled soon. But whoever is appointed will need to restore trust in global trade cooperation, bringing the largest players to work together to overcome many intractable disputes. The incoming Director-General should move beyond the traditional broker role to exercise active leadership to shape the discussion and help reach agreements on contentious matters, supported by a strengthened WTO secretariat, more effective coordination with Geneva ambassadors, and dedicated support from a core group of trade ministers.

PRIORITY 1: Promote the positive role of trade in fighting COVID-19 and ensuring resilience in future health crises

Evidence from the first months of the pandemic indicate that global value chains have allowed countries to retain access to diversified sources of medical equipment and thereby strengthen their response capacity. Contrary to a widely accepted view in the early stages of COVID-19, trade is not a problem in the crisis but rather a core element of the solution. Happily, many nations or small groups of countries have taken unilateral steps to facilitate commerce, especially in medical supplies and medicines. The Global Trade Alert reports that while 92 jurisdictions adopted 215 export controls on these goods from early 2020 until mid-October, 106 jurisdictions executed 240 import policy reforms on these products over the same period.

The next Director-General should convene high-level dialogues among governments and other stakeholders on lessons learned, with the help of COVID-19 reports from the WTO secretariat and analytical support from other agencies. A problem this past year has been the failure of WTO members to fully report on pandemic-related measures, including protectionist actions but also positive steps. That shortcoming must be corrected. The WTO should strengthen its monitoring of such actions to ensure information-sharing, analysis,

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and greater discussion by the organization's committees. A working group of international institutions like the World Health Organization and the World Bank could explore future options to provide greater transparency on availability of critical medical supplies, following the example of the Agricultural Market Information System.

PRIORITY 2: Foster a COVID-19-related agreement on medical supplies and vaccines

The Director-General should promote multilateral or large-scale plurilateral efforts to reach a new COVID-19 agreement to liberalize imports, limit the resort to export restrictions, and facilitate the movement of critical medical supplies and medicines. The initiative could draw from some good models on the table, including a European Union conceptual paper in circulation that may soon lead to a formal proposal. The Director-General should also elicit a commitment from members to a standstill on new export curbs and, if possible, a rollback of restrictions previously imposed, many of which affect the world's poorest countries.

The tragedy of vaccine nationalism must be avoided at all costs, with equal distribution guaranteed across countries. The WTO should support the World Health Organization, the World Intellectual Property Organization, and multistakeholder initiatives for the vaccines to reach all, when ready.

PRIORITY 3: Facilitate creation of a lasting solution to the Appellate Body crisis

The WTO Appellate Body has been paralyzed since December 2019 because of a refusal by the United States to fill vacancies on it, depriving the trading system of an effective mechanism to settle trade disputes. A generally accepted dispute resolution process is critical to the functioning of global commerce and investment, as well as to peace and fair treatment of small countries. This stalemate has led to a proliferation of unilateral protectionist measures, further eroding the system. While the European Union, Brazil, China, and others have put in place an interim appeals arrangement to retain a two-step mechanism for conflict resolution among them, it is only a partial and temporary solution.

Amid the negative impact of a dysfunctional system, governments have collectively taken stock of the 25-year experience with the Appellate Body and, with the exception of the United States up to now, have largely coalesced around a list of issues to be clarified by the WTO General Council, such as the completion of appeals within a 90-day requirement or for the Appellate Body members to leave promptly when their term expires. With a Biden administration more inclined than its predecessor toward multilateral engagement, the opportunity to restore an improved WTO dispute settlement function should be seized.

PRIORITY 4: Fast-track negotiations to reach an agreement on digital trade

More than 80 countries are engaged in negotiations on an e-commerce pact, launched in January 2019. The negotiations are complex on the substantive front, with diverging views among large players on issues such as data flows, data localization, data privacy, customs duties and internet taxes, and internet censorship. Reaching agreement will be challenging but even a modest accord could spur global economic recovery. In the absence of a WTO-wide accord, willing members should move forward with a plurilateral agreement among themselves, open to all. The Director-General's leadership could help speed such an accord.

PRIORITY 5: Stimulate a WTO discussion on improved disciplining of subsidies

Before COVID-19, finding a way for US-style market-led capitalism and Chinese-style state-led capitalism to coexist had become one of the most critical challenges facing the WTO. Concerns over whether multilateral rules were adequate to discipline the use of industrial subsidies and restrain their impact on market distortions, overcapacity, and unfair competition led to great tensions in the system. The potential trade impact of the massive fiscal and monetary programs put in place by governments to address the economic fallout from the pandemic adds another complex dimension to this discussion, as does the increase in domestic support for agriculture in a handful of WTO members. If left unaddressed, these issues could become a pervasive problem for global trade.

These are not easy problems to tackle, and a resolution is not expected soon. The Director-General could engage the major trading partners, including the European Union, the United States, China, Japan, and others in such a conversation, especially because many of these countries are the largest subsidizers. Improved notification and transparency, with an added role for the WTO secretariat, working in collaboration with the Organization for Economic Cooperation and Development, could be the starting point.

OTHER PRIORITIES

The priorities laid out above are not the only items on the WTO agenda. Long-overdue negotiations on fisheries subsidies should reach an agreement soon, which could pave the way for the trading system to support enhanced action on the environment. Critical to all is finding a new balance on the contribution of the larger emerging economies to the trading system, in the context of each negotiation. But priorities first. Their successful implementation could also help reinstate the habit of trade cooperation.

SUCCESS REQUIRES A PROACTIVE DIRECTOR-GENERAL

To revitalize the WTO and lay the groundwork for the next ministerial conference, scheduled for mid-2021, the Director-General should reach out to the main players with behind the scenes diplomacy to assess how to bridge gaps among them. A first priority is to build trust in the Director-General's sound judgment and impartiality. In focusing on the larger players, the Director-General should always keep in mind that while serving all WTO members equally, the poorest among them need the good offices of the WTO leadership the most. The next Director-General should listen to them and carry their needs close to her heart.

In navigating this complex environment, a core group of trade ministers could help spearhead the foregoing agenda and bring political energy to the discussions. Reinstating an effective coordination mechanism with ambassadors in Geneva is necessary, with the Director-General meeting and consulting regularly. The WTO secretariat could be further leveraged to support implementation of these priorities.

One point that merits special consideration is the future role of the United States in the WTO. Once the main architect of the system, for the past four years the United States has been a rogue member. Irrespective of the potential merit of some of its concerns, its tactics have severely undermined the organization. As President-elect Joseph R. Biden prepares to assume office on January 20, 2021, part of the challenge will be to smooth over relations while also managing expectations on how much can be achieved.



Rebuilding the Global Economy

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MEMORANDUM ON

STRENGTHENING THE ROLE OF THE INTERNATIONAL MONETARY FUND TO ENHANCE GLOBAL RESILIENCE TO CRISES

To: The Managing Director of the International Monetary Fund
From: José De Gregorio
December 2020

Background: The world rightly expected a series of crises to afflict the emerging-market and developing economies (EMDEs) as a result of the COVID-19 pandemic. This concern seemed inevitable, given the massive capital outflows at the beginning of the crisis. But that has not happened. Since the start of the COVID-19 crisis, the International Monetary Fund (IMF) has swiftly adjusted its financing facilities to face the emergency. The Fund has about \$1 trillion for financial support, of which a quarter has been made available, and it is ready to do more. It has acted properly and in a timely manner given the magnitude of the crisis.

The IMF's policies, along with the macro stimulus undertaken by the advanced economies as well as many EMDEs, and central bank actions successfully prevented crises.¹ Their actions do not remove concerns about financial fragility or the human and economic toll of the pandemic. But the IMF's mission and new emphasis on rapid response with less rigid baggage has been vindicated.

The Fund increased access to its facilities that provide fast financial assistance, such as the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI). Access to the RCF and RFI, without ex post conditionality, has been increased from 50 to 100 percent of an IMF member's quota per year and from 100 to 150 percent on a cumulative basis. Overall limits have also been increased, from 145 to 245 percent of quota per year under the General Resources Account (GRA) and the exceptional access limit under the Poverty Reduction and Growth Trust (PRGT) from 50 percent of quota to 183.33 percent. All of these limits have been increased until April 2021. The Fund also created a new credit facility, the Short-Term Liquidity Line (SLL).

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1 At the end of 2019, the index for credit default swaps (CDS) for EMDEs closed at 174 basis points, at the peak of the turmoil in mid-March 2020 it jumped to 465 basis points, and then has declined to 165 basis points recently. Many EMDEs have tapped international financial markets.

A total of 83 countries have received financial support from the Fund since late March 2020, for a total of \$102 billion.² Most countries (71) have received assistance from the RCF, RFI, or both, with an approved amount of \$30 billion. In contrast, only 3 countries have received approval for about half of resources committed, \$52 billion, through the FCL: Chile, Colombia, and Peru.³ A total of 29 countries, most of which have also received some other emergency financial assistance, have been granted debt service relief from the Catastrophe Containment and Relief Trust for \$250 million in April and for \$237 million in October. Finally, the Fund has extended two Stand-By Arrangements for \$10 billion and two Extended Fund Facilities and made several augmentations to existing programs.

KEY PRIORITIES

PRIORITY 1: Facilitate fiscal expansions with backloaded consolidation

Public finances are under stress, and weaknesses are likely to continue at least through the next year. IMF projections in October indicate the world budget deficit will increase from 3.9 percent of global GDP in 2019 to 12.7 percent of GDP in 2020. The fiscal deficit of EMDEs is forecast to increase from 4.9 percent of EMDE GDP in 2019 to 10.7 percent in 2020. The expected reversion will be gradual, as economies are expected to experience only a partial recovery. Fiscal support will be needed at least for the next couple of years.

In order to avoid undesirable early fiscal consolidation, fiscal adjustments must be backloaded and the Fund must be prepared to increase lending. In this regard, it would be convenient for the Fund to increase access on a cumulative basis to access before its 14th General Review of Quotas of 2016, which was 600 percent of quota, well above the current 435 percent. In addition, for small and low-income countries, access to RFI and RCF could be doubled to 200 percent of quota in a year and 300 percent on a cumulative basis.

There is wide heterogeneity of financial assistance across countries. Moreover, it is remarkable that only a small number of countries has been approved for an FCL, the IMF's largest and more flexible credit facility. This could be because few EMDEs have "strong public fundamentals and institutional policy framework" or because many eligible countries have chosen not to apply for the FCL. Indeed, no country from the Association of Southeast Asian Nations (ASEAN) and major country of emerging Europe has applied for the FCL. However, it cannot be ruled out that some countries may not be interested in applying because of stigma, and for this reason a confidential prequalification process could be implemented for the FCL and SLL or a fast preliminary assessment could be provided. Moreover, as the health crisis prolongs in some EMDEs, the Fund could create a new Pandemic Support Facility, which should provide fiscal and balance of payment support specifically to deal with the health crisis for a period of three years.

Although the Fund has made available a quarter of its firepower to EMDEs, only a tenth has been granted in the first eight months of the COVID-19 crisis. Indeed, this amount is less than what was committed in the first eight months of the global financial crisis. The current availability of private financing and the fact that many countries entered the crisis

² An exchange rate of 1.38 dollars per special drawing right (SDR) has been used to express amounts in US dollars. For details on the IMF response, see [here](#).

³ With respect to the quota, Chile was approved for 10 times its quota. Mexico, not included in the figures above because it was approved in 2019, has the largest amount committed, \$61 billion, five times its quota. No country has made use of the funds from this facility, which provides unlimited access.

with buffers, such as sovereign wealth funds and international reserves, may explain the low demand for borrowing during the current crisis. However, it cannot be ruled out that issues such as stigma and access constraints are preventing some economies from seeking financing. For this reason, the Fund should revise access and qualification mechanisms, as discussed above.

Member economies borrowing from the Fund should have credible medium-term fiscal consolidation programs. The IMF has a dual role with respect to members. First is to provide financial assistance, which it has done efficiently, but more may be needed. However, in terms of fiscal expansions to foster a recovery, emphasis should be on digitalization, fighting climate change, and helping reduce the large increase in poverty that the crisis has generated. Second, the Fund, in the context of surveillance, monitors fiscal developments in borrower countries. EMDEs need to avoid fiscal inertia, but consolidation must wait until economies return to some normality.

This is an opportunity to strengthen the role of the Fund not only in the current crisis but also in the longer term. The increased access to some IMF facilities should be made permanent and not ended in April 2021.

PRIORITY 2: Take three steps to increase global resilience to crises

Increase availability of resources

In terms of resources, it seems the \$1 trillion may be enough firepower under current circumstances. However, a deterioration of financial conditions in EMDEs may require additional resources. Moreover, the crisis will be long, and therefore the Fund should increase its firepower. A new \$1 trillion issue of the Fund's special drawing rights (SDRs) would be desirable.⁴ While SDRs are allocated to member countries according to quotas, a nonproportional allocation could be achieved by creating a common pool overseen by the Fund, to expedite financial support to countries in need. Resources from the IMF provide not only liquidity but also insurance against future constraints on foreign financing.

Provide more debt relief

The IMF also has a global role in the international financial system. The Common Framework for Debt Treatments Beyond the Debt Service Suspension Initiative (DSSI) endorsed by the G20 and the Paris Club is a step forward, however insufficient. The DSSI was designed as debt service postponement for 73 low and lower-middle income countries. In contrast, the Common Framework is debt relief, on a case-by-case basis, which is essential for countries that have become insolvent. Another important advantage of the Common Framework, compared with DSSI, is that it includes the private sector, which implies that the question of whether an autonomous public financial institution should enter DSSI is no longer an issue in the Common Framework and should participate.

The Common Framework should be extended to emerging markets deemed to be insolvent. There are issues of moral hazard in countries that have been fiscally irresponsible. For this reason, an extension to emerging market economies should be for those that have reached insolvency only as a result of the COVID-19 crisis. It is also important to increase private

⁴ A number of policymakers and academics have proposed such an allocation of SDRs, as well as the idea of creating a common pool.

sector involvement to have equitable burden sharing. The IMF should work within the G20 on new initiatives for sovereign debt restructuring. In the meantime, it should also incentivize the use of financial instruments that make public financing of EMDEs more resilient, such as bonds indexed to commodity prices or to GDP or more in general state contingent bonds.

Develop the Integrated Policy Framework

In terms of policy advice the Fund has changed. For example, its views on the benefits of procyclical fiscal policy, exchange rate intervention, and capital controls have been gradually changing, since the aftermath of the Asian financial crisis, to a more realistic approach, recognizing that one size does not fit all.

The Fund has been recently developing an Integrated Policy Framework, which focuses on the optimal combination of policy tools to face volatile capital flows. For this reason, monetary policy and exchange rate flexibility could be complemented with macroprudential measures, capital flows measures, and foreign exchange intervention. This is a valuable exercise, founded in rigorous economic analysis and review of experiences. However, it should not be used to support inconsistent policies or to ignore fiscal sustainability. For example, foreign exchange intervention and capital controls cannot be used for sustaining exchange rate misalignment. It is also necessary to be clear about what is the target for different combination of policies and their implications on external adjustment. Are capital controls aimed at exchange rate competitiveness or capital flows volatility and financial stability? What would happen if all EMDEs tried to stabilize the currency when facing a global depreciation of the dollar? Having a flexible approach to macroeconomic policies is important, however it should start with recognizing the role of fundamentals and the difficulty to reach clear cut general recommendations. In any case, it is a step toward the old view that all problems are fiscal and therefore the solution requires fiscal tightening. This is particularly relevant during global crises.

Uncertainty in the global economy is daunting, particularly given the uncertainty on the health front. So the Fund has to be prepared for these contingencies, act with the speed and flexibility it has already shown in the first year of the crisis, and add building blocks to a safer and more resilient global financial system.



Rebuilding the Global Economy

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MEMORANDUM ON

THE FINANCIAL STABILITY BOARD'S ROLE IN GUARDING AGAINST RISING NONBANK RISKS

From: Patrick Honohan

To: The Chair of the Financial Stability Board

December 2020

Background: Banking having been at the center of the global financial crisis, it is not surprising that the most conspicuous impact of the Financial Stability Board's (FSB) work since then has been in relation to bank capital and bank resolution. But the FSB's charter does *not* limit it to—and does not even emphasize—the banking subsector of finance. The FSB must more energetically guard against nonbank risks that have grown over the past few years and look likely to dominate the next decade. It also needs to deepen its engagement with risks in and from emerging and developing economies, and work to raise its game in information technology–related supervisory dimensions such as big data and cyber risks.

Because microprudential supervision has been designed mainly to protect the payments system and the deposit insurance system, prudential supervision regimes for nonbanks are far less intrusive and comprehensive than those for banks. But on the scale that they operate at present, the activities of large nonbank investment firms threaten financial and economic stability in ways other than imposition of losses on retail creditors.

The financial market panic in March 2020 revealed how much of the sources of financial system stability risk lies outside banking, with the scramble for cash resulting in dysfunction of what are normally thought of as the most liquid and resilient markets of all.

It is wholly unsatisfactory that a bunch of leveraged investment funds should have to be rescued in order to restore order to the most important safe asset market in the global financial system. Their threat to the global commons warrants commensurate regulation and supervision.

KEY PRIORITIES

PRIORITY 1: Rethink the approach to regulating nonbank financial firms

The FSB has not ignored nonbanks, but the experience of March 2020 should hammer home the increasing importance of nonbanks as amplifiers of systemic risk. Tighter regulation of banks, and the persistently low interest rate environment, have resulted in a migration of risk to nonbanks, many of them highly leveraged with venturesome business models that entail maturity mismatches.

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The macroprudential regulatory safety net against systemic macroprudential risks needs to be widened and strengthened. The problem of where to set the boundary between what and who is regulated and who is not is a perennial one that has received some FSB attention but without triggering sufficient international regulatory initiatives.

Runs on near banks are not the only vulnerability that needs to be guarded against. Restrictions on leverage and maturity transformation are among the tools that might be needed, and on an international basis.¹ We are overdue a deep rethink that would result in a more specific and explicit common international framework for ensuring that macroprudential risks outside the banking area—and indeed beyond money market funds and insurance firms—are more effectively regulated and supervised.

PRIORITY 2: Fully engage China and other emerging-market and developing economies

Although it is already more than a decade since the G20² mandated the expansion of the membership of the FSB's precursor organization to include much wider representation beyond the traditional G10+,³ the latter group of countries still tend to dominate the FSB's governance and agenda. At a time of shifting geopolitical power structures, maintaining the overall effectiveness of the FSB will require a new push for inclusiveness. It will be increasingly important to ensure full and active engagement of China and the other emerging-market and developing economies to ensure that its work fully reflects the growing importance of new financial centers from which future crises could emanate.

PRIORITY 3: Plug supervisory gaps in big data (and cyber-risk)

Supervisors need to better understand the ever-changing business models and playbooks of the major market participants in order to ensure that financial stability is not being placed at risk. Better stability-focused market intelligence is needed, both qualitative and quantitative.

This task will demand in particular more collection and assessment of fine-grained “big” data. Technical innovation in the collection and handling of big data is already widely recognized as essential to the future of financial supervision. The official sector is well behind the private sector in this regard, and comparatively little will be achieved if there is not a step change in the degree to which the relevant data can be collected and transmitted across jurisdictions.

An example here is the disappointing take-up of the initiative to assign legal entity identifiers (LEIs). (Strengthening systemic resilience to cyber-attacks is a somewhat related challenge.)

Progress will require careful analytical and legal work as well as practical international cooperation between supervisors at a much faster pace than has yet been achieved.

1 For example, one interesting recent proposal suggests loan-to-value ceilings for institutional real estate investment firms (Munoz, Manuel A. “Institutional real estate investors, leverage, and macroprudential regulation.” *VoxEU*, November 14, 2020).

2 The members of the G20 are Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

3 The G10, established in 1962, is composed of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States, as well as Switzerland, which formally joined in 1983.

PRIORITY 4: Resolve the challenges of international digital currency

Intertwined with the question of improving regulatory access to and management of big data is the design of effective regulation of financial services provided by large technology/information (Big Tech) firms. The proposed Libra/Diem cryptocurrency and the importance of Big Tech firms in China and other emerging markets in providing payments and other financial services point to a potential concentration of market power (built on information as well as capital) in financial services worldwide in future years, presenting risks to the effectiveness as well as the stability of the system.

Partly in response, many central banks are now actively toying with the idea of creating some form of central bank digital currency (and the FSB has contributed to a wave of studies of the potential stability impact of such initiatives). However, the reluctance of central banks to go global with such initiatives indicates that the private sector will retain leadership in low-cost, efficient payments, including cross-border payments.⁴

The private and public initiatives in this area have the potential to destabilize national currencies, particularly in smaller economies. The FSB needs to get ahead of this risk.

TWO THINGS TO GUARD AGAINST

Watch out for side effects on inclusion and developing economies

While stability is its main focus, the FSB must not lose sight of the need to address the risk that measures adopted to promote stability could harm financial inclusion and economic development. It is not that regulations should be looser in low-income countries, but, if they are not to be counterproductive, their technical complexity must not exceed the local capacity to supervise and enforce. Voices from countries with less developed financial systems need to be better heard in standard setting.⁵

Resisting regulatory pushback on “too big to fail”

The failure to implement resolution systems designed to eliminate the problem of financial firms that are “too big to fail” (TBTF) points to a related problem. Admittedly, it does seem to be the case that large banking firms no longer command the same market advantage in funding costs that long reflected investor beliefs that they would be rescued by governments. But it is far from clear that failing large banks will indeed be resolved in a way that protects the public finances. Public authorities in Germany and Italy, for example, worked between 2016 and 2018 to avoid the application of the new European legislation on bank resolution, and public funds were provided to bail out creditors even of failed banks of only moderate size. These actions are not the only indications that the apparent political and technical consensus on the possibility and desirability of ending TBTF formed by 2013 likely requires defending.

⁴ Cf. Peter Bofinger and Thomas Haas. 2020. “CBDC: Can central banks succeed in the marketplace for digital monies?” *CEPR Discussion Paper* 15489.

⁵ Other examples would be the damaging effect on small countries' banking systems of inadequately nuanced anti-money laundering and combating the financing of terrorism (AML/CFT) safeguards.



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MEMORANDUM ON

OVERCOMING CHALLENGES IN BANKING REGULATION AND SUPERVISION AND MONETARY POLICY

To: The General Manager of the Bank for International Settlements
From: Olivier Jeanne
November 2020

Background: Established in 1930 and based in Basel, Switzerland, the Bank for International Settlements (BIS) is “owned” by 63 central banks. Its role is to serve as a counterparty in financial transactions and to facilitate collaboration, research, and analysis promoting stability in the global financial system. The current recession created by the COVID-19 pandemic makes it imperative for the BIS to help its members to overcome the main challenges in banking regulation and supervision and monetary policy.

On the **banking side**, the regulatory reforms that followed the global financial crisis allowed most banking sectors to enter the COVID-19 crisis in good shape. The liquidity stress resulting from the COVID-19 shock was largely contained and governments used banks to provide economic stimulus in emerging-market and developing economies and also in advanced economies in unprecedented ways. Bank credit was supported by various forms of government guarantees, regulatory forbearance, and looser macroprudential policy. Macroprudential policy thus seems to have become a tool in managing demand in the COVID-19 crisis. But a bank solvency shock of unknown size is coming. A macroprudential loosening is not what is called for in expectation of a solvency shock, which raises questions about the appropriate path for macroprudential policy looking forward.

On the **monetary policy side**, the COVID-19 crisis has rung the death knell for monetary policy’s long awaited return to normality. Unconventional monetary policy is no longer the prerogative of advanced economies. For the first time, central banks in emerging-market and developing economies have also resorted to large-scale market interventions. While the pre-COVID-19 debates about unconventional monetary policy will continue and intensify, new questions will arise as to their effects in the emerging-market and developing economies. In a world of low natural rates of interest, more fiscal-monetary cooperation is needed, and the management of high debt-to-GDP ratios will pose further challenges. Political pressures are likely to rise in favor of rolling back central bank independence in all countries.

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KEY PRIORITIES

Against this background, the BIS should focus on the following priorities and initiatives:

- **The BIS must provide advice on how macroprudential authorities can support bank credit now and at the same time generate buffers for the coming solvency shock.** The countries that fail to reconcile these two objectives run the risk of “zombifying” their banks, effectively rendering them insolvent and unable to allocate credit efficiently in the long run. One approach would be to mandate early bank recapitalization based on COVID-19 stress tests that would be frequent enough to phase in recapitalization as the magnitude of the shock becomes clearer. It will be important that higher capital adequacy ratios be achieved through an increase in bank capital rather than a decrease in bank loans.
- The international banking linkages and spillovers are likely to be important given the size and the correlations of the solvency shocks. **The BIS could propose that an international stress test incorporating these spillovers be run under its auspices.** This exercise would also have the advantage of ensuring a minimum standard of information sharing (to which national supervisors may become more reluctant precisely when it is more important).
- The experience of China after the global financial crisis of 2008-10 shows that bank credit stimulus can be associated with the development of undesirable forms of shadow banking, in which nonbank financial intermediaries step in to supply credit throughout the system but without regulatory oversight. **The BIS will need to expand its efforts to track and measure the development of shadow banking among its members.**
- The containment of the liquidity stress in March 2020 should not breed complacency about liquidity risks in the future. The liquidity stress observed so far came primarily from financial market disruptions rather than solvency concerns. Concerns about solvency could lead to liquidity pressures of a different nature and they could become more difficult to contain. **The international stress test proposed above should include a strong liquidity component, in particular for the dollar wholesale funding market.** One question is whether reliance on the wholesale funding market should be prudentially curtailed.

NEGLECTED ISSUE

- **One neglected issue that may require an increasing share of BIS attention is the threat to central bank independence.** There has been an increase in populist pressures to curtail central bank independence, in advanced and emerging-market and developing economies. The case for central bank independence as it was made in the 1970s and 1980s (as a bulwark against inflation) has lost its appeal. However, central bank independence may still be very important for different reasons (think, for example, of the risks of having US Federal Reserve international liquidity provision succumb to nationalist influences). Another relevant issue is the independence of financial regulators, whether inside the central bank or free standing. Central banks should not just lay low and wait for threats to their independence to pass. The case for central bank independence needs to be intellectually reinvigorated, and the BIS is a natural thought leader on this.

ACTIONABLE TO-DO LIST:

- Provide advice on how macroprudential authorities can support bank credit now and at the same time generate buffers for the coming solvency shock.
- Propose an international bank stress test under BIS auspices, which should include a strong liquidity component, in particular for the dollar wholesale funding market.
- Expand efforts to track and measure the development of shadow banking among its members.
- Intellectually reinvigorate the case for central bank independence, which is under threat as populism rises across the globe.



Rebuilding the Global Economy

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MEMORANDUM ON

A THREE-PART STRATEGY TO TAKE THE COMPREHENSIVE AND PROGRESSIVE AGREEMENT FOR TRANS-PACIFIC PARTNERSHIP TO THE NEXT LEVEL

To: Leaders of the Parties to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)

From: Charles D. Lake II

November 2020

EXECUTIVE SUMMARY

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) is a free trade agreement among the countries that had originally negotiated the Trans-Pacific Partnership (TPP) with the United States. While the United States withdrew from the TPP in 2017, the remaining 11 countries negotiated the CPTPP among themselves. They are Canada, Australia, Brunei, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. In the context of the COVID-19 pandemic, US presidential election, and increasing US-China hegemonic competition, CPTPP countries—under Japan’s strong leadership as chair in 2021 and Singapore’s in 2022—have an important and timely opportunity to implement an ambitious three-part strategy:

- **Expand** the agreement’s scope to cover emerging issues such as digital governance, supply chain resilience, and foreign investment reviews.
- **Rebrand** the pact as the “Comprehensive Agreement for International Partnership” or CAIP to appropriately reflect its expanded scope.
- **Engage** a broad group of like-minded, market-oriented countries to join in the effort to establish a new framework with a set of rules approved by all participants as a preferred alternative to the state capitalist model.

The parties to the CPTPP have largely delivered on a regional framework that sets the highest standards. With continued strong leadership from CPTPP 2021 Chair Japan, 2022 Chair Singapore, and other CPTPP governments, the strategy outlined herein will help: (1) address new challenges to maintaining an open global trading system; (2) foster sustainable, balanced, and inclusive global growth in the years ahead, as governments seek to address the long-term damage wrought by COVID-19; (3) fill the gap left by the collapse of the negotiating function of the World Trade Organization (WTO) while creating pressure to reinvigorate it; (4) build consensus around an alternative to China’s state capitalist model; and (5) ensure that CPTPP remains the centerpiece of any future US reengagement and is not supplanted by a wholly new framework.

Charles D. Lake II, chairman and representative director of Aflac Life Insurance Japan Ltd., is a member of the board of directors of the Peterson Institute for International Economics.

KEY PRIORITIES

EXPAND: Bring into CPTPP the best practices for key disciplines, addressing the post-COVID-19 world

CPTPP already incorporates advanced WTO-plus disciplines on state-owned enterprises, e-commerce, and a host of other cutting-edge issues, as well as ambitious gains on industrial, services, and agricultural market access. Yet economic and technological developments have rapidly emerged over the past few years. The challenge now is to build on CPTPP's breakthroughs to ensure that it remains at the forefront of global trade developments. As the WTO shows, failure to continually update an agreement risks a loss of relevance as members and traders look elsewhere for new opportunities.

Digital governance. The best practices emerging from recent accords could inform a new initiative to enhance the norms established by CPTPP. In particular, Japan has been a leader in championing international initiatives to promote high standards of digital governance through its Data Free Flows with Trust (DFFT) concept launched during its G20 presidential year of 2019. CPTPP incorporates principles and rules governing digital trade, and Singapore has taken a leading role to forge subsequent regional and bilateral agreements (Australia-Singapore, Singapore-New-Zealand-Chile digital economy agreements) that have refined and expanded the framework established by CPTPP.

Supply chain resilience. The border closures, quarantines, shutdowns of markets, food production facilities, and key transportation and storage infrastructure, and loss of access to critical drugs, materials, and parts that have resulted from the COVID-19 pandemic dramatically underscore the need to improve the resilience of supply chains and address overreliance on Chinese production. Already, countries have begun efforts that could become building blocks for greater cooperation.

High-level plurilateral approach to investment reviews. Concerted, often state-backed foreign investment by entities of state capitalist countries in strategic sectors is compelling like-minded countries to coordinate their investment screening regimes. A number of countries are increasingly working to enhance coordination and create common standards that incorporate and align recent trends in the United States and its allies.

REBRAND: Rename the pact to reflect a broader than regional, global and thematic scope

To reflect its truly global nature, the agreement should be rebranded with a new name, for example, the "Comprehensive Agreement for International Partnership" or CAIP. A new name would allow participating countries such as the United States to avoid any negative perceptions associated with the Trans-Pacific Partnership or "TPP" and help to promote the initiative as part of recovery efforts to rebuild from the COVID-19 crisis.

ENGAGE: Work to expand the pact to like-minded, market-oriented countries

Opening the pact to more countries that can meet its standards. Consistent with CPTPP's history as an inclusive, open-architecture arrangement, this expansion into the CAIP should not be limited by geography. Eligibility should reflect the membership's common commitment to market principles and recognition that accession to harmonized, high-standard "software" for trade can play a major role in driving shared prosperity, bolstering competitiveness and setting global rules and standards on key issues. Such an inclusive

approach could expand membership, including to fast-growing economies such as India and China, should they demonstrate their readiness to commit to the agreement's disciplines.

The United States potentially open to reengaging. President-elect Joseph Biden has called for a “pause” in trade deals but has also called for reestablishing US leadership in the world and rebuilding US relationships with allies. Getting the United States into a transformed CPTPP—i.e., CAIP—framework is likely to involve US demands for significant changes. It would also require rebuilding congressional support and an extension of Trade Promotion Authority, which expires on July 1, 2021.

CONCLUSION

A strategy to “Expand, Rebrand, Engage” can enable leaders to “make their own luck” by creating opportunities for expanding trade and capitalizing on those opportunities when they emerge.



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MEMORANDUM ON

THE HEALTH AND ECONOMIC CRISIS IN AFRICA

To: The Executive Secretary of the United Nations Economic Commission for Africa (UNECA)

From: Adnan Mazarei

December 2020

Background: Africa faces a significant combination of health and economic crises. The health toll of the COVID-19 pandemic has been lower than in many other regions, but the human cost is significant and will continue to rise. More resources are needed to address the public health needs of the people in many African countries.

In addition, largely as a result of the global pandemic, the continent's already difficult economic conditions are being strained by lower commodity prices, tourism revenues, and remittances. Sub-Saharan economies are projected by the International Monetary Fund (IMF) to contract by 3 percent in 2020. Some of the gains in economic development and living standards made by Africa in recent years could be reversed. Quick steps must be taken to address the pandemic and ease the continent's resource constraints, enabling African policymakers to provide greater fiscal support for health and social goals without further eroding medium-term financial sustainability.

While the situation may differ country by country, the United Nations Economic Commission for Africa (UNECA) could focus on some broad priorities, especially by helping to mobilize international financial support. Given the UNECA's limited mandate and resources, success depends on working together with the continent's other agencies, especially the African Union and the African Development Bank, as well as with the IMF and World Bank.

KEY PRIORITIES

- **PRIORITY 1: Distribute food and vaccines rapidly to fight COVID-19.** Greater emphasis must be placed on fighting the pandemic through strengthening health systems and food security, as well as making sure (including working with global civil society) that poor countries receive a vaccine as soon as available. Getting the vaccines without delay is not only a moral issue but one that effects the bottom line of economic performance and fiscal space. Given debt issues, the longer the pandemic spreads in Africa, the less ability governments have to fight pandemic-induced economic recessions.

Adnan Mazarei, nonresident senior fellow at the Peterson Institute for International Economics, was a deputy director at the International Monetary Fund, where he worked on resolving financial crises in emerging markets.

- **PRIORITY 2: Relax financing constraints for governments.** Many African countries are already in debt distress or at high risk of such distress, especially if capital flows to Africa reverse anew. External financing needs are large: According to the IMF, sub-Saharan Africa may need about \$290 billion in external financing during 2020–23.¹ Absent new external financing, debt standstills, or reduction, countries may have to sacrifice pandemic response or needed public investment to service external debt.

It is therefore first necessary to rapidly assess whether a country's debt is *sustainable or not*. If not, creditors—official and private, in the Paris Club or not—need to participate in debt restructuring. Delaying debt restructurings has proven to be costly. Many African countries have benefitted from participation in the G20 Debt Service Suspension Initiative (DSSI), but several countries have opted out of it, fearing damage to their credit ratings and market access. Also, DSSI will expire at the end of June 2021, well before the crisis will end in even the best case scenario. Efforts are needed to extend DSSI's coverage to vulnerable middle-income African countries and to lengthen the suspension period.

- » The UNECA could, together with the African Union, African Development Bank, and United Nations Development Program, convene private creditors—who have not participated in the DSSI—not only to support the DSSI but also to consider ways for private creditors to encourage the flow of funds to African countries.
- » African countries have been borrowing heavily from China. Pre-pandemic, these resources had contributed to the continent's economic development. China should participate in a multilateral framework to address disruptive debt issues. Although China participates in the DSSI, it does not, as a general rule, offer debt relief within multilateral frameworks, such as the Paris Club. The UNECA also needs to play a greater role in improving the transparency of African countries' debt to China and its terms.
- » There will likely be increased pressure from the United States and other governments to prevent international financial institutions and multilateral development banks' resources from being used to service debt to China and private creditors. That would in turn block needed aid and finance to African countries. So the UNECA has to prevail upon private and Chinese creditors to participate as a priority issue.

- **PRIORITY 3: Mobilize domestic government resources.** Low-income African countries still derive the largest part of their domestic revenues from indirect taxes (and to some extent from tariffs). Designing and implementing an effective value-added tax (VAT) and getting basic administration and compliance issues under control is critical to raising the revenues for inclusive and equitable spending. That said, the focus of world attention in the last few years has been on a process of reforms to international corporate taxation. Low-income countries do stand to benefit from the adoption of international corporate minimum taxes, one of the approaches under international discussion, and they should press for the adoption of such taxes in the Inclusive Framework process.²

1 International Monetary Fund, *Sub-Saharan Africa Regional Economic Outlook*, October 2020.

2 The Inclusive Framework is the 140-country organization, run by the Organization for Economic Cooperation and Development, for developing a new international tax structure.

- **PRIORITY 4: Promote trade and investment in Africa.** To help recover from COVID-19, Africa must attract foreign direct investment and aid, generate employment, and facilitate economic integration. Accordingly, the UNECA should continue to emphasize implementing the African Continental Free Trade Area (AfCFTA), which was agreed in 2018 to create the world's largest free trade area connecting 1.3 billion people in 55 countries. African countries can promote trade facilitation (e.g., through better infrastructure and customs facilities), modernize their regulatory systems, remove barriers to investment and—especially—fight corruption to improve their investment climates and trade opportunities.



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MEMORANDUM ON

RECOMMENDATIONS ON SOVEREIGN DEBT

To: The International Monetary and Financial Committee

From: Peter Orszag

November 2020

Background: In the wake of the COVID-19 pandemic, and despite ample liquidity in most global markets, numerous governments are struggling with debt challenges reflecting not only the current crisis but also the legacy of borrowing during easy global financial conditions over many years. To resolve these restructurings effectively and efficiently, reform rather than revolution is necessary. Six steps would be helpful.

PRIORITY 1: Enhance private sector participation in future short-term debt relief

The International Monetary and Financial Committee (IMFC)¹ should task the International Monetary Fund (IMF) to develop, in coordination with market players and other stakeholders, contingent clauses in debt contracts that trigger an automatic extension or standstill of payments due for a certain time period based on a set of triggers to be defined (and that could involve a declaration from the Fund itself). Governments should be encouraged to issue debts allowing for such standardized conditional short-term relief that would not automatically trigger rating downgrades. Admittedly, this approach is oriented toward future crises more than the current one.

PRIORITY 2: Review the creditor terms set by the IMF itself

The Fund is, more than ever, an anchor for international coordination of all public and private creditors. However, the recent experience in Argentina, which restructured its debts in 2020, highlights a risk that could jeopardize this position: the Fund's own substantial financing role.

It is first worth reviewing whether the interest rate charged by the Fund itself should be reduced in the context of near-zero special drawing right (SDR) interest rates. It is a senior creditor but also receives an interest rate (above 4 percent in current existing programs, slightly below 4 percent in recent new ones) exceeding that of other bondholders post-

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Disclosures: Lazard advises governments in negotiating with public and private sector creditors on debt sustainability issues. Most recently, it advised Argentina and Ecuador in negotiating successful debt restructurings and assisted several countries in benefiting from the G20 supported Debt Service Suspension Initiative (DSSI).

¹ The IMFC is a 24-member board of central bank governors, ministers, or others of comparable rank that advises and reports to the IMF Board of Governors on the supervision and management of the international monetary and financial system.

restructuring. Such elevated margins were intended to make the Fund's exceptional access lending framework less appealing to borrowers, but conditionality associated with this lending already plays a crucial role along that dimension.

In addition, to avoid excessive debt being held on the balance sheet of the Fund, the IMFC should encourage the Fund, beyond certain specified funding quotas, to cofinance a program rather than to finance entirely through its own balance sheet. In such circumstances, the Fund would for example turn to a group of sovereign wealth funds (SWFs) to provide cofinancing.

PRIORITY 3: Develop guidance on value recovery instruments

IMF staff technical assessments of debt sustainability play an essential role in setting the stage for debt restructuring negotiations. A conservative approach towards future economic growth assumptions in the debt sustainability analysis could be combined with contingent securities that pay out if economic activity exceeds the assumed levels. The Fund should provide guidance on various mechanisms for such value recovery instruments (VRIs) to overcome criticisms addressed against various bespoke instruments currently in existence. The VRIs could provide payments to creditors based on certain indicators such as GDP, export levels, commodity prices, and so on.

PRIORITY 4: Promote efficiency in debt negotiations with private creditors

Over recent decades, the IMF has played a key role in promoting a collaborative and efficient participation of private creditors in debt restructurings. Part of that role involves promoting the standardization of collective action clauses (CACs) in debt contracts to limit the ability of litigating creditors to block a restructuring.²

New generation CACs proved efficient in the most recent debt restructurings, protecting debtor countries from the risks associated with holdouts and litigating creditors. But at a time when debt restructurings could become more frequent than in the past, further reforms could prove useful. The IMF should support a lower threshold for so-called single-limb aggregation methods under CACs and also loosen the constraints around the "uniformly applicable condition" when deploying the single-limb method.

PRIORITY 5: Enlarge the Paris Club to include China

For years, the Paris Club of sovereign creditors has been essential to ensuring an efficient coordination of lender countries (most of them from the Organization for Economic Cooperation and Development) and a good coordination with the IMF for the resolution of debt crises. Over the past 20 years, China has emerged as a very large lender to developing countries.

The time has come to integrate China fully into the Paris Club. Such a change would make the debt restructuring process considerably more fluid and effective. While the Paris Club traditionally takes decisions based on consensus, China, as the dominant bilateral creditor, could be promised for a few years that the agreement of a block representing at least a 60 percent share in a debtor country's bilateral debt is required to make decisions.

² Such CACs force an entire class of bondholders to accept a restructuring if a sufficient share of creditors, rather than all, accept the terms.

PRIORITY 6: Update prejudgment interest rates in key jurisdictions

Although under the jurisdiction of local authorities, the interest rate charged on civil litigation matters can materially affect sovereign debt negotiations. For example, many sovereign debt disputes are ultimately subject to New York state law. Since 1981, New York Civil Practice Law and Rules has set the prejudgment interest rate for civil litigation at 9 percent, a rate that today is in material excess of prevailing market interest rates.

Nominal interest rates were much higher in 1981, when the New York rate was set. Tying the prejudgment rate to current market interest rates, as represented by US Treasury yields, would normalize it while allowing for it to track the cost of debt over time. The IMFC should support a market-based interest rate applied to prejudgment disputes about sovereign debt.

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