The Establishment of A New Global Economic Order

Lawrence J. Lau 刘遵义
Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong
and
Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

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Tel: +852 3943 1611; Fax: +852 2603 5230
Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl

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Abstract

- The World needs rules that govern economic transactions among nations that are universally accepted, with adequate enforcement mechanisms. They include international trade and cross-border direct and portfolio investments. Global problems such as climate change and pandemics also require coordinated global solutions.
- The World Trade Organization (WTO) has lost its effectiveness. Going forward, it will be necessary to rely on voluntary accession by different individual economies to regional free trade agreements, such as the Regional Comprehensive Economic Partnership (RCEP). The governance of multilateral economic organisations needs to be reformed. The method of invoicing, clearing and settlement of international transactions will need to be diversified, and own-currency clearing and settlement of bilateral international transactions should be encouraged and promoted. As part of overall de-risking, the World needs an alternative to the Society for Worldwide Interbank Financial Telecommunication (SWIFT).
- Exporters, importers, cross-border direct investors and long-term portfolio investors all prefer relatively stable exchange rates. Bilateral exchange rates between two major economies can be stabilised through an incentive-compatible bilateral mutual exchange rate stabilisation scheme proposed by Prof. Robert Mundell. Economic globalisation without losers may be achieved within an economy by suitable government interventions. The short-term cross-border flows of capital can be regulated through a financial transaction tax on both outflows and inflows, originally proposed by Prof. James Tobin.

Outline

- Introduction
- International Trade
- Cross-Border Direct and Portfolio Investments
- The Prevention of Global Climate Change
- Concluding Remarks

Introduction

- Why is public polity research important? A U.S. Secretary of State was quoted to have said: “If you are not at the table, you will be on the menu.” It is important for any major country, such as China, to have a well-thought-out position or positions on any significant international issue, that it can bring to the table. China must not only be at the table, but must also participate in the design and selection of the menu. We should not forget the sad history of the 1919 Treaty of Versailles Conference, at which China was both at the table and on the menu.
- One could have titled this lecture alternatively as “The Re-Establishment of the Global Economic Order”.

Introduction

- The World needs rules that govern economic transactions among nations that are universally accepted, with adequate enforcement mechanisms. They include:
  - International trade in goods and services; and
  - Cross-border direct and portfolio investments.
- Global problems such as climate change and pandemics also require coordinated global solutions.

International Trade in Goods and Services: Post-World Trade Organization (WTO)

- The WTO, for various reasons, has lost its effectiveness as the rule-setter and arbiter in international trade. The issues facing all economies are rules on access to trade, tariff and non-tariff barriers, and export restrictions.
- Going forward, it will be necessary to rely on voluntary accession by individual economies to regional free trade agreements, such as the Regional Comprehensive Economic Partnership (RCEP). RCEP members consist of ASEAN + 3 (China, Japan and South Korea), Australia and New Zealand.
- Other regional free trade agreements, such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), also exist and new ones may also develop. However, it is essential for these agreements to allow exceptions explicitly due to the different conditions of the individual member economies. For example, each member may be allowed a fixed number of exceptions of its choice. For another example, the "infant industry" exception should be allowed upon request, but only with a specific duration limit, say ten years.

International Trade in Goods and Services: Post-World Trade Organization (WTO)

- An issue of great potential practical importance, is how the origin of an imported good or service is to be determined, since it has implications on the applicable tariff rate. A simple but workable idea is to determine the origin(s) by the share of value-added of a good or service. Consider an electrical appliance finally manufactured in Mexico with components from China, Suppose the value-added shares are 50% China and 50% Mexico, then the tariffs to be assessed in the U.S. will be based half on the tariff rate on a similar Chinese manufactured product and half on a Mexican manufactured product (which may be zero because of the United States–Mexico–Canada Agreement (USMCA)).

International Trade in Goods and Services: Post-World Trade Organization (WTO)

- Another issue of great practical importance is the taxation of e-commerce in both goods and services. Tariffs can, in principle, be assessed in the same way as regular imports. It is the taxation of the profits from e-commerce that can be problematic. Should a Chinese e-commerce firm without a physical presence in the United States pay U.S. taxes on its profits earned from the U.S.? And if so, should these same profits be taxed by China?
- The free trade agreements should cover, in addition to trade in both goods and services, government procurements, subject to national defense restrictions.

International Trade in Goods and Services: Reform of Global Governance

- Currently, the World Trade Organization (WTO) operates under the unanimity rule, that is, all of its 166 existing member economies must approve in order for any new rule to be adopted or a rule change to be made.
- It is proposed that the unanimity rule be modified so that preventing a rule change will require a minimum of no votes from members representing 10% of the number of member economies as well as 10% of the total population of all the member economies (approximately 8.2 billion at the present time). (A similar rule can apply to regional free trade agreements.)

International Trade in Goods and Services: Reform of Global Governance

- With this rule, China and India will each effectively have a veto if they can find another 16 member economies to vote no with them.
- The U. S.(population 350 million) and the European Union (population 450 million) plus the other four of the "five eyes" (Australia, Canada, New Zealand and the U.K.) will also meet the requirement, but the G7 (population 780 million) by itself will be short in terms of the number of members and in terms of population. Africa (population 1.2 billion) will qualify by itself, but South America (425 million) and even Latin America (650 million) will fall short as well as the ASEAN (675 million).

International Trade: Invoicing, Clearing and Settlement of International Transactions

- Since the early 1970s, the invoicing, clearing and settlement of bilateral trade and investment transactions between two economies has mostly been done in the U.S. Dollar.
- If bilateral cross-border transactions between two economies can be settled in their own national currencies rather than in a third currency such as the U.S. Dollar, the transaction costs and the exchange rate risks are both reduced, because only one currency exchange is required and hence there is only one exchange rate risk. If the settlement is made in a third currency, two currency exchanges are required, doubling the transaction costs, and exchange rate risks are incurred by both the exporter and the importer.
- Thus, own-currency clearing and settlement benefit both the exporting and the importing economy. This practice is, in a sense, a return to what was the norm before 1970 under the Bretton Woods system before the U.S. unilaterally abandoned its commitment to a fixed price for gold in terms of the U.S. Dollar. Own-currency clearing and settlement is gradually re-gaining wider international acceptance.

International Trade: Invoicing, Clearing and Settlement of International Transactions

- With more and more clearing and settlement done in own currencies, the need for the maintenance of a large foreign exchange reserves consisting mostly of U.S. Dollar-denominated assets is reduced.
- However, bilateral trade between two economies is seldom exactly balanced, so that bilateral settlement in the own currencies of the two trading-partner economies may not be able reduce the unsettled balance to zero. But if a group of economies can agree to clear and settle their within-group transactions in their own national currencies among themselves, the unsettled balances can be further reduced, without having to use the currency of a country outside the group.
- The within-group own-currency settlement was tried in the clearing and settlement of the multilateral balances of Western European economies in the early 1950s under the guidance of the Bank for International Settlements, with the assistance of some funding from the U.S. Marshall Plan, and was found to be quite effective.

International Trade: Invoicing, Clearing and Settlement of International Transactions

- The Society for Worldwide Interbank Financial Telecommunication (SWIFT) international payment system has been an effective mechanism for the clearing and settlement of international transactions in U.S. Dollar since 1973.
- However, SWIFT imposed sanctions against Russian individuals and private institutions in addition to the Russian state in 2022, under U.S. pressure, because of the Russia-Ukraine conflict. As a result, all Russian financial assets in the U.S., European Union, Switzerland and the U. K. have been effectively frozen. Iran has also been denied access to SWIFT for many years.
- As a result, many countries, including Iran and Russia, have begun to look for alternatives to SWIFT.

International Trade: Invoicing, Clearing and Settlement of International Transactions

- The continued access of Chinese financial institutions to SWIFT is not automatically assured. China developed its own Cross-border Interbank Payment System (CIPS), offering clearing and settlement services for international financial transactions for its financial institution members.
- In addition, there is also the mBridge project being organised by the Hong Kong Monetary Authority in conjunction with the central banks of China and several other countries.
- The BRICS countries are also organising a clearing and settlement system independent of the US dollar, which is said to have been joined by 159 member countries and will be operational in October this year. However, it is not envisaged that a new BRICS currency will be launched.

International Trade: Invoicing, Clearing and Settlement of International Transactions

- While clearing and settlement in own currencies within a group of countries is unlikely to result in a net un-settled balance of zero, own-currency settlement can significantly reduce the net outstanding un-settled balances within a group of economies, as demonstrated by the experience of the Western European economies in the 1950s under the Bank for International Settlements. Any remaining unsettled balances can be covered by major member economies with significant official foreign exchange reserves.

International Trade in Goods and Services: Exchange Rate Determination

- For many economies, the exchange rate is too important to be left entirely to the vagaries of the free market. It is the responsibility of a central bank to monitor the exchange rate of its national currency and intervene if necessary.
- Exporters, importers, cross-border direct investors and long-term portfolio investors all prefer relatively stable exchange rates. They do not need daily fluctuating exchange rates.
- While economic theory shows that free trade benefits all economies because of the differences in their comparative advantages, there is no theoretical nor empirical analysis to support the idea that daily freely fluctuating exchange rates are beneficial to all economies, or for that matter, to any economy.
- The market for the bilateral exchange rate between two trading-partner economies may sometimes be quite thin. The central banks of the respective economies can offer forward currency contracts in their own currencies to bona fide exporters and importers to reduce their exchange rate risks and hence encourage the use of their own national currencies for invoicing, clearing and settlement.

International Trade: The Exchange Rate Stabilisation Scheme of Prof. Robert Mundell

- The late Prof. Robert Mundell, the 1999 Nobel Laureate in Economic Sciences, proposed an incentive-compatible bilateral mutual exchange rate stabilisation scheme which can reduce the wild fluctuations that can sometimes occur in a bilateral exchange rate.
- He first proposed his scheme to stabilise the Euro/US$ exchange rate. His idea is that the Federal Reserve Board and the European Central Bank (ECB) should agree on a reasonable range for the Euro/US$ exchange rate (currently 1 Euro = 1.1 US$).
- Let us suppose that the agreed range is between 1 Euro = 1 US$ and 1 Euro = 1.2 US$. When 1 Euro = 1 US$, the Euro is becoming too weak relative to the US$, potentially hurting U.S. exports to the Euro Area, so that the Federal Reserve will start buying the Euro with US$ to prevent the Euro from falling below1 Euro = 1 US$.

International Trade: The Exchange Rate Stabilisation Scheme of Prof. Robert Mundell

- Similarly, when 1 Euro = 1.2 US$, the Euro is becoming too strong relative to the US$ so that the ECB will start buying the US$ with Euro to prevent the US$ from falling below 1 Euro = 1.2 US$, which will potentially hurt exports from the Euro Area to the U.S.
- We note that in both cases, the Federal Reserve and the ECB have both the incentive (to support their respective exporters) and the wherewithal (the US$ and the Euro) to intervene as necessary.
- Similar stabilisation schemes can be designed between the US$ and the Yuan and between other pairs of major currencies. They will help to reduce the volatility of exchange rates and facilitate both international trade and cross-border investments.

International Trade in Goods and Services: Economic Globalisation without Losers

- Economic globalisation increases the welfare of all participating economies because of the enlargement of the choice sets facing every economy. When the choice sets expand, welfare cannot decrease; so that all individual economies benefit from economic globalisation in the aggregate.
- However, economic globalisation creates winners and losers in every economy. The winners are the enterprises and workers in the exporting and importing sectors, and the consumers and users of imported products. The losers are the consumers and users of the exported products and the enterprises and workers previously producing products that have been replaced by imports. The free market will only reward the winners but not compensate the losers. It is up to the individual governments to compensate the losers within their respective domestic economies.

International Trade in Goods and Services: Economic Globalisation without Losers

- Where is the government going to find the resources to compensate the losers? In principle, since the overall welfare is increased, there should be enough gain to make everyone better off. Thus, one should tax the winners to compensate the losers. However, in practice, the winners are very difficult to identify precisely.
- A relatively simple proposal is to impose a non-distortionary tax of say 1% on both the values of exports and imports. With this revenue, the government can undertake to help the affected enterprises to adjust or wind down and to help the displaced workers retrain and tide them over the unemployed period. Hopefully, no net losers will be left behind.

Cross-Border Direct and Portfolio Investments

- Different economies have to enter into investment protection agreements with one another. These agreements should provide for national treatment to foreign direct investors. Reciprocity should be a key feature of such agreements.
- Cross-border portfolio investment is different from cross-border direct investment because it is not as long-term oriented. There may have to be specific and explicit provisions for repatriation of both capital and profit after taxation.
- Capital flows, especially short-term capital flows, otherwise known as "hot money", have to be regulated because of their disruptive effects on the exchange rate and the financial sector. The late Professor James Tobin, the 1981 Nobel Laureate in Economic Sciences, proposed a financial transaction tax. It can. for example, be levied at a fixed rate of say 1% on both capital inflows and outflows. This will make it prohibitive for short-term speculative round-trips but will not discourage long-term inbound and outbound direct and portfolio investments.

Prevention of Global Climate Change

- Global climate change is a threat to all mankind. It can be successfully prevented only if the entire World will work together. China is committed to peaking its carbon emissions by 2030 and achieving net carbon neutrality by 2060.
- The United Nations Climate Change Conference (Conference of Parties) also has a unanimity rule similar to the WTO, which should also be modified.
- The best way forward for everybody is probably the adoption of a universal carbon tax, recognising that it is a tax on only the current flows. Reliance on carbon trading, as opposed to a carbon tax, has its inherent weaknesses, for example, inadequate monitoring and potential fraud.
- Given that China will be peaking its carbon emissions by 2030 and achieving net carbon neutrality by 2060, it is in an excellent position to manage a carbon tax. By 2060, Chinese exports to the rest of the world should be paying zero carbon tax.
- However, it may be necessary to help the poorest developing economies to navigate a successful energy transition.

Prevention of Global Climate Change

- We should also recognise explicitly the "shared and differentiated" responsibilities--the developed economies were responsible for the creation of the past stocks of carbon dioxide even though they may generate less carbon emission than the developing economies in terms of current flows.
- There is an issue of international and inter-generational equity as to how the responsibilities for the cumulated past stock of carbon emissions should be allocated and fulfilled. A first step is to try to estimate the geographical origins of the current stock. Just as a polluter has to bear the liabilities of its past pollutions, the original carbon emitters will have similar responsibilities.
- Finally, every country should be encouraged to consider its optimal sustainable steady-state population based on its available resources. Our planet is unable to sustain an indefinite growth of our total population.

Concluding Remarks

- Our new School of Public Policy can focus on both the research and the teaching of appropriate policies for international trade in goods and services and cross-border direct and portfolio investments, and on the related issues of capital control, exchange rate determination and taxation policies. Our School of Public Policy can also undertake objective research on shared and differentiated responsibilities for global climate change.
- These issues are important not only to China and also to the rest of the World, including the Global South. China should take a leadership role among the developing economies.
- In the long run, it is distinguished original research that will provide the foundation of our teaching and establish the reputation of our School of Public Policy. There is much work to do. I wish our School of Public Policy every success in the future!