

R E S T O R I N G

G-8 Leadership of the

World Economy

Recommendations for the Evian Summit from the Shadow G-8

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Letter of Transmittal to the Leaders of the G-8 Member Countries

The report that follows was adopted unanimously by the 20 members of the “shadow G-8” after the group met in Paris on January 8–9, 2003, and updated its views in April 2003 following the conclusion of the war in Iraq. The purpose of the group was to develop proposals for the G-8 summit to be held in France in June 2003. We conveyed our initial report to the G-8 sherpas who are preparing the summit in March 2003 and hereby transmit our final report to the Heads of State and Government that will be meeting in Evian.

This was the fourth annual meeting of the “shadow G-8.” Our initial session was held in Tokyo on April 10–11, 2000, and we presented our first report to Prime Minister Mori, as chairman of the Okinawa summit, on April 12 of that year. We met to discuss the Genoa summit in Turin on January 21–22, 2001, and in Genoa itself on July 1–3 of that year, and shared our thoughts with leaders of the Italian government in Rome (including our member Renato Ruggiero, who was then Foreign Minister of his country) immediately thereafter. We developed our views for the Kananaskis summit in Washington on April 5, 2002. Our group has added seven members since its original meeting and has lost two (Robert Zoellick, who has become the United States Trade Representative, and Heizo Takenaka, who was our original co-chairman and has now become Minister of State for Financial Services, Economic and Fiscal Policy of Japan).

Our “shadow G-8” is based on the premise that recent G-8 summits have not fulfilled their potential. We believe

the summits should reform their methodology and adopt agendas that effectively address the sweeping changes in global economic and security affairs that characterize the early years of the new century. We make no effort to cover the full array of topics that have been included in recent summits but instead attempt to prioritize a short list that deserves strategic attention by the summitters, and were very pleased that last year’s summit in Canada itself adopted that approach.

The “shadow G-8” was initially sponsored by the Nippon Foundation and was supported in 2003 by the Charles Stewart Mott Foundation. It was originally organized by the Tokyo Foundation, then chaired by Professor Heizo Takenaka, and the Institute for International Economics. Its meetings in 2001 were hosted by the Italian Institute of International Affairs and the San Paolo/IMI Bank. The meetings in 2002 were cohosted by the Institute for International Economics and the Canadian Institute of International Affairs. The session in 2003 was arranged by the French Institute of International Relations and supported by the German Marshall Fund of the United States. The full list of participants and a note on the sponsors follow the report.

The “shadow G-8” seeks to assemble a group of distinguished private citizens, from all eight of the summit countries, that have had extensive experience with the issues involved including through their personal involvement with previous summits. Dr. Henry Kissinger, for example, was involved in the first two summits in 1975

and 1976. Renato Ruggiero has been active in seven different summits. A number of our members have functioned as sherpas to help prepare those events. Our group has functioned continuously since early 2000. Its members exchange views frequently on possible items to address in our annual reports and circulate background papers on individual issues.

As noted at the outset, this report was adopted unanimously by the 20 participants in the group. Not every member, of course, necessarily agrees with every word in the document. But we were able to reach a strong consensus on every issue and thereby convey our recommenda-

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tions with a firm sense of conviction that their adoption would significantly promote international prosperity and security.

Our “shadow G-8” hopes that its analyses and proposals will make a useful contribution to a successful summit at Evian. We plan to continue meeting annually in an effort to support future summits as well, including in the United States in 2004. Our group expresses its gratitude to the Institute for International Economics for carrying out the project, to the French Institute for International Relations for cohosting the group in 2003 and to the Charles Stewart Mott Foundation for its generous support of our activities.

Thierry de Montbrial

President

Institut Français des Relations Internationales

Restoring G-8 Leadership of the World Economy

Recommendations for the Evian Summit from the Shadow G-8

OVERVIEW

The sharp disruption of relations among leading G-8 countries, due to the Iraq war and elements of the postwar planning, dramatically emphasizes the need for a successful G-8 summit at Evian in early June. The summit in France will be the first meeting of Heads of State and Government, including those who have clashed sharply over the war, since its conclusion. It is imperative that these leaders convincingly demonstrate their desire to achieve prompt reconciliation among their nations and to resist any temptations toward recrimination. They can do so only by launching new initiatives that demonstrate both their will and their capacity to cooperate effectively.

Economic policy is the obvious choice for such new initiatives. All G-8 economies are performing far short of potential and this report describes numerous areas in which crises could erupt. Moreover, the sharp deterioration in relations among some of the G-8 countries over security and political issues could spill over into the economic domain, intensifying trade frictions and triggering other disruptions that could further jeopardize the economic outlook. The summiteers will obviously have to cooperate on reconstruction in Iraq itself, but they must go beyond this immediate requirement to demonstrate that they can resume effective and credible global leadership.

This report therefore urges the G-8 at Evian to adopt a coordinated strategy for reviving global economic growth.

A coordinated G-8 program could promote more rapid, as well as balanced and thus more sustainable, global growth to replace the excessive reliance on US expansion that has prevailed for almost a decade. Effective G-8 action to strengthen global growth, in addition to cooperation in the reconstruction of Iraq itself, would demonstrate the resolve of the major governments to overcome their disputes over Iraq and thus restore their traditional relationships. Each of the major countries should thus commit to adopt specific new policy measures to address its central economic problems.

Europe should:

- adopt fundamental reform of its labor markets, at both the European Union and national levels, to enhance the mobility of workers and thus the productivity of its overall economy;
- complete the creation of truly unified capital and money markets;
- reform pension systems, to retain necessary benefits for retirees while restoring fiscal prudence;
- take further steps to end barriers to competition;
- amend or reinterpret the Growth and Stability Pact to restore at least a modicum of flexibility to counter cyclical downturns; and
- modify the guidelines of the European Central Bank

to pursue an inflation target of 1 to 3 percent that is both symmetrical (to protect against deflation as well as inflation) and a ceiling that is a bit more relaxed than at present.

Japan should:

- immediately and substantially write off the nonperforming loans in the banking system, and restore the underlying assets to the productive economy, to revive the country's financial health and confidence in its economic future;
- sharply expand the supply of reserves to the financial system, to reverse the current deflationary expectations as soon as possible;
- aggressively and completely deregulate and privatize, particularly in the services sector, to encourage creation of new businesses and employment; and
- enact further short-run fiscal stimulus, with particular emphasis on creating new government safety nets to cushion the inevitable adjustments to the new situation, coupled with clear plans to start reducing the budget deficit and national debt as soon as sustained economic growth is restored.

The United States should:

- avoid any new tax cuts that are not aimed at immediate stimulus;
- freeze the substantial tax cuts that are now scheduled to phase in later in ways that will substantially erode the revenue base of the US Government; and
- cooperate with the other G-7 countries in developing a plan of action to limit any serious damage that might result in the short run from further decline of the exchange rate of the dollar, while at the same time promoting continued constructive correction of the

large international current account imbalances over the next year or so.

With the conclusion of the Iraq war, public attention in all G-8 countries has now refocused on their economies. Most G-8 governments have already launched efforts to enact at least large parts of the needed reforms. Chancellor Schroeder has recently proposed bold changes in German labor laws. France has proposed important reforms in its pension system. Prime Minister Koizumi attempted last fall to win support for fundamental restructuring of the Japanese banking system.

Domestic political hurdles have, however, prevented adoption of such reforms to this point. The critical question is how to overcome those hurdles. The reforms that are needed, as summarized in our report, are well known. The problem for some time has been their implementation rather than their identification.

We believe that the G-8 can play a decisive role in providing an answer. As described in our report, predecessor summits in the late 1970s and mid-1980s devised economic coordination strategies that effectively addressed some of the central global economic problems of those periods. The adoption of *international* economic programs helped summit governments to overcome *internal* opposition to reform by committing all members to make specific contributions to a *global* strategy that was demonstrably in the *national* interest of each. Hence previously intractable domestic resistance to reform, as in the United States with respect to energy deregulation in the late 1970s, could be overcome.

We believe that such a situation exists today. It is critically important for the G-8 governments, especially those that have clashed over Iraq, to demonstrate that they can now work together effectively to achieve important shared purposes, such as restoration of satisfactory global growth. Leaders should be able to forge sufficiently strong domestic support for that critical *security* goal to overcome

entrenched resistance to the changes that are essential to implement the required *economic* programs. The security imperative of restoring traditional ties among the G-8 countries could thus be of critical assistance in enabling their governments to achieve the needed internal reforms and to enhance the performance of their economies.

We thus recommend that the G-8 pursue its security imperative of political reconciliation by adopting a coordinated global growth strategy and, in turn, using that security imperative to promote adoption of that strategy. By doing so, the Evian summit could simultaneously address its two most urgent and critical challenges: restoring effective relationships among its members and boosting both the prospects for the world economy and global confidence in those prospects.

Our report suggests a number of other steps that the summiteers could take that would simultaneously promote political reconciliation and economic progress. Perhaps the most urgent is to provide renewed political impetus to the Doha Round of international trade negotiations, which is faltering badly. The World Trade Organization will hold an important ministerial meeting in Mexico in September that must get the negotiations, and indeed the global trading system as a whole, back on track. Over their entire history of 28 years, the summits have been more successful in promoting global trade liberalization than any other single set of initiatives. The G-8 needs to take a decisive lead in this area once again, especially by agreeing to reduce their overall levels of support for agriculture and by further directing their remaining subsidies in this sector away from trade-distorting price supports toward income supports.

Evian will address a number of other important issues including the international water problem, development in Africa and other poverty-stricken parts of the world, global governance, and the legitimacy of the G-8 itself. We believe that the Heads of State and Government would fail the cardinal test of leadership, however, if they were to ignore the central and critical challenges that face them

in the post-Iraq environment: the imperative of achieving reconciliation after the bitter disputes of the recent months, in a manner that is apparent and credible to the world as a whole, and the urgent requirement to strengthen their individual economies and thus the prospect for the global economy as a whole. We thus urge them to focus on these central themes as they complete their preparations for Evian and conduct the summit itself.

Implementation of such a program at Evian would go far to enable the G-8 to start restoring effective, credible and legitimate leadership of the world economy. Our report documents the substantial deterioration in the performance of G-8 summits in recent years, due mainly to the unwillingness of the members to address problems internal to the group itself as their predecessors did so successfully in earlier years. Indeed, the G-8 countries seem to have adopted a nonaggression pact against each other that has relegated the entire process to impotence. The G-8 itself needs substantial reform and the program we propose for Evian would mark a vitally important step in that direction. We commend it to the summiteers and their sherpas, as they begin the fifth cycle of summits since the institution was created in 1975, in terms of the long-range future of the G-8 itself as well as the need to address the priority challenges of the day.

THE DECLINE OF THE G-8

The Evian summit in June 2003 will begin the fifth cycle of annual conferences of Heads of State and Government since the initial meeting of the group in Rambouillet, also chaired by France, in 1975. It is thus an appropriate time, in considering a course of action for this year's conclave, to step back and assess the evolution of the summit process over this span of almost three decades.

In doing so, we will stress primarily the economic dimensions of the summit process. This is not because

we oppose the inclusion of political issues in that process (though we do note that the entire first cycle of meetings, which witnessed some of the group's greatest successes, was limited to economic concerns). Nor is it because we ignore the inevitable proclivities of Leaders to address the headline issues of the day.

We do so rather because we believe that the current geopolitical uncertainties heighten the need for improved economic performance and policies in the G-8, to strengthen both the capability and the confidence of our countries to respond to the unprecedented security challenges that they face. In particular, any possible military actions may have substantial international economic consequences that need to be managed effectively and cooperatively. We also stress the economic aspects of summitry because we believe it is these aspects of the G-8 process that most urgently require reform. And we acknowledge that economic affairs represent the comparative advantage of our group, most of whose members specialize in that area.

In assessing the current state of the annual summits, particularly in the economic area, our "Shadow G-8" has concluded that the effectiveness of the G-5/7/8 has declined sharply since the group was originally created. There are a few areas in which the summits have continued to make useful decisions, especially in continuing the global momentum toward trade liberalization. But we believe that the overall record is one of substantial decline, which has become exceedingly costly during an era of accelerating globalization when international policy cooperation has become more rather than less essential.

There are two basic reasons for this deterioration of the G-8 process. First, the group no longer seriously addresses the policy shortcomings of *its own* members or seeks to devise effective means of cooperation *within* the group to help remedy those shortcomings. The original G-5 was inspired by two primary ideas: to conduct informal but tough and candid "peer review" of each others' performance and policies, and to fashion cooperative strategies that would produce results that might elude any of the

individual members acting solely on their own. Implementation of those precepts led to the most noteworthy successes of the institution, particularly in the late 1970s and the mid-1980s.

The G-8 now seems to have given up on both of these themes. Far from conducting effective peer reviews, the members seem to have adopted a *nonaggression pact* under which they consciously refrain from criticizing each other—presumably due to a fear that today's critics may themselves be the next to face criticism. The result has been a severe erosion of the utility of the institution in identifying and promoting necessary changes in the economic policies of the individual members.

There are numerous contemporary examples of this problem, as we will discuss below in some detail. Europe must substantially reform both its labor markets and the Stability and Growth Pact, which now requires the adoption of perverse economic policies—for example, tax increases and expenditure cuts in the face of risks of recession. Japan must escape deflation, and eliminate large parts of its banking system to restore financial stability and thus a prospect for growth. The United States must substantially reduce its external deficit, which both drains resources from the rest of the world and poses a constant threat of financial crisis, and avoid the buildup of large new budget deficits. Yet recent summits have virtually ignored these issues, and many others like them, and we are not confident that Evian will address them either.

In addition to ignoring some of the deepest policy problems within the group, the G-8 has apparently given up the idea of attempting to fashion coordinated or even cooperative responses to them. Such programs are not necessary or even appropriate in every year, and can even be counterproductive if constructed poorly or applied ineffectively. But there are clearly periods in which joint policy approaches are demonstrably superior to purely national efforts. Moreover, it is sometimes more feasible for individual countries to adopt painful but essential reforms if other countries are doing so at the same time. This

is especially true if there is in place an ongoing process of “peer pressure” under which each country’s progress will be periodically reviewed by its partners.

Indeed, such international strategies may on occasion be pivotal in enabling reform-minded G-8 governments to overcome domestic political resistance to necessary change. A classic case was President Carter’s use of the economic package agreed at the Bonn summit in 1978, where Germany and Japan committed to expand domestic demand to strengthen the world economy and help reduce the US trade deficit, to successfully persuade the US Congress to begin decontrolling energy prices and thus to accelerate the necessary global adjustment to the oil shocks of that decade. Could a coordinated international package today help Prime Minister Koizumi overcome internal opposition to reform the Japanese financial system? Could such a package help European governments carry through the structural reforms that are so essential to revitalize their economies? Could an international approach help avoid a substantial renewed deterioration in the fiscal position (and thus presumably an even further deterioration in the external financial position) of the United States?

The second fundamental reason for the decline of the G-8 is an inevitable corollary of the first. Having decided to stop addressing the problems and potential for economic performance and policy within the group, the summiteers have taken increasingly to *instructing nonmember countries* on proper courses of action in the rest of the world. To be sure, problems outside the G-8 itself, such as financial crises in Latin America and East Asia or epidemics and famines in Africa, have demanded international attention. Leadership from the G-8 may often be an essential component of resolving such “out of area” problems, including by bringing external pressures to bear (as is currently being attempted, for example, with respect to the NEPAD process in Africa).

But the juxtaposition of these two basic changes in the operation of the G-8—the adoption of a nonaggression pact toward each other alongside an energetic advocacy

of reform by nonmembers—has produced much of the contemporary problem faced by the summits. On the one hand, the failure to improve their own performance and policies makes it much more difficult for the G-8 to promote reform elsewhere. Such leadership must come at least partly by example, especially in the international sphere, and the absence of decisive action by the G-8 itself reduces the prospect for decisive action elsewhere. Moreover, poor G-8 economic performance weakens the entire global economy and produces a far less hospitable environment in which the rest of the world can pursue the changes that are necessary for their own progress.

On the other hand, the apparent unwillingness of the G-8 members to criticize themselves, combined with their revealed proclivity to criticize others, has produced a crisis of legitimacy for the institution. The widespread charge that the G-8 is both undemocratic and hegemonial stems fundamentally from its asking others to do what it is unwilling or unable to do itself. That charge is of course not limited to the G-8 but is leveled at the entire globalization process, of which the G-8 and its key members are the leading symbols, a matter of sufficient gravity that we address it separately in the concluding section of this report as an issue that should be addressed explicitly at Evian.

The result of all this is that the G-8 has come to appear both ineffective and illegitimate, the basic cause of its weakness over the past decade or so. There are two logical ways to remedy this situation, which we believe will continue to render the G-8 largely impotent unless and until it is resolved. One would be for the G-8 to return to its initial approach of candidly addressing its own members’ problems and seeking cooperative strategies for dealing with them. The other is to broaden the membership of the group, to restore its legitimacy by incorporating at least a substantial number of the previously unrepresented countries to which much of the G-8’s attention has been addressed in recent years.

These two strategies can be mutually reinforcing and we will suggest a mix of them. The first emphasizes the

need for policy reform within the G-8 countries themselves, including the role that cooperative or even coordinated strategies can play in achieving these reforms. The second suggests an ongoing dialogue between the G-8 itself and a group of additional countries, that are also very important to the world economy, to which the G-8's recommendations are quite properly addressed but which cannot be expected to respond effectively if they remain outside the process.

Defenders of the G-8 might counter that the group has recently been forced to devote the bulk of its attention to political and security issues, and hence has had little time for these economic topics. Some might argue, moreover, that Heads of State and Government should in fact use their precious few hours together to address just such topics that inevitably rank at the top of the world agenda at any point in time.

We fully agree that the G-8 should address global security and political issues, and have indeed offered numerous suggestions in those areas in our three previous reports. We would note, however, that the substantial erosion of G-8 effectiveness on economic issues began well before the recent explosion of concerns over terrorism, proliferation of weapons of mass destruction, increased conflict in the Middle East and other crises. Indeed, it was thought that the end of the Cold War over a decade ago would enable our governments to devote more attention and more resources to their domestic, including economic, problems. Yet economic performance in much of the G-8, notably Japan and Europe, worsened substantially over the succeeding decade and the failure of the G-8 to respond effectively has become increasingly apparent and increasingly costly.

In addition, we believe that the renewed imperative of security cooperation among the leading industrial powers *heightens* the need for effective G-8 economic cooperation. The pressure to devote increased resources to military budgets increases the need for improved economic performance. The imperative to strengthen poorer parts of the

world economy, including to reduce their susceptibility to terrorists and other destabilizing blandishments, does so as well. The political urgency of displaying G-8 solidarity in the face of threats from outside the group, as surfaced at least temporarily after 9/11 to help achieve the agreement at Doha to launch a new round of multilateral trade negotiations at the WTO, further supports the case for a sharp renewal in G-8 economic activism.

There is finally the traditional concept of comparative advantage. The G-8 can sometimes provide useful support for political cooperation among its members. It is not, however, the proper body to deal with most of the world's security and political issues. Those functions properly and usually fall to the United Nations, to NATO or to other bodies that have been created and developed specifically to address such topics.

By contrast, the G-8 was originally created to deal with international economic issues. It largely limited itself to those topics for its initial seven-year cycle, and had some of its greatest successes during that period. Its members still account for a substantial share of the world economy. Collective action by several of the leading countries is essential to achieve progress in the economic sphere. The G-8 retains both the ability and the legitimacy to exercise effective leadership on global economic matters if it will address those issues seriously and resume its earlier willingness to focus honestly, first and foremost, on the shortcomings and needs within its own membership.

The heightened urgency of political and security issues at present in fact suggests a new strategic role for the G-8. The group should focus intensively on the *economic aspects* of the contemporary security problems. This approach would call for particular emphasis on energy markets and energy security, sharing the costs of the military and especially post-conflict situations, and the global economic growth profile that both heavily affects, and is so heavily affected by, these other variables. For example, any new "Marshall Plan for Iraq," or for the Middle East more broadly, should be worked out and implemented through

intensive G-8 cooperation. The current situation indeed offers huge new opportunities for G-8 cooperation as well as demanding better performance, and thus better economic policies, from all its members.

THE WORLD ECONOMY

The world economy is in tolerable shape. We expect a modest recovery throughout 2003 and 2004, led by a pickup in the United States and continued rapid expansion in China.

At the same time, numerous crises remain possible. Deflation is already evident in two of the world's largest economies, Japan and China (albeit for very different reasons), and could set in elsewhere (perhaps particularly Germany and even the United States) in the near future. Renewed bubbles, e.g., real estate in the United Kingdom or United States, are real if unlikely risks. The Japanese financial system could implode. The orderly decline of the dollar over the past year could accelerate into a hard landing. Renewed currency disruptions in Latin America or elsewhere could imperil global capital markets.

Our main economic concern, however, is that so many countries and indeed entire regions are performing far short of their potentials. Japan's "lost decade" has now extended well beyond ten years. The European Union is performing poorly in terms of both realizing its current growth potential and, even more so, expanding that potential to provide the more buoyant prospects of which it is clearly capable. The economy of Latin America is faltering and is replete with financial crises; it will continue to falter until Brazil, which accounts for half the continent, achieves a decisive turn-around and until stabilization is achieved in several crisis countries. Most of sub-Saharan Africa and much of the Middle East remain mired in stagnation or worse.

Moreover, world growth is badly unbalanced. The United States accounted for 70 percent of G-8 growth in

the second half of the 1990s and has again become the dominant factor as Europe and Japan continue to disappoint. One major result has been an explosion of the external deficit of the United States, rising by about \$100 billion (or 1 percent of GDP) annually in all but one of the past five years. It has now reached over \$500 billion (about 5 percent of GDP) per year, far above all previous records. The net international investment position of the United States has reached a negative level of about \$3 trillion and is rising by 20 to 30 percent annually. The gradual and orderly decline of 5 to 10 percent in the average value of the dollar over the past year, as called for in our last report, will help reduce these imbalances. But faster and more consistent growth in the rest of the world, particularly in the other G-8 countries, must be part of any constructive and lasting remedy to this threat to international financial stability, the open trading system and global prosperity as well as to meet the domestic needs of those countries themselves.

Yet the G-8 has said very little about these issues in recent years, let alone done anything about them. The "finance G-7" of ministers of finance and (usually) central bank governors, which also conducted extremely effective coordination strategies in earlier periods (such as the Plaza Agreement in 1985 to correct the huge international imbalances of that period and the subsequent Louvre Agreement of 1987 to restabilize exchange rates), has done no better recently, undercutting the excuse that sometimes emanates from the summits that "these matters can be left to our top economic officials."

To pursue the strategies that we propose to deal with these problems, the G-8 should keep three basic principles fully in mind. First, *each member needs to address both macroeconomic and microeconomic shortcomings in its current policies*. Japan must reform its banking system and enact structural reforms in many of its uncompetitive (mostly services) sectors, while countering deflation with more effective monetary policies and further short-term fiscal stimulus. Europe must reform its labor and capital markets

while revising the Stability and Growth Pact (and perhaps the *modus operandi* of the European Central Bank). The United States must increase its national savings, including by avoiding renewed deterioration of its long-term budget position, and reform its energy and environmental policies. The G-8 agenda will be incomplete if it ignores either macro or micro issues in any of the major economies.

Second, *the reform agenda must comprise both short-term and long-term measures*. Japan must eliminate deflation in the short run while restoring fiscal prudence for the long run. Europe must avoid tightening fiscal policy in the near future and achieve more flexible labor markets over time. The United States needs an orderly but early correction of its huge external imbalance while ceasing to drain the world of both capital and energy over the more distant future.

Third, *the G-8 must look for new international arrangements that can help the governments of its member countries overcome domestic resistance to the needed policy reforms*. The international rules of the WTO help countries avoid the creation of new trade barriers and, in cases such as China's recent entry to the organization, dramatically promote their liberalization. Even informal agreements, such as those of the G-7 at the Bonn summit in 1978 noted above with respect to US energy policy or the Plaza Agreement of finance ministers in 1985, can have decisive impact. The goal now should be to fashion statements, policy recommendations and joint action programs that will enable the leaders of the G-8 countries to take the steps that they know are needed, and frequently wish to implement, by helping them overcome the entrenched domestic opposition that has prevented timely adoption of these measures to date.

With these principles in mind, we turn to a review of the situation in each of the major G-8 regions. We believe that important policy changes in each are feasible as well as necessary and that the G-8 can play a helpful, sometimes even central, role in galvanizing those actions. The

G-8 strategy will need to include some of the specific policy issues that we address in the next sections of this report, following our discussion of economic policy, and we will pull together a proposed "action program for Evian" in our final paragraphs.

Japan

Japan has experienced a "lost decade" of economic stagnation since its financial bubble burst in the early 1990s, the worst performance of any G-7 country in the postwar period. It is experiencing the first prolonged deflation in an industrialized nation since the 1930s. Its national debt and budget deficits are far higher than those of any other G-7 member. Unemployment and bankruptcies have soared to postwar highs for Japan. The country will probably benefit from the global recovery that is now underway but its longer run outlook remains shaky.

The most important element of the problem is the structural weakness of Japan's banking system. Non-performing loans have reached such a level that respected analysts estimate that fully one half of the banking system is insolvent and that the inevitable recapitalization of the remaining institutions will cost 15 to 20 percent of GDP. Progress in addressing the problem has been very slow and concern is growing, both in Japan and around the world. On some accounts, the situation is in fact getting worse and a major financial crisis—embracing capital flight from Japan and runs on individual banks—could erupt at almost any time.

Underlying these economic difficulties are fundamental political problems in Japan. It has proven extremely difficult to overcome institutional rigidities that block reform of the banking system and other entrenched impediments to restoration of economic progress. Major changes may be needed to create a political system that is more responsive to Japan's fundamental needs. Japan must move quickly and decisively, at all these levels, to begin the necessar-

ily extended and painful process that will rectify its deep current problems and provide a foundation for the renewed economic progress which the country remains fully capable of achieving.

The preceding three paragraphs are repeated verbatim from our report of a year ago. Japan has not erupted into crisis but neither has any fundamental improvement occurred in its dire economic situation. A dynamic new Minister for Financial Services was appointed in late 2002 and Prime Minister Koizumi, to his credit, endorsed the Minister's proposals and sought their adoption. Even the personally popular Prime Minister was unable to win approval of the program, however. Hence Japan continues to "muddle through," with further deterioration in both the banking system and the prospects for ending deflation along with continued severe deterioration of the country's fiscal position.

The agenda for urgent reform in Japan, that should be candidly addressed and pursued by the G-8, is thus quite extensive. The required "creative destruction" will inevitably cause transitional hardships in the country, although a restoration of confidence in the future could also usher in a period of surprisingly high "catch-up growth" that would absorb some of the output gap that has ballooned over the decade of stagnation. *The G-8 should press Japan to adopt the following initiatives:*

- *immediate and substantial write-off of non-performing loans in the banking system and restoration of the underlying assets to the productive economy, to revive the country's financial health and confidence in its economic future (and thus renewed growth in both private investment and consumer spending);*
- *a sharp further expansion in the supply of reserves to the financial system, to reverse the current deflationary expectations as soon as possible;*
- *aggressive and complete deregulation and privatization, particularly in the services sector, to encourage creation of new businesses and employment; and*

- *further short run fiscal stimulus to counter the inevitable additional disruption of the economy from comprehensive banking reform for a year or so, with particular emphasis on creating *new governmental safety nets* to cushion the inevitable adjustments to the new situation, coupled with clear plans to start reducing the budget deficit and national debt as soon as sustained economic growth is restored.*

Europe

Europe is the most perplexing of the three major economic zones. It never fell into absolute recession during the 1990s, unlike Japan or the United States, and we do not expect a recession now. Some of the members of the European Union (particularly smaller countries and those on the periphery) are doing well. The euro has strengthened steadily in the exchange markets over the past year. A number of initial reforms, including in difficult areas such as taxes and pensions, have been adopted.

The overall economic performance of Europe, however, is deeply disappointing. The annual growth of labor productivity for the region as a whole dropped in half over the past decade, as in Japan, while it was doubling in the United States. The weakness was particularly acute in Euroland; countries that have not adopted the euro, notably the United Kingdom, have done better than those that have. The largest countries of the euro zone, especially its former bellwether Germany, have dragged down the entire region. The pending enlargement of EU membership will make its collective decision-making process even more difficult in the years ahead.

At the same time, plans for many of the needed reforms have already been developed and articulated at some length. The EU summit at Lisbon in 2000 endorsed a series of needed structural changes. The Lamfalussy Committee spelled out how to achieve a truly unified financial market. The EU Commission itself has provided numerous blueprints, most recently "to restore the competitiveness

of the Union.” The European Central Bank is engaged in an intensive review of its own policies and practices. Numerous academic studies have suggested reforms of the Stability and Growth Pact. The issue for action is to select from these myriad proposals, prioritize among them, and—most critically as in the other countries—assess how the G-8, and international encouragement and/or pressure, can help overcome the internal resistance to essential changes.

We therefore believe that the G-8 at Evian should candidly discuss the outlook for Europe and seek agreement by the European members of the group to pursue the following reforms:

- *fundamental reform of labor markets*, at both EU and national levels, to enhance the mobility of workers and thus productivity of the overall economy;
- *full adoption and implementation of the Lamfalussy Report*, to complete the creation of truly unified capital and money markets;
- linked to these structural reforms, *amendment or reinterpretation of the Stability and Growth Pact* to focus on national debt positions rather than annual budgets, and on changes in those debt positions over the life of the business cycle rather than in individual years, to restore at least a modicum of flexibility for the use of discretionary national fiscal policy to counter cyclical downturns;
- *modification of the guidelines of the European Central Bank*, to pursue an inflation target of 1 to 3 percent that is symmetrical (with a well-defined floor to protect against deflation as well as a ceiling to protect against inflation) and a ceiling that is a bit more relaxed than at present;
- *further moves to end barriers to competition* (e.g., further liberalization of energy markets) and a significant review of state support for vital public services; and
- *long-term adjustment of pension systems*, retaining necessary benefits for retirees while restoring fiscal prudence in the countries most seriously affected.

The United States

The United States has performed by far the best of the G-8 over the past decade. In particular, productivity growth has increased sharply while it was falling in Europe and Japan.

But the United States has also experienced major problems in recent years. Recovery of the financial markets from the bursting of the stock market bubble may take some time. The corporate governance scandals have weakened consumer and investor confidence. Comparative international results continue to show that America’s primary and secondary education systems require substantial further improvement. Renewed increases in health care expenditures are draining substantial resources from other parts of the economy. The high costs of the legal system have a similar impact.

The main economic policy problem now facing the United States, however, is the renewed deterioration of its budget position. Even allowing for purely cyclical effects, the sharp increases in the deficit over the past two years—and especially the outlook for further increases over the next five to ten years—are alarming. Some increases in government spending for homeland security, and perhaps for national defense, may be unavoidable. Modest tax cuts with immediate impact, to help assure renewed growth, can be justified.

The G-8 at Evian should, however, urge the United States to avoid any new tax cuts that are not aimed at immediate stimulus and to freeze the sizable tax cuts that are now scheduled to phase in over the rest of the decade in ways that will substantially erode the revenue base of the US Government. The expansionary effect of those cuts on the economy, given their structure, is of uncertain merit in any event. They were adopted prior to September 11, 2001, and the movement toward war in Iraq, and simply need to be rescinded in light of all that has occurred since that time.

This fiscal outlook is particularly worrisome because the national savings rate of the United States remains far too low to finance the levels of investment needed to sus-

tain recent productivity growth and economic expansion. The country has therefore depended on huge inflows of foreign capital, which average about \$4 billion every working day (to cover the large *outflow* of US foreign investment as well as the current account deficit). The stability of the US economy, the global financial system and indeed the entire world economy is dependent on a continuation of these flows—or on smooth adjustment of the underlying imbalances.

Macroeconomic Cooperation and Adjustment

We are thus encouraged by the “soft landing” of the exchange rate of the dollar that has begun to occur over the past year, as called for in our report in 2002. However, the smoothness of the adjustment so far appears to be much more a matter of luck than design. Moreover, we suspect that the decline of the dollar to date, which amounts to less than 10 percent on a trade-weighted average basis, has achieved no more than one half of the needed correction. Hence *we continue to recommend that the G-7 Leaders instruct their Ministers of Finance to develop a plan of action to both limit any serious damage that might result in the short run and to promote a constructive correction over the next year or so. (We also recommend that that Finance Ministers be brought back into the G-8 summits, where they played an important role in earlier and more successful periods.)*

We would also repeat our admonition that *no country, least of all a member of the G-8 itself, should intervene in the currency markets to drive exchange rates away from levels required for systemic stability, e.g., by promoting renewed appreciation of the dollar.* Japan has done so with its repeated efforts to “talk down” the yen and even buy dollars directly, despite its being by far the world’s largest creditor country and its continuing to run large and growing current account surpluses.

The sharp increase in US trade deficits in recent years has of course provided an important stimulus to growth in other countries in both the G-8 and around the world.

Hence any substantial reduction in the US deficits, without a corresponding pickup in domestic demand elsewhere, could substantially weaken the world economy. A central element in any constructive long-term correction of the present international imbalances is thus a sharp increase in economic growth in the other parts of the G-8 itself, notably Europe and Japan. The reforms proposed above in the policies of those countries, which are needed primarily to improve the lives of their own people, would therefore also serve an international purpose of the highest priority. *The installation and implementation of a program of constructive international adjustment to the large and growing international imbalances should be a top focus of the G-8 at Evian.*

For such a program to be negotiable for Evian, with full and equitable participation by all G-8 members, it will have to include contributions by individual countries to resolution of some of the other problems that are, or should be, on the group’s agenda. Hence our recommendations for how the G-8 can prepare a package to strengthen the world economy, largely by reinforcing the efforts of those forces within each of the members that seek to change policy in desired directions, must await our discussion of those topics. We turn first to trade, then to energy and environmental issues, then to North-South topics with a particular focus on Africa, and conclude on the overall management of globalization.

TRADE POLICY

Substantial progress has been made on international trade policy over the past couple of years. Led by the strong support of the G-8 at its Genoa summit in 2001, as recommended in our report to that meeting, the membership of the World Trade Organization agreed at Doha in November 2001 to launch an ambitious new set of negotiations to further reduce global barriers to trade and to strengthen the international rules that govern it; they properly agreed to focus the round on the needs of the poorer countries,

and indeed to call the initiative the Doha Development Agenda. In the summer of 2002, President Bush succeeded in obtaining Trade Promotion Authority from the Congress so the United States can now participate meaningfully in the new endeavor. Following another of our recommendations, the United States and the European Union seem to have implemented a *de facto* standstill agreement on any renewed cycle of retaliation and counter-retaliation that could seriously threaten the global trading system.

Historians of the G-5/7/8 process have concluded that its most consistently successful arena for policy initiatives has been international trade. The group was in fact initially created, in large part, to resist the protectionist pressures that were inevitably unleashed by the first oil shock in the early 1970s. Former top trade officials of member countries have testified that the successive rounds of global liberalization in the GATT/WTO would never have occurred without the political impetus provided by the G-5/7/8 summits. The successful recent effort to launch Doha reinforces this stellar record.

The G-8 needs to address trade again at Evian. The most immediate requirement is to infuse renewed vigor in the Doha process, which already shows signs of faltering as deadlines for advancing key components of the negotiations are missed. In particular, there are worrisome indications that G-8 countries are failing to meet legitimate concerns of developing nations to the extent that the latter could withhold cooperation from the initiative and thus condemn it to irrelevance or even failure.

Even more seriously, there are signs of significant erosion of open markets within the G-8 itself. Major disputes, on issues ranging from agricultural trade through steel to export subsidies, threaten renewed conflict between the United States and a number of its trading partners, especially the European Union. Subsidies on agriculture remain high within all G-8 countries and have even increased recently in some, including the United States. Renewal of the momentum toward liberalization remains the best defense against these protectionist relapses. In addition, the explo-

sion of regional and bilateral free trade agreements, where Japan and the United States are now following the earlier initiatives of the European Union, raise questions about the primacy and even the future of the multilateral trading system that the G-8 countries themselves have worked so hard to build and sustain over the past half century.

The most urgent target of a new G-8 effort should be the upcoming ministerial meeting of the WTO at Cancún in September 2003. This "midterm ministerial" could play a critical role in restoring momentum to the entire Doha process. It must impart substantial impetus to that process if the round is to have a chance to be concluded successfully by the agreed target at the end of 2004, or even at a later date if political realities force a delay. In particular, several decisions must be made at Cancún to respond to the legitimate needs of the dozens of developing countries whose active participation in the round is extremely important for both economic and political reasons.

We therefore recommend that the G-8 agree at Evian to make the following offers at Cancún, conditional of course on acceptance by the developing countries of appropriate obligations on their own part to contribute meaningfully to a successful final package for the Doha round:

- *a major contribution, of both money and human resources, to building the capacity of the developing nations both to participate in the round itself and to implement its agreed outcomes, to avoid replication of the widespread view in those countries that they were unable to bargain effectively in the Uruguay Round and are even today unable to fulfill some of the obligations they accepted in it;*
- *agreement that the poorer countries can import as well as produce generic drugs to help counter the ravages of a wider range of diseases than already agreed, notwithstanding the strictures of the TRIPS accord in the Uruguay Round; and*
- *acceptance of considerably longer timetables for implementation of components of the Doha liberalization package*

by the poorer countries, as a much more constructive resolution of the dispute over “special and differential treatment” for those nations than exempting them from the liberalization obligations themselves.

There are two other trade policy issues that the G-8 Leaders should address for Cancún. One is agriculture, which has traditionally been the most difficult component of major multilateral negotiations. As noted above, it has recently been moving in the wrong direction once again. It is the most crucial area of trade relations for some developing countries, many of which could become major exporters in the absence of the large and rising subsidies of their much richer competitors. This may be a policy area where international agreement, and even external pressure, can be particularly helpful in pushing national policies in constructive directions—both within the G-8 itself and in some other key countries.

There are two steps that the Leaders should start addressing that would be of central importance in resolving the crucial problems of global agricultural conflict: reducing their overall levels of support for agriculture, and further redirecting their remaining subsidies away from price supports toward income supports. It will inevitably take time to translate such preliminary conversations into substantive policy changes, and this is indeed the main reason why the conclusion of the Doha round may be delayed beyond its target date. It is imperative that the effort begin at Evian, however, to offer a prospect for credible inclusion of the agricultural issue in the final Doha package—which will be a make-or-break item for numerous developing countries and other participants in the negotiation.

The other trade issue for the Leaders to address at Evian is regionalism. Over two hundred bilateral and regional trade deals have been agreed and many more, including among large trading countries such as the United States and Australia or Japan and Mexico, are now being negotiated. Indeed, well over half of world trade is now covered by these pacts and that number will rise sharply if megare-

gional negotiations, as for a Free Trade Area of the Americas and deals between the European Union and Mercosur and between China and ASEAN, are successful.

Throughout the past fifty years, regional and global trade liberalization have proceeded in tandem. Indeed, the two paths to the reduction of barriers have often reinforced and even catalyzed each other. However, the current explosion of new FTAs and the problems described above in effectively pursuing the multilateral Doha negotiations provide a strong reminder that the former could impede, or even derail, the latter.

Hence there is, again, a need for G-8 Leaders to face the issues candidly and *reaffirm their commitment to give priority to the multilateral system, seeing any regional and bilateral agreements they pursue in that broader context and making sure that they structure those agreements in ways that are compatible with their global obligations.* In addition, the Leaders should agree that any free trade agreements that they conclude will be comprehensive in scope, including agriculture, to assure their conformity with the WTO. They should also instruct their trade ministers to devise the most effective methods available, including possible amendments to the charter, to substantially strengthen the WTO rules that govern regional and bilateral agreements in order to insure that they do not deviate importantly from the goals and precepts of the multilateral system. These techniques should then be pursued as either an integral component of the Doha round itself or independently.

The most dramatic step that the G-8 Leaders could take at Evian, to underline their commitments both to the success of the Doha round and to the superiority of the multilateral trading system in the global trade hierarchy, would be an agreement to eliminate all of their tariffs on industrial products by a date certain (perhaps 2015 or 2020) if the rest of the WTO membership was willing to do so (perhaps with a longer phase-in period for the poorer countries). In addition to the traditional economic merits of liberalization, such a commitment would signal the elimination of all preferential tariff arrangements over the same timetable by the simple expedient of eliminating all tariffs on a global basis.

Proposals to this end have already been tabled in the Doha negotiations and we urge the Leaders to endorse them at Evian.

There are thus three specific initiatives that the sum-iteers should take at Evian in the area of trade policy: a package of measures to respond to the legitimate needs of developing countries within the context of the Doha round, commencement of reforms to reduce the adverse impact of current agricultural policies on world trade (and especially on developing countries), and initiation of steps to assure the continued compatibility of regional/bilateral agreements with the multilateral trading system, including the ultimate elimination of all tariffs.

ENERGY SECURITY AND THE GLOBAL ENVIRONMENT

International Energy Security

Following a sharp increase in crude oil prices in 1999; the ability of OPEC countries (with help from key non-OPEC exporters) to defend historically high prices (around \$25/barrel) through the years 2000 to 2002; the September 11, 2001, events and their aftermath in international and especially Middle East politics; and especially the conflict in Iraq; energy security is back on the agenda. It is now widely recognized that there is no sensible alternative, for any major importer, to trading oil with foreign partners. Even for the United States, which still has much larger reserves than other large importers, there is little scope for cost-effective reduction in the rise of oil imports (let alone a reduction in absolute levels of imports). Moreover, even if possible, the reduction of so-called "oil dependence" would not make sense in a globally integrated oil market.

In this context, there are two dimensions to international energy security, apart from military protection of unstable exporting regions: 1) defense against short-term

"shocks" and 2) access of exploration and development capital to world energy resources. Each of these should be addressed by the G-8.

First, the G-8 should strengthen emergency oil stockpiles. Stockpiles are the only available tool to deal with severe short-term supply shortages, whatever their origins. There are two problems that could be remedied to improve international energy security.

One is that the emerging market economies generally lack emergency stockpiles. These economies account for a growing share of global petroleum demand and would suffer substantially in case of a severe oil "shock." As oil security is clearly a public good, *OECD countries should support financially the building of such stocks. The proposal of the Bush administration that emerging countries could lease spare capacity in the US Strategic Petroleum Reserve* also deserves attention.

The second problem is that existing strategic stocks lack a clear doctrine for utilization. There are many reasons for that, some of them quite good. For example, governments want to keep their hands off price management, which would be both very costly and bound to fail. (The EU proposal of building a Commission-controlled strategic stock dedicated to counter-cyclical intervention makes little sense, has been sharply criticized by the vast majority of industry and academic experts consulted, and should be abandoned.) A practical solution, long advocated by economists but never implemented, consists in *treating strategic stocks as a publicly provided source of supplementary supply that the private sector can bid for through options contracts.*

Second, the G-8 should consider ways to strengthen the legal regime for international energy investment. A great deal has been done in this area over the last 15 years. More is needed, however, as most of the energy-rich regions are plagued with defective governance and especially defective security for investments, which especially hinders the flow of foreign investments. The United States favors bilateral approaches as well as a regional scheme that would be part of the Free Trade Area of the Americas (FTAA).

The Energy Charter Treaty (ECT), the only multilateral energy-specific international legal instrument, already has 50 parties and perhaps more in the near future. The United States, by far the largest “exporter of energy capital,” has not signed it. *The G-8 should endorse the Energy Charter Treaty process and encourage its enlargement to both new capital-importing and capital-exporting countries.*

Climate Change and Global Environment

Especially in the wake of the U.S. decision not to ratify the Kyoto protocol in 2001, climate change has become a major subject of disagreement within the G-8. In March 2002, the US government unveiled an alternative strategy. Under that plan, the United States commits to reduce the greenhouse gases (GHG) emissions intensity of its economy by 18 percent over 10 years. This objective would be attained through essentially voluntary measures.

Most observers agree that this is a “wait and see” position rather than an aggressive plan to reduce GHG emissions. “Business as usual” projections show a 14 percent decrease of emissions intensity by 2012, which suggests that the Bush administration’s target requires merely a continuation of the historical decline in the energy intensity of the American economy plus a modest effort. In any case, absolute emissions will continue to grow; under the assumptions used by the administration, US emissions would rise by 14 percent between 2002 and 2012. (The target agreed upon by the United States under the Kyoto protocol was minus 7 percent between 1990 and 2010.)

The US rejection of Kyoto reflects *inter alia* a deeply rooted allergy toward the idea of quantitative mandatory commitments enforced at the international level—a view not limited to the current administration. It would be hopeless and counterproductive to suggest that the United States should return to the protocol. But *the G-8 Leaders should encourage the United States*—the largest single emitter of GHG, one of the highest per capita emitters, and one of the richest economies in the world—to *adopt a more radi-*

cal approach to combating climate change. Russia should also be encouraged to sign the Kyoto protocol.

The Bush administration strategy includes a substantial financial effort in R&D, including in low-carbon technologies like renewable energy and carbon sequestration technologies. Technological breakthroughs in the energy and transportation sectors will clearly be needed to tackle effectively this global problem. Hence *the “Kyoto countries,” especially Europe and Japan, should endorse more aggressively the R&D effort led by the United States and contribute more to it themselves.* But both the development and the commercialization of new technologies require a strong and lasting price signal: each ton of carbon emitted should be priced to guide the choices of economic agents.

The U.S. stance is not the only problem. Developing countries, especially the bigger ones, will account for most of the growth in emissions in the coming decades. They have made clear, however, that they will not accept constraints on their economic growth potential to deal with an issue that the rich countries’ economic growth has created over the past century. Beyond Kyoto, *new approaches are therefore needed to engage the developing world in the global effort to reduce GHG emissions. Possible avenues include rethinking emissions targets; supporting low-carbon technology transfers; greening development assistance; and creating incentives to adopt the least carbon-intensive growth path.*

Climate change is only one of many global environmental problems that will require stronger international regimes. We suggested the *creation of a Global Environmental Organization* in our 2001 report. We continue to believe that this would be an appropriate means of strengthening the governance of the world’s environment and suggest that G-8 discussion of such a new structure would be useful.

NORTH-SOUTH ISSUES

Underdevelopment remains a major challenge to be faced by the G-8. Persistent political instability, together with sit-

uations of extreme poverty in several parts of the developing world, pose a serious threat to global stability as they may lead to the emergence of vast zones of lawlessness and undermine the stability of the international system. The ongoing debate about the new aid architecture, and the ways to make development assistance more effective, should thus continue to rank high on the G-8 agenda.

A number of commitments have been taken since 2000, notably the Millennium Development Goals (MDGs) and an increase of official development assistance (ODA). The G-8 should monitor these efforts and assess remaining difficulties in meeting them. Beyond renewing commitments to the MDGs, however, it is time to take concrete steps in this direction. In this respect, a comprehensive approach to development assistance should be favored that involves a systematic assessment of the impact of industrial countries' policies, in particular trade policies, on the poorer countries. New initiatives should be launched to meet the MDG relating to access to safe water, along the lines of the proposals of the World Panel on Water Infrastructure Financing chaired by former IMF Managing Director Michel Camdessus. The G-8 Leaders should also launch initiatives in two important areas: debt relief and support to the NEPAD.

Debt Relief

Debt remains a major burden for many developing countries. The HIPC initiative, jointly launched by the IMF and the World Bank in 1996, was intended to be a comprehensive solution to unsustainable debt with an emphasis on multilateral debt. The initial HIPC initiative was modified in 1999, under public pressure, to make it more effective and to place debt relief within an overall framework of poverty reduction.

While there is a widely held consensus on the rationale for debt relief for the highly indebted least advanced countries, the problem is how to make the HIPC initiative more efficient, in particular with a view to reducing poverty.

There is clear evidence that even the enhanced framework does not satisfactorily address the problems of the poorest countries; for example, it is perfectly possible for a country to receive a reduction in its stock of debt and yet to experience an increase in its average external debt service. A further issue relates to the conditions for HIPC eligibility, which exclude a number of middle-income economies from the scheme.

Despite the shortcomings of the HIPC initiative, the most realistic approach is probably to support improvements in the enhanced framework rather than call for a replacement of the current plan. We would repeat four suggestions made in our report a year ago:

- *limit the annual debt service of any qualified HIPC to 2 percent of its GDP;*
- *expand coverage to all poor countries, including several larger ones (especially Indonesia, Nigeria and Pakistan);*
- *create a contingency fund that would safeguard HIPC debt servicing capabilities from natural disasters and changes in eligible countries' export prices; and*
- *fund relief of debts to the IMF and some of these other costs, especially the contingency fund, by using up to \$10 billion of IMF gold.*

In addition, the G-8 should agree that HIPC debt relief will not be deducted from traditional development assistance (from both bilateral and multilateral donors). The additionality principle should be forcefully implemented.

NEPAD

The pursuit of development goals is of course not the exclusive responsibility of rich countries. It implies crucial efforts at good governance from developing countries, as recognized in the NEPAD initiative. As already underscored in our report of last year, this initiative, launched by African countries themselves for the first time in history,

should receive strong but not unconditional support from the G-8.

The NEPAD is already facing enormous difficulties, making the scheme extremely fragile. Recent developments in Africa necessarily raise doubts about its chances of success. The situations in Zimbabwe and in Côte d'Ivoire, and the lack of constructive reactions on the part of neighboring countries, suggest that the prospects for the implementation of good governance and sound economic policies are rather bleak and that the effectiveness of peer pressure is badly wanting. African solidarity with President Mugabe is clearly incompatible with the NEPAD commitment to critical self-evaluation and should be forcefully denounced.

Neither is a traditional conditionality approach appropriate in this case, however, since progress in good governance will necessarily be very slow. Yet it should also be a task of the G-8 to exert the necessary pressure on African governments to make sure that their commitments to good governance and sound economic policies can be made a reality.

A central set of issues relates to governance principles regarding natural resource revenues. Looting and corruption are major sources of instability, conflicts and poor economic performance. Transparency in reporting revenues, and flows of payments and expenses, are necessary. They involve multinationals as well as host governments. The G-8 should endorse the quest for good practices in that area and recommend practical steps to implement them, either on a voluntary or a compulsory basis.

Recommendations toward good governance should come within a package in which developing countries' commitments receive adequate support and incentives through donor countries' readiness to help. A major contribution to the NEPAD could be to help African countries meet their own objectives in terms of good governance by suggesting good principles, including the organization of peer review, and using them as a basis to guide the donor-recipient partnership that is called for by NEPAD.

THE MANAGEMENT OF GLOBALIZATION

Globalization and Domestic Policies in the G-8

This report has discussed a number of aspects of globalization: world economic growth and stability, trade policy, energy and the environment, development and the poorer countries. It has suggested that the G-8 could, and should, play a much more effective and much more legitimate role in addressing all these problems. It proposes a sharp reform in the management, or at least the steering, of the globalization process by the world's largest countries—those with the greatest responsibility for promoting global stability and progress.

There are widespread perceptions, however, that the process of global integration is both outside control by responsible authorities and unfair to the poor. This message, which has been widely repeated especially since the late 1990s, has received even more credibility after the bursting of the bubble of the New Economy and the doubts raised about corporate governance in various countries. The perceptions are largely based on flawed arguments but governments also have a responsibility for failing to effectively counter their spread. In order to counter the distrust of globalization in the general population, *governments from the G-8 should deliver a much clearer message about their assessment of globalization and design more adequate policies to both address the challenges of increased global competition and to achieve a wider spread of the benefits of globalization.*

The message about globalization and the associated technological trends needs to be refined, and to be made more explicit and credible. There are benefits and costs, winners and losers, unambiguous effects and more uncertain implications. As a result, the doubts and opposition to globalization cannot be addressed simply through brandishing an ideological conviction without due regard to adjustment problems and to major issues of impact of poverty.

In addition, many analyses have underlined the techno-economic dynamics of globalization and governments have often reinforced the perception that globalization is a compelling trend that is out of their control. International markets and globalization have indeed often become easy scapegoats for governments looking to excuse their own failures or shortcomings. The G-8 has sometimes contributed to the problem by suggesting that it, and its member governments, are impotent in the face of global capital flows.

The G-8 can play an important role in countering this perverse perception by giving a lucid interpretation of the process of globalization and by explaining the enduring role of national governments. In order to do so, however, governments must realize in practice their capability to conduct relevant policies to adapt to the acceleration of change which is brought by globalization and innovation. Improved economic growth and financial stability, particularly if achieved through coordinated G-8 approaches as suggested above, could help considerably in this regard. These principles may also be illustrated by two crucial sets of issues on the G-8 agenda, poverty reduction and corporate governance. In both areas, rich countries can conduct much more effective policies simply by bringing their practices more closely in line with what they preach.

Poverty Reduction

Since the 1980s, a number of developing countries, in particular China and India, but also more recently smaller poor countries such as Vietnam, have been experiencing sustained growth and rising living standards. At the global level, these remarkable experiences have resulted in a substantial reduction in absolute poverty and lower inequalities between the populations of developing countries and populations of richer countries. Results based on the observation of life expectancy and malnutrition also show that the situation of hundreds of millions of poor people has become less difficult over the last decades.

These positive results are unevenly spread among poor countries, however, and absolute poverty is now more concentrated in Africa. The situation there is worsening, and life expectancy is falling in the countries stricken by AIDS. These facts, along with the increasing demand for equality in the context of globalization, should nevertheless not make us forget the positive dynamics of the process. The G-8 should fully acknowledge these dynamics and recommend adequate policies to leverage the potential of globalization for development.

International policies towards global poverty, including in particular debt relief and aid, are addressed above in the North-South section of this report. *Domestic* policies in rich countries can also contribute by reducing protectionism, which hampers exports from poor countries, especially in agriculture and textiles. Trade issues which are being discussed as part of the Doha development round are also addressed above but it is important to underscore the role of domestic policies in facilitating liberalization.

Increased trade with developing countries has had a modest but noticeable impact on low-skilled workers in rich countries. As a result, improved efforts in terms of education and training in these countries will both increase opportunities for poor countries and promote upward mobility for low-skilled workers in rich countries themselves.

Governments should also strengthen their labor markets and welfare systems to address the specific situation of low skilled workers and the possible consequences of liberalization of certain sectors. In some countries, this may require stronger social protection, while in others a generally strong system may not adequately address the specific problems faced by the low skilled. In Europe, in particular, policies promoting professional mobility would both address the issue of unemployment and promote innovation, two of the major goals set by governments at the EU level.

G-8 domestic policies should—and can—aim at both national and international solidarity. In recent years, some

of the domestic policies of the G-8 countries have been quite unfavorable to poor countries. This has reinforced the sentiment that globalization was unfair. *Hence G-8 countries need to re-examine their domestic policies, especially with respect to education/training and safety net programs, with their international obligations—and particularly the legitimacy of globalization—very much in mind.*

Corporate Governance and Regulatory Convergence

The current confidence crisis generated by the bursting of the bubble and corporate scandals should be interpreted in the longer-term context of the increased role of financial markets in the world economy. Since the late 1980s, many countries, in particular the United States, Japan and the EU, have experienced a gradual movement away from banks and other institutional means of mobilizing savings toward securities traded in financial markets. In all three regions, markets have been gradually replacing traditional institutions as the centerpiece of finance. This movement has developed in countries with different corporate governance systems, like the so-called *shareholder* and *stakeholder* models, without generating convergence towards a single model. Different kinds of governance have proved compatible with various combinations of institutional and market-based finance.

The increased role of financial markets nevertheless adds to the need for sound corporate governance and disclosure rules. This is why efforts to strengthen corporate governance have taken place in different countries, in Europe in particular, before the corporate disclosure scandals that surfaced in the United States in 2002. After the recent scandals in the United States, and doubts raised about a number of companies in Europe, corporate governance has now become a major object of attention throughout the G-8. It is all the more important to tackle these issues seri-

ously as rich countries, financial leaders and international organizations had been criticizing poor accounting and lax corporate governance as major culprits in the Asian crisis in the late 1990s.

As is often the case, relevant regulations are mainly domestic in scope. *The role for the G-8 is mainly to underscore the importance of sound governance rules and practices for the effective functioning of market economies.* The G-8 should thus support the efforts by all countries to strengthen their domestic rules, which should take fully into account the recent events and correspond to the needs of modern economies with sophisticated financial markets, and where innovation drives competition. In such economies, the balance between incentives to innovate and security becomes more difficult to strike, as illustrated by the new economy bubble and its aftermath. Three basic issues may be underscored in this perspective: effective oversight of the CEO, reliable financial reporting and sound compensation practices.

The recent experience of rich countries suggests that professional rules have failed in a number of cases and that there is a role for new legislation in this context. The United States, where the business community as well as the government have long been advocates of maximum self regulation, passed the Sarbanes-Oxley Act in 2002, which, along with other reforms under way, represents a remarkable expansion of the regulation of corporate governance, disclosure, reporting and accounting requirements and penalties. Other countries and the EU are also considering new legal frameworks, which are considered necessary to restore confidence and further expansion of capital markets on a sound basis.

The G-8 should strongly support the completion of these reforms and their effective implementation. The latter depends on the efficiency of regulatory authorities, which should be given greater strength and means to control the contemporary complex financial markets. In Europe, the required

evolution toward better disclosure rules and more efficient regulation would be eased by the completion of the single financial market.

Besides this emphasis on national and regional efforts, the G-8 should consider the international aspects of corporate governance and related rules on disclosure and accounting. A major issue is accounting standards because investors increasingly need to compare financial performance of firms in different countries. The movement toward a single global capital market would ideally call for harmonized accounting standards at the world level. *Hence the G-8 should agree to support the efforts of the International Accounting Standards Board to reach a consensus on clearly defined, sensible and practicable accounting principles, and should direct their Ministers of Finance to seriously consider the creation of an international body to monitor compliance with them.*

The G-8 and Global Leadership

In recent years, the legitimacy of the global governance regime has been questioned in many quarters. Much has been said, for example, about the “non-democratic” character of the international economic institutions with a focus on the WTO, the World Bank and the IMF. As a consequence, these institutions have made efforts to become more open to NGOs and to take care of the specific problems that representatives from the poor countries face to participate fully in their meetings and negotiations. The G-8 should recognize the growing role of civil society in the building up of global governance and encourage the search for innovative mechanisms aimed at introducing the voice of representative groups into policy deliberations, particularly in the multilateral institutions.

A related issue is the role of global summits in the provision of leadership and the definition of the group of Leaders who participate in these summits. Collective action is necessary both to avoid damaging beggar-thy-neighbor policies and to provide for global collective

goods such as peace and stability, rules-based frameworks for international trade and finance, and environmental preservation.

The G-8 has contributed to the building up of more collective action since the 1970s but faces a crucial dilemma in the context of globalization. Collective action between more than 150 countries cannot be organized without a smaller group providing guidance and leadership. Given its weight in world economic, financial and military affairs, the G-8 is the obvious locus to do so and has technical legitimacy. At the same time, the G-8 represents the interests of the largest and richest countries, and will not appear politically legitimate to other countries or to civil society groups. This is compounded with the growing perception around the world that G-8 governments are failing to reach cooperative solutions to some of the world’s most pressing economic, social, and environmental problems—especially by failing to deal with major problems within their own borders, as stressed at the outset of this report.

The answer to this issue of leadership, and the need to build consensus among a relatively large group of countries, can be twofold. First, the G-8 should focus on generating collective action among its own members to deal with problems internal to the group, as laid out in the previous section on the world economy. Second, on broader global issues, the G-8 should aim at providing impulses and building effective coalitions rather than at imposing the preferences of its member countries. This should prove less difficult if the G-8 has fruitful consultations with a number of developing countries, including the poorest. In this perspective, the G-8 could seek broader participation in its own meetings in order to anchor its political leadership in a more legitimate structure.

Since 2000, host countries of the G-8 meetings have in fact tried different ad hoc mechanisms for consulting the leaders of some developing countries. These exercises have had to deal with the central issue of the selection criteria to choose the countries which should be included, an issue

addressed in the 2001 edition of this group's report to the Leaders of the G-8 member countries. There we suggested the criterion of "systemic significance" for inclusion in the process and noted that this principle is used to organize the G-20 meetings of finance ministers and central bank governors. *Hence we proposed that the G-8 invite additional countries that are members of the G-20 to join it at periodic summits, and we repeat that proposal here with a specific call for that process to begin at Evian.*

Such a criterion, however, does not allow for the participation of the poorest countries. The last two G-8 summits, at Genoa and Kananaskis, have addressed this need by inviting the five African leaders chosen by their counterparts to represent the NEPAD process. We believe that this group, perhaps along with one or two other of the poorest countries, should be added to the G-20 to provide a fully representative group that would greatly enhance both the effectiveness and legitimacy of the G-8 in carrying forward the proposals made in this report.

AN ACTION PROGRAM FOR EVIAN

The G-8 faces major opportunities at Evian. It can address and help resolve a number of key problems facing the world economy, the global trading system, a series of energy and environmental issues, poverty in Africa and elsewhere in the poorer countries, and the management of globalization. In doing so, it can go far toward restoring its own effectiveness and legitimacy as well as enhancing the lives of its own people and others in all parts of the world.

To do so, however, it must substantially reform its own activities. Its members must be willing to candidly address the problems of their G-8 partners and thus to have their own problems addressed as well. This is the only means by which the group can deal effectively with the most pressing issues now facing the world economy. Doing so would also help restore legitimacy to the G-8 as an institution.

The G-8 would then be far more able to help resolve "out of area" problems in the rest of the world. This leadership function is highly desirable, indeed essential, but cannot be carried out unless the G-8's members are putting their own houses in order and devising collective action programs to do so by moving together. They should thus seek to construct, and subsequently implement, such a program for Evian. The elements of such a program are clear:

- reform of domestic economic policies, at both the macro and micro levels and over both the shorter and longer runs, as described above for Japan, Europe and the United States to strengthen the prospects for renewed and sustained global economic growth;
- major new trade initiatives, especially in agriculture and to eliminate all industrial tariffs by a date certain, but also to limit the risks to the global trading system of the proliferation of new bilateral and regional arrangements, to assure a successful WTO Ministerial Conference at Cancún and provide needed impetus for the Doha round;
- new initiatives in the energy and environmental areas, especially by the United States but hopefully also by a number of other G-20 (including developing) countries, to strengthen international energy security and reduce the risks of further environmental degradation (especially global warming);
- additional improvements in debt relief, the provision of foreign assistance, and especially trade policies toward the poorer countries to enhance their development prospects; and
- a series of steps, both substantive and procedural, to counter the critics of globalization (1) by expanding public understanding around the world of the benefits of that phenomenon; (2) through the adoption of domestic policies that will more efficiently counter its adverse transitional effects on some groups and indeed expand the opportunities for all sectors of our societies

to take advantage of globalization even if they may now feel that they are being victimized by it; and (3) to “democratize the G-8” itself by inviting the rest of the G-20, along with the designated representatives of the NEPAD process, to meet with them at Evian and periodically thereafter.

A wide-ranging program of this type would generate substantial benefits for all G-8 member countries (and for the world as a whole). It would also require substantial contributions from each of them: Japan would have to deal decisively with its banking system and stop intervening to weaken the yen; Europe would have to reform its labor markets and liberalize the Common Agricultural Policy; the United States would have to rescind some of its planned tax cuts and take much more aggressive steps to

counter its emission of greenhouse gases. Hence this is the type of package that can be brought together only by the G-8, indeed only by the Leaders of those countries as they realize the great benefits of policy coordination even as they accept some short-run political costs from elements of their respective inputs to the process.

As noted at the outset, Evian will convene the fifth cycle of summits of the world’s leading industrial democracies. Its participants can take a number of steps that would go far to revive the G-8 as an effective leadership group within the world economy as they deal with some of the most pressing problems that face the world economy. We urge the Leaders of the G-8 nations, and especially the French chair of Evian, to seize this historic opportunity to do so. We hope and believe that the proposals made in this report can help point the way.

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