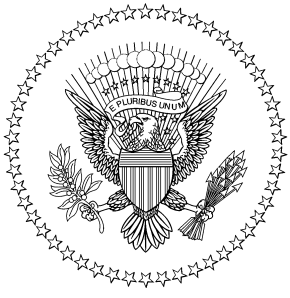
Economic Report of the President



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CHAPTER 7

Supporting Global Economic Integration

The world economy has become increasingly integrated. Goods, services, capital, and people flow across borders with greater frequency and in ever-greater volumes. For some, cross-national interaction has become even more a part of day-to-day activity than interactions within their own country.

Americans benefit tremendously from their interactions with other countries, just as they do from their interactions with each other in different States. Such interactions allow Louisianans to drink California wine, Chicagoans to eat bananas and pineapples from Hawaii, and savers in Ohio to provide financing to business startups in Florida. In the same way, international trade allows Americans to enjoy French wine and Colombian coffee and to take advantage of investment opportunities in the United Kingdom.

Despite these benefits, many geographic, institutional, and historical factors impede the free flow of goods, capital, and people across national borders. Realizing the full benefits of international interactions requires building into our economic system mechanisms that facilitate the removal of such impediments. National compacts such as the interstate commerce clause of the Constitution help to link the activities of different States. In the same way, international institutions have developed to promote linkages around the world. Such institutions seek to provide a stable framework for international transactions, while respecting the sovereignty of each country that chooses to participate, as well as serving a valuable coordinating role. International financial institutions such as the International Monetary Fund (IMF) help to promote international monetary and financial cooperation. All of these institutions also evolve in response to changes in the global economy, just as the transactions themselves are likely to change in response to institutional initiatives.

This chapter begins by describing the increasing integration of the world economy and of the United States with the world economy. It then sets out some of the benefits of this globalization and addresses some of the concerns it has engendered. Finally, it discusses the role of institutions within the international economy, covering both recent activities and some likely areas for change.

The United States in the International Economy

Trends and Patterns in U.S. and World Trade

Several factors have contributed to the increased integration of the U.S. economy with the rest of the world. For one, the costs of communicating between a producer in one country and a buyer in another have fallen dramatically, thus reducing the total costs of dealing with a foreign trade or financial partner. One measure of these falling costs is the cost of international telephone service: the average amount billed to end users for a minute of international telephone service fell from $2.23 in 1975 to $0.45 in 2000 (in dollars unadjusted for inflation).

In 2000, of the 10 largest international telecommunications carriers in the world as measured by minutes of outgoing traffic, three were U.S. companies, and they held first, second, and sixth place. International telephone traffic worldwide continued to grow rapidly, by more than 20 percent in that year. The flow of international telephone traffic to and from the United States continues to exceed that for any other country in the world. Worldwide satellite industry revenue also grew by 17 percent in 2000. These numbers suggest the continuing significance of international and global communications to U.S. and foreign business firms, who sell and purchase products and services in all parts of the world, and to U.S. and foreign consumers.

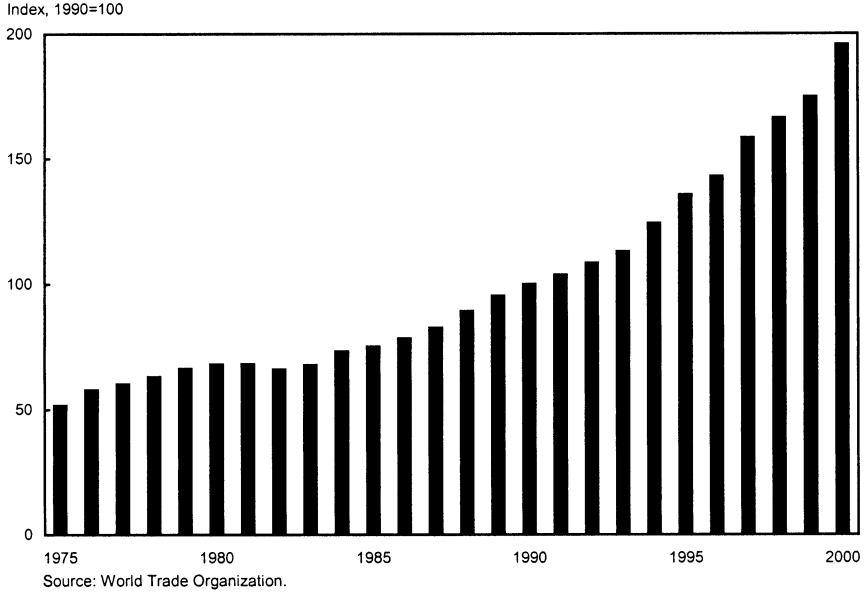
The costs of transporting goods between countries have also fallen, and this, too, stimulates international trade. Average nominal freight and insurance costs for U.S. imports fell by about 50 percent between 1975 and 2000, and air cargo rates on long-distance routes declined substantially. Over the same period, the share of U.S. imports that arrives by air increased from 9.2 percent to 25.4 percent. With this widespread use of speedier delivery times, trade in perishable goods as well as in inputs used in just-in-time production processes has grown. The United States now imports eggs from New Zealand and electronic components from Malaysia. Exports from the United States, such as the telecommunications equipment we send to Japan, are also available more quickly to consumers and producers in other countries.

In tandem with these falling communications and transport costs, international efforts to reduce policy barriers to trade have helped to further link the economies of different countries. Average tariffs on industrial goods in developed countries have fallen from 40 percent 50 years ago to around 4 percent today. Nontariff barriers to trade, such as quotas and some regulatory barriers, have also been dramatically reduced.

All these changes in transactions costs have profoundly affected international flows of goods, services, and capital. On a pure volume basis, global merchandise trade has increased substantially in the last two and a half decades, growing by 277 percent between 1975 and 2000 (Chart 7-1). During this same period, U.S. exports grew by around 393 percent, from $230 billion to $1.1 trillion (in 1996 dollars). The importance of international transactions in relation to overall U.S. economic activity has also risen. In 1975 total trade (measured as exports plus imports) was equal to less than 16 percent of GDP, but by 2000 that figure was over 26 percent (Chart 7-2). About 8 percent of the labor force is now engaged in producing goods and services that will be sold in foreign markets.

The United States trades with many countries around the world. Canada is our top-ranking trading partner, accounting for 20.3 percent of trade in 2000 (again measured as exports and imports combined). Mexico (12.4 percent) and Japan (10.6 percent) rank second and third, respectively. The countries of the European Union together account for 19.3 percent of U.S. trade. This concentration of U.S. trade in transactions with other high-income countries follows a historical pattern. But trade with a broader

Chart 7-1 **World Merchandise Trade Volume**
Worldwide trade in goods has nearly quadrupled since the mid-1970s.



Source: World Trade Organization.

Chart 7-2 **U.S. Trade Relative to National Output**
Trade is substantially more important to the economy than it was 25 years ago.

Note: Trade is measured as exports plus imports.
Source: Department of Commerce (Bureau of Economic Analysis).

range of countries already constitutes an important share of our international transactions, as Mexico's high ranking demonstrates. And this trade is growing: trade with low- and middle-income economies grew from $78.5 billion in 1975 to $750.2 billion in 2000.

The reduction in impediments to international transactions has also been accompanied by changes in the types of goods being traded. Manufactures have become an increasingly important element of world trade in goods: their share of world merchandise exports rose from 69.8 percent in 1975 to 74.8 percent in 2000. About 80 percent of both U.S. merchandise exports and imports in 2000 were manufactured goods; as recently as 1980 only 55 percent of imports and 70 percent of exports consisted of manufactures. Within manufacturing, certain industries are particularly trade-oriented. Ranked on the basis of exports as a share of shipments, nonelectrical machinery and computer and electronic equipment were the leaders. In each of these industries, exports accounted for 30 percent or more of U.S. firms' total shipments (Table 7-1).

This increasing importance of manufactures reflects in part another important change in the nature of U.S. trade: more and more trade now involves the exchange of intermediate inputs across borders. For example, a

TABLE 7-1.—*U.S. Manufacturing Trade as Share of Shipments and Consumption, 2000*

[Percent]

Product category description	Exports as percent of shipments	Imports as percent of consumption
Total manufacturing	19.8	26.3
Food	7.1	5.3
Beverages and tobacco products	6.0	9.0
Textiles and fabrics	26.0	25.4
Textile mill products	5.2	14.7
Apparel and accessories	15.5	57.5
Leather and allied products	33.5	80.1
Wood products	6.6	17.8
Paper	11.2	13.1
Printing, publishing, and similar products	5.8	4.9
Petroleum and coal products	4.7	12.2
Chemicals	21.7	19.9
Plastics and rubber products	11.5	11.3
Nonmetallic mineral products	10.0	16.7
Primary metals	15.4	27.1
Fabricated metal products, not elsewhere specified	10.5	12.6
Machinery, except electrical	36.0	33.4
Computer and electronic products	44.6	50.8
Electrical equipment, appliances, and components	24.8	32.4
Transportation equipment	22.9	33.0
Furniture and fixtures	4.6	20.1
Miscellaneous	26.3	45.2

Note.—Product category descriptions based on the North American Industry Classification System (NAICS). Consumption is defined as shipments minus exports plus imports.

Sources: Department of Commerce (Bureau of the Census) and U.S. International Trade Commission.

firm may purchase one input to its production from one country, and another from another country, and assemble the final good at home or even in a third country. One way to measure such interactions is to look at the amount of imported inputs used in goods that are in turn reexported. One study found that, in 1990, such vertical specialization accounted for about 20 percent of all exports in a sample of 14 major trading economies, including the Group of Seven (G-7) large industrial economies (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States). Increases in such vertical trade have been found to account for more than 30 percent of the growth in the ratio of world exports to world GDP. Such trade may help to enhance the efficiency of producers, since they now have access to a wider range of input sources than are available domestically. (Box 7-1 discusses the importance of vertical trade in overall U.S. trade.)

Box 7-1. Vertical Trade and Production Sharing

A large portion of U.S. trade, both imports and exports, is trade in partially finished products, also called intermediate inputs. Examples include the steel used in automobile manufacture, and the cloth and other textiles from which finished apparel is made. This type of trade goes by many names, such as vertical trade, vertical specialization, and production sharing, although these terms have somewhat different meanings. Vertical trade, the broadest category, includes any production process that is not confined to one country. Vertical specialization is slightly narrower. It is defined as the use of imported inputs to produce goods that are subsequently exported. Production sharing is narrower still: imported inputs are used to produce goods that are then exported to the country from which the inputs came.

Some of these production processes are organized by a single (vertically integrated) firm, but in a growing number of cases separate companies in different countries manage different stages of production. In the past, many companies felt that the only way to guarantee the timely arrival, exact adherence to specifications, or quality of an intermediate good was to own all the steps on the supply ladder (hence the name "vertical integration"). For similar reasons, it may sometimes have been difficult to locate plants overseas. However, the past decade or so has seen large improvements in the technology available to coordinate and monitor manufacturing in different parts of the world. This includes everything from cheaper and better international telephone service to fax machines to Internet-linked computer-aided design packages. These advances have allowed companies and countries to specialize in those steps of the production process that they are best at performing, leading to an increase in vertical trade.

The extent of vertical trade can be gauged in a number of different ways. One way is simply to measure the amounts of intermediate goods that are imported or exported. However, it is sometimes difficult to decide whether a good should be classified as intermediate, because this depends on its intended use, which may not be known. Auto tires are a good example of this. They can be used as an intermediate good and put on cars to be sold as part of a final product, or they can be sold in retail stores as a product themselves. The ideal would be to look at how much of a traded good's value is added in each of the countries involved in its production. One measure of this is the imported input share, that is, the share of the value of production that is attributable to imported inputs. Another such measure would be the amount of

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Box 7-1.—*continued*

production sharing, which is defined as U.S. materials shipped abroad for processing and then sent back to the United States. Note that production sharing is a special case of vertical trade, since vertical trade also covers inputs shipped to Mexico or Canada, finished there, and exported to any country, not just the United States.

The U.S. Government has kept statistics on production sharing since about 1963. These numbers are collected because products assembled abroad from U.S. manufactured components qualify for different tariff treatment: only the portion of the product's value not accounted for by U.S. inputs is subject to duties. The tariff provision that governs such production sharing is number 9802. Two main categories of goods covered under this provision are goods assembled of U.S.-made components, and metals. Of course, the data collected do not capture the entire extent of production sharing, as certain products are exempt from duties under various agreements such as the North American Free Trade Agreement (NAFTA). In fact, in the first table below, which traces U.S. imports from selected economies in the Asia-Pacific Economic Cooperation (APEC) forum, the total recorded in 2000 fell from the previous year, possibly because of increased exemption of goods. In the table, "customs value" is the total value of the goods imported into the United States, and "U.S. content" is the percentage of value that comes from U.S. inputs. Therefore, under provision 9802, duties would only have to be paid on the difference between the customs value and the value of U.S. components: the value added abroad. For example, in 2000, the United States imported $1.38 billion worth of goods from Korea for which a 9802 exemption was claimed. The U.S. content of those goods totaled 54.6 percent, or $750 million, and therefore the value added abroad was 45.4 percent, or about $630 million.

In addition to collecting statistics, the U.S. Government occasionally publishes surveys of developments in production sharing. According to a recent survey, major industries involved in vertical trade include the automotive industry and various electronics industries. For example, the United States imports motor vehicles from Canada ($45.7 billion, or 35 percent of the total), Japan ($34.5 billion, or 27 percent), and Mexico ($21 billion, or 16 percent). Exports of motor vehicles from Japan, which is not covered by NAFTA, contained U.S. components comprising 2.4 percent of the value of these imports. Exports of motor vehicles from Canada and Mexico, however, have historically contained U.S. components equal to one-quarter and

continued on next page...

Box 7-1.—*continued*

U.S. Imports from Selected APEC Economies under Tariff Provision 9802

Economy	1998		1999		2000	
	Customs value (millions of U.S. dollars)	U.S. content (percent)	Customs value (millions of U.S. dollars)	U.S. content (percent)	Customs value (millions of U.S. dollars)	U.S. content (percent)
Australia	25.0	16.6	18.7	22.3	18.8	26.4
Canada	427.8	45.4	358.9	49.0	483.1	48.0
China	1,477.2	15.7	1,612.0	16.9	1,242.4	20.3
Hong Kong, China	558.9	41.2	451.2	38.1	253.2	38.8
Indonesia	298.0	18.3	296.8	18.0	190.1	26.2
Japan	12,363.1	4.1	15,058.2	3.8	17,851.3	3.0
Korea	1,601.2	49.1	2,002.3	52.0	1,378.0	54.6
Malaysia	1,830.7	50.0	2,109.1	47.3	1,639.3	54.0
Mexico	27,162.2	53.3	25,875.0	53.8	19,429.9	52.9
New Zealand	2.0	36.9	.9	51.6	3.2	18.3
Peru	.9	34.2	4.0	6.4	1.6	1.8
Philippines	2,253.7	50.1	2,331.3	48.8	2,098.7	44.5
Russia	2.7	26.6	1.8	18.0	5.8	39.9
Singapore	556.4	27.1	200.6	40.7	235.5	40.3
Chinese Taipei	1,511.2	35.9	1,716.7	34.1	881.8	44.8
Thailand	663.6	55.3	592.0	56.8	396.3	56.4
Vietnam	78.5	11.2	114.2	13.8	47.9	20.9
Total	50,813.3	38.6	52,744.2	36.7	46,157.1	32.0

Source: U.S. International Trade Commission.

two-fifths of their value, respectively. (The last years for which such data are available are 1988 for Canada and 1993 for Mexico. After that, those countries were covered by free-trade agreements and no longer recorded values for provision 9802.) And indeed, the United States exported $17 billion worth of automotive parts to Canada in 2000, and $7.3 billion to Mexico.

Another sector in which production sharing is prevalent is electronic products. U.S. content in machinery and electronic products imported from Mexico under the production sharing provision was $4.9 billion in 2000. As mentioned previously, however, not all production sharing is captured by provision 9802, as there may be other programs under which the goods in question get more favorable treatment. Luckily, we can get a rough idea of the discrepancy through the following calculations. Mexico also collects statistics on U.S. products imported as

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inputs to planned exports under its maquiladora and PITEX programs. The measured value of imports of machinery and electronics intermediate goods from the United States was $37.2 billion in 2000 (a much larger number than $4.9 billion). Overall, Mexico exports 92 percent of its maquiladora products to the United States, and so one can estimate that the U.S. content of machinery and electronic products under all production sharing arrangements was at least $34.2 billion in 2000. This implies that the 9802 statistics capture only a small portion of all production sharing between the United States and Mexico. As an illustration, the second table in this box lists the top 20 production sharing commodities from Mexico. The U.S. content, measured as a percentage of the final value, is typically quite high.

Top 20 Product Categories in Production Sharing in U.S.-Mexico Trade, by U.S. Content, 2000

Product category description	Customs value (millions of dollars)	U.S. content (percent)
Cotton sweaters, pullovers, and similar articles	232.0	80.4
Parts and accessories of motor vehicles	355.3	78.0
Manmade fiber sweaters, pullovers, and similar articles	273.2	76.8
Cotton T-shirts, singlets, tank tops, and similar garments	588.8	75.5
Safety seat belts for use in motor vehicles	491.6	74.5
Insulated electric conductors	236.7	66.3
Motor vehicles for transport of goods, 5-20 metric tons	297.5	60.6
Switches for electrical connections	246.6	60.2
Connectors such as coaxial, cylindrical multicontact	417.4	59.0
AC motors	264.8	56.1
Other electrical telephonic apparatus	266.6	55.2
Insulated ignition wiring sets and other wiring sets for vehicles	699.7	48.0
Motor vehicles for transport of goods, not over 5 metric tons	247.9	46.9
Boards, panels, consoles, etc., for electrical control consoles	252.4	43.9
Non-high-definition color television reception apparatus	759.7	38.3
Cotton women's or girls' trousers, breeches, and shorts	934.1	35.5
Cotton men's or boys' trousers and shorts	825.4	35.3
Parts of motor vehicle seats	283.5	16.0
Display units for ADP machines	273.8	2.5
Digital processing units	249.8	2.4

Note.—Product category descriptions based on the Harmonized Tariff Schedule (HTS).

Sources: Department of Commerce (Bureau of the Census) and U.S. International Trade Commission.

Interestingly, the often back-and-forth nature of vertical trade means that a significant portion of the value of U.S. imports simply represents the value of previous U.S. exports. Many domestically produced goods are shipped abroad for further processing or assembly and then returned to the United States, in another illustration of how international trade becomes part of the overall production process. This is a particularly striking feature of U.S. trade with Mexico. In 1998, for example, the United States imported $93 billion worth of goods from Mexico, $27.2 billion of which entered the country under a special "production sharing" provision of U.S. law that gives duty-free treatment to the reimportation of goods produced with U.S. components. Of this $27.2 billion, $14.5 billion (53 percent) represented the U.S.-made content of these imports. That $14.5 billion also represents at least 15 percent of all U.S. imports from Mexico.

Lower international transactions costs have facilitated trade in services as well as in goods. Between 1986 and 2000, total U.S. trade in services grew by over 200 percent. One reason is that falling communications costs have allowed many products that were not traded in the past, such as financial services, to become more readily available on the international market. U.S. trade in financial services quadrupled between 1986 and 2000, from $5.1 billion to $21.5 billion. Other categories of U.S. services trade, such as travel, education, and royalties and license fees, have also greatly increased.

Trends and Composition of Capital Flows

Like trade and services flows, global capital flows have increased enormously over the past 30 years. These flows represent funds channeled from savers in one country to borrowers in another. From the end of World War II through the early 1970s, capital controls in most countries heavily regulated or even prohibited the international flow of capital. Only when these controls were liberalized, especially in the late 1970s and early 1980s, did cross-border financial transactions begin to surge.

Global capital movements can be analyzed in terms of both gross and net flows. For example, suppose that early in December German residents purchase $200 worth of U.S. securities from U.S. residents, and that later that month they sell $50 worth to U.S. residents. Considering only these transactions, capital flows into the United States from Germany amount to $150 ($200 in purchases minus $50 in sales). Suppose further that, over the same month, U.S. residents first purchase $100 worth of German securities from German residents and then sell them $30 worth. Considering the latter two transactions, capital flows into Germany from the United States amount to $70 ($100 in purchases minus $30 in sales). From the perspective of the United States, net capital inflows amount to $80 ($150 of inflows minus $70 of outflows). One measure of gross capital flows, used in the tables in this

chapter, would sum the capital flows into and out of the United States to arrive at a total of $220. A broader measure, usually not available from official data sources, would sum all cross-border purchases and sales to arrive at a total of $380. Regardless of which concept is used, gross capital flows will be larger than net flows by definition.

Although it may appear that the gross basis overstates the importance of capital flows, gross flows do measure the amount of international funds flowing in and out of a country's financial system. Especially for developing economies, it is important to know if these flows are so large that they might overwhelm the capacity of the domestic financial system to process them.

Unfortunately, data on gross capital flows come from different sources and are often fragmentary. Since cross-border financial transactions are usually not subject to tariffs or quotas, national authorities have lacked a strong incentive to document their size. Nonetheless, the IMF estimates that, in the 30 years since 1970, gross capital flows as a percentage of GDP have risen almost tenfold for the advanced economies and more than fivefold for developing economies. Table 7-2 presents more recent measures of capital flows. From 1990 through 2000, estimated capital flows on a gross basis in advanced economies more than quadrupled.

TABLE 7-2.—*Estimated Gross Private Sector Capital Flows*[1]
[Billions of U.S. dollars]

Item	1990	1995	1996	1997	1998	1999	2000
Advanced economies: gross flows	1,536.8	2,285.6	2,975.4	4,163.8	4,053.4	5,885.2	6,432.1
Direct investment	404.7	515.5	567.6	674.7	1,104.3	1,774.8	2,070.7
Portfolio investment	377.5	818.3	1,182.8	1,348.8	1,871.4	2,731.1	2,628.7
Other[2]	754.6	951.8	1,225.0	2,140.3	1,077.7	1,379.3	1,732.6
Memoranda							
Gross financing to other markets[3]	38.1	151.2	209.8	274.9	148.9	163.7	216.5
Equities	1.2	10.0	17.8	26.2	9.4	23.2	41.8
Bonds	8.7	59.2	103.0	126.2	79.5	82.4	80.5
Loans	28.2	82.0	89.0	122.5	60.0	58.1	94.2
United States: gross flows	189.1	697.5	878.9	1,226.9	876.8	1,218.8	1,566.3
Direct investment	85.7	156.5	178.4	210.4	320.7	456.4	440.1
Portfolio investment	30.4	218.9	280.1	316.9	354.2	475.2	610.6
Other[2]	73.0	322.1	420.5	699.6	201.9	287.2	515.6

[1] Gross flows are the sums of the absolute values for inflows and outflows of each country.
[2] Generally, bank loans.
[3] Data include new formal international offerings or syndicates, but exclude bank lending that is not syndicated and investments that do not occur through public offerings. Thus, substantial amounts of financing are excluded.

Note.—Advanced economies comprise Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.
Detail may not add to totals because of rounding.

Capital flows can also be categorized by the nature of the investment being undertaken. Capital used by a firm in one country to establish a plant in another is labeled foreign direct investment, as are large purchases of equities that imply a lasting interest in an enterprise. Purchases of long-term bonds, money market instruments, and small amounts of equities are labeled portfolio investment. Residual transactions such as loans fall into the category labeled "other" in Table 7-2. Gross capital flows have shifted toward direct and portfolio investment in the past decade.

The explosion in gross capital flows obscures the fact that, on a net basis, capital flows have grown much less rapidly (Table 7-3). This difference in the two measures means that larger amounts of funds are crossing borders, but that the balance of inflows and outflows is remaining roughly constant. These net flows also reflect the balance of domestic saving and investment in a country. If a country saves more than it invests, the excess savings must go abroad. Similarly, if a country invests more than what is available from domestic saving, the extra funds must come from abroad.

These net capital flows are also just the mirror image of the country's current account balance, which, roughly speaking, consists of the balance in its combined goods and services trade and the net flow of income generated from cross-border investments. A country that sends savings abroad, on net, is enabling the rest of the world to spend more on that country's goods and services than that country is spending on goods and services produced by the rest of the world; such a country has a current account surplus. A country that is attracting savings from abroad, on net, is able to spend more on goods and services produced by the rest of the world than the rest of the world is spending on goods and services that the country itself produces; that country has a current account deficit.

Although net capital flows on a global basis have increased relatively little in recent years, this is not the case for the United States, as Table 7-3 also shows. The United States recorded large current account deficits over the past decade, reflecting an increased desire on the part of foreigners to invest in the United States. The United States also ran large current account deficits in the 1980s. An important source of financing for these deficits was foreign official purchases of U.S. government debt securities. In the 1990s, however, the bulk of foreign investment entering the United States consisted of purchases of private assets. In particular, direct investments in the United States have shown a very rapid rate of increase over the past several years. In short, rapid rates of productivity growth and increases in economic activity over the past decade have made private assets in the United States more attractive for foreign investors.

Because the world's developing economies have relatively little capital compared with the developed economies, there is a presumption that capital

TABLE 7-3.—*Estimated Net Private Sector Capital Flows*
[Billions of U.S. dollars; inflow (+), outflow(-)]

Item	1990	1995	1996	1997	1998	1999	2000
World	162.7	100.7	280.4	213.0	127.0	343.9	423.8
Direct investment	-45.5	-12.1	1.5	10.3	-13.7	46.8	133.3
Portfolio investment	46.1	81.8	22.0	50.0	-140.4	254.2	287.5
Other	162.2	31.0	256.9	152.7	281.1	42.8	3.1
Memoranda							
Emerging markets	39.2	205.7	233.3	116.8	69.6	59.6	8.9
Direct investment	19.3	96.5	119.6	145.2	155.4	153.4	146.2
Portfolio investment	.5	41.2	86.9	48.6	-4.2	31.0	-4.3
Other	19.4	68.0	26.8	-77.0	-81.6	-124.8	-133.0
United States	26.3	14.2	39.7	253.6	172.0	321.6	406.9
Direct investment	11.3	-41.0	-5.4	.8	35.7	145.6	135.2
Portfolio investment	-27.2	-26.1	-19.6	78.9	82.0	212.7	360.7
Other	42.1	81.3	64.7	173.9	54.3	-36.7	-89.0

Note.—World is defined here as advanced economies (Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Hong Kong (China), Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States) plus emerging markets (the developing countries, countries in transition, and Israel, Singapore, South Korea, and Taiwan (China)—the IMF definition in "World Economic Outlook," December 2001).
Detail may not add to totals because of rounding.

Sources: Department of Commerce (Bureau of Economic Analysis) and International Monetary Fund.

should flow from the latter to the former. Hence capital flows to and from these developing economies receive much attention. Table 7-3 shows that these flows have varied enormously over the past decade. In the early 1990s some developing economies made enormous strides in structural economic reform and removed restrictions on capital flows, leading to a renewed interest on the part of international investors. Net flows skyrocketed, reaching $233 billion in 1996. However, the financial crises that began in East Asia in 1997 and then occurred in Russia and Brazil in 1998 and 1999 dampened investors' appetites. Net flows fell to close to zero in 2000 but are believed to have increased moderately in 2001. A swing in net banking flows accounts for most of the decline since 1996. This was due to both a decrease in international bank lending to developing economies and an increase in deposit outflows from developing economies to international banks. (The lower international bank lending reflects in part a move from cross-border lending to more lending by subsidiaries within the countries.) However, direct investment flows have remained fairly stable over the past 3 years, a sign that investors are still willing to undertake long-term investments in the developing economies.

Cumulating net capital flows for a given country and accounting for changes in the prices of assets held across borders yields the net international investment position for that country with the rest of the world. For example,

suppose that a country begins international transactions with the rest of the world and for 10 years enjoys net capital inflows of $1 billion a year (possibly including reinvested earnings). At the end of these 10 years that country's net international investment position would show that the rest of the world has accumulated a total of $10 billion in claims on that country, assuming that the prices of these claims did not change over the 10-year period. These claims could be in the form of portfolio investments (if, for example, investors in the rest of the world bought bonds issued by the country's corporations) or direct investments (if the rest of the world bought controlling interests in the country's corporations).

Table 7-4 indicates that, worldwide, these cross-border claims are quite large in the aggregate, at over $21 trillion, equal to almost 70 percent of world GDP. The claims are largely divided among bank loans, equities, and bonds. Central bank reserves make up a fourth, relatively small category. These holdings are now much smaller than those of private investors, having grown at about half the rate of gross capital flows over the last 30 years.

TABLE 7-4.—*Estimated World Cross-Border Claims and U.S. International Investment Position, Year-End 2000*

Item	Billions of U.S. dollars
World cross-border claims	21,261.0
Bank loans and deposits	8,317.6
Equities	4,516.5
Debt securities	6,377.2
Central bank reserves [1]	2,049.6
U.S. claims on rest of world [2]	7,189.8
Bank assets	1,276.7
Corporate stocks	1,828.8
Bonds	577.7
Central bank reserves [3]	128.4
Other	3,378.2
Rest-of-world claims on United States [2]	9,377.2
Bank liabilities	1,139.8
Corporate stocks	1,589.7
U.S. Treasury securities, corporate and other bonds	2,013.9
Central bank reserves [3]	922.4
Other	3,711.4

[1] Gold valued at SDR 35 per ounce..
[2] Direct investment at market value.
[3] Gold valued at market price.

Note.—Detail may not add to totals because of rounding.

Sources: Department of Commerce (Bureau of Economic Analysis), Bank for International Settlements, and International Monetary Fund.

Table 7-4 also indicates that the United States is a party (either a lender or a borrower) in roughly 80 percent of global cross-border claims. As noted above, foreign investors have found the U.S. economy very attractive and have built up their holdings of U.S. assets. At the same time, U.S. citizens have substantial holdings of foreign assets. Foreign-owned assets in the United States total $9.4 trillion, and U.S. claims on the rest of the world total $7.2 trillion, so that the United States is today in the position of a net debtor.

In most cases, transferring capital across borders requires a foreign exchange transaction, in which the currency of one country is exchanged for that of another. As capital flows have increased, so has turnover (the total value of transactions) in the foreign exchange market. Data for foreign exchange turnover correspond to the broadest measure of capital flows discussed earlier. There is no attempt to net purchases and sales against each other, either across trading days or across transactions that finance one country's purchases versus those that finance its sales. Since 1989 daily nominal foreign exchange turnover has more than doubled; it now averages $1.2 trillion. But turnover has actually fallen since 1998, for two reasons. One is that the introduction of the euro as the common currency of the European economic and monetary union means that many cross-border transactions within Europe no longer require an exchange of currencies, and the other is that consolidation has occurred in the international banking sector.

Given the annual capital flow data summarized in Table 7-2, the turnover data suggest that gross flows for the year as a whole are the product of extraordinarily large flows on a daily basis within the year. This provides yet another explanation for policymakers' concern that in some cases the sheer size of these flows could overwhelm the resources of a poorly supervised financial system in the event of a sharp reversal. This issue is discussed further later in the chapter.

The Benefits of Globalization

The various trends, described in the previous section, toward increased interaction between people and firms in different countries—increases in trade as well as increases in capital flows—are often collectively referred to as globalization. Each of these forms of globalization, and others such as international migration, benefit the United States in a variety of ways, as this section will show.

The Benefits of Trade

International trade, both exports and imports, benefits the economy in a number of different ways. In a general sense, exports benefit the economy

because American workers have another market—the global market—in which they can sell the goods and services they produce. Over 12 million American jobs are supported by exports. Opening foreign markets for U.S. producers allows them to expand their output and hire more American workers. Before the North American Free Trade Agreement (NAFTA) went into effect in 1994, for example, U.S. shipments of assembled motor vehicles to Mexico were severely hampered by Mexico's high tariffs and other regulations designed to protect the local automotive industry. Under NAFTA, Mexico was required to reduce these barriers: in 1998 Mexico eliminated its tariffs on light trucks produced in the United States, and all remaining Mexican tariffs on medium and heavy trucks and buses were eliminated on January 1, 2002. Subsequently, U.S. exports of motor vehicles to Mexico rose from $975 million in the 5 years preceding NAFTA to $6.6 billion in the 5 years after NAFTA. And this happened despite a major recession in Mexico following that country's financial crisis of 1994-95.

The health of many sectors of the American economy depends upon trade. America's farmers, for example, rely on sales to foreign markets. Exports of U.S. agricultural products amounted to $53 billion in 2000, and roughly 25 percent of cash sales by farmers and ranchers come from sales to foreign consumers. U.S. agricultural exports support 740,000 American jobs.

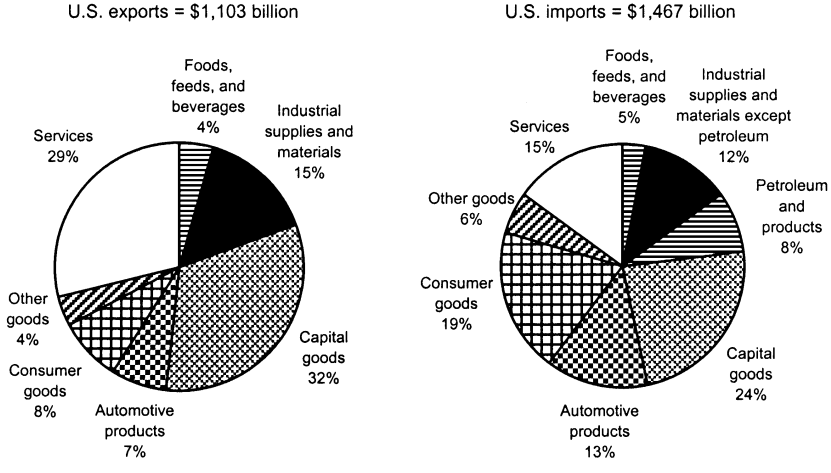
Trade also benefits the economy in a number of more specific ways. First, trade may reduce the prices of some of the goods that we consume. When a country is closed to trade, domestic consumers are forced to buy only those goods produced in their home market. Often, however, a producer in another country is able to produce the same goods more efficiently, that is, at a lower cost. When trade is open, consumers have the choice of buying the imported good at the lower price. In addition, now that domestic producers are competing with imports, they will have greater incentive to produce using the lowest-cost methods possible. Thus international trade tends to reduce the prices of some goods traded. Of course, if the United States is already the lowest-cost producer of a good, domestic consumers will continue to purchase it from domestic suppliers.

A second specific benefit of trade is that it gives a country's consumers access to the many different goods and services produced around the world. For example, without trade, we would not be able to purchase coffee from Costa Rica, or enjoy certain fresh tropical fruits year-round. We would not have access to some products at all, or would be able to consume only the domestic variety. Similarly, when a firm needs a specialized input for a production process, trade often allows it to choose from many options available around the world, rather than only those produced at home. This option allows the firm to produce more efficiently, and be more competitive internationally, than without this choice.

As a third benefit of international integration, trade helps boost productivity in the United States. Increased competition from trade provides incentives for domestic firms to produce using the most efficient, lowest cost methods possible. Firms that are successful in international competition are likely to be more productive than those that sell only at home. In fact, recent evidence shows that exporters tend to be relatively more efficient and to pay higher wages than nonexporters. One study found that, in 1992, a worker at an exporting plant earned wages that were 10 percent higher, and nonwage benefits that were 11 percent higher, than a worker at a nonexporting plant.

Trade also allows the U.S. economy as a whole to specialize in the products that it is comparatively best at producing. This is because trade between nations is the international extension of the division of labor. The United States exports some of the goods and services that it is relatively better at producing, and receives in exchange goods and services that other countries are relatively better at producing. For example, the United States exports manufactured goods that require high levels of technical skill, such as telecommunications equipment and professional scientific instruments. Some of these industries, such as electronics and computer equipment, sell at least a quarter of their merchandise overseas (Table 7-1). This reflects the relative abundance of highly skilled labor in the United States. U.S. imports, on the other hand, tend to be in areas such as consumer goods (Chart 7-3). This specialization of economic activity based on comparative advantage

Chart 7-3 **U.S. Trade by Sector in 2000**
The largest category in both exports and imports is capital goods.



Note: Data are on a national income and product accounts basis.
Source: Department of Commerce (Bureau of Economic Analysis).

allows the United States as a whole to use its resources most effectively, and it allows Americans to purchase goods from the world's best sources of those goods. Thus both exports and imports are beneficial and help make the United States a richer and more efficient economy.

Trade also increases productivity because it gives exporters access to a larger total market. Because some goods, such as automobiles, are produced most cheaply in large quantities, a larger market may allow exporters to reduce their production costs through economies of scale. Finally, trade benefits the economy through the access it provides to foreign technology and ideas. We can import innovative products from abroad and use them to increase our own efficiency, or to create even newer technologies, raising the rate of economic growth.

The Benefits of Capital Flows

Just as trade flows result from individuals and countries seeking to maximize their well-being by exploiting their own comparative advantage, so, too, are capital flows the result of individuals and countries seeking to make themselves better off, in this case by moving accumulated assets to wherever they are likely to be most productive. Increased capital flows benefit both the lender and the borrower. From the lender's perspective, cross-border capital flows provide an opportunity to diversify an investment portfolio. To the extent that returns on international assets do not move in lockstep with returns on domestic assets, diversification through cross-border investments both increases expected returns and lowers risk. These benefits lie behind the large increases in capital flows documented earlier in the chapter. The "home bias" to investment portfolios is falling: whereas in the late 1980s only 6 percent of U.S. residents' equity holdings were in foreign assets, more recent estimates put that share at more than 10 percent. Even that, however, is below the percentage that most models of optimal portfolio selection would predict.

For the borrower, cross-border capital flows allow for an expansion of production possibilities. Lending from abroad allows more capital to be combined with other inputs to increase the production of valuable goods and services. Some of the increase in output will be used to pay back the lender, but a substantial fraction should contribute to a rise in domestic standards of living. This is particularly important for developing economies, where overseas capital effectively substitutes for or augments often-scarce domestic sources of investment. Capital inflows can help keep domestic interest rates low, making sure that government borrowing to finance programs for education and health care does not crowd out private domestic investment.

Capital flows also boost efficiency in the borrowing country. New ideas and techniques accompany capital flows across borders, allowing for a more

efficient allocation of resources within the country. Such knowledge transfers boost productivity in the receiving country, allowing for more rapid technological economic progress there. This is most evident in the case of foreign direct investment, where new plants and new management methods can lead to sharp increases in output. Capital inflows also help expand and diversify the financial system in the recipient country, and this, too, leads to a more efficient allocation of capital and faster growth.

The increases in economic well-being associated with increased capital flows require a supportive domestic environment. Without this support, capital flows can reverse themselves sharply, imposing large adjustment costs on the borrowing economy. The risks of a reversal are heightened if the borrowing economy is pursuing unsound macroeconomic policies, or if supervision of the financial system is inadequate.

Quantifying the positive relationship between increased capital flows and faster growth is difficult, for several reasons. First, poor macroeconomic or regulatory policies may render some countries unable to harness investment capital in ways that promote sustainable growth. Second, causation between capital flows and economic growth is likely to run both ways. An increase in capital available to an economy will boost growth, but as an economy grows, it is more likely to attract foreign capital. This confronts economists with a chicken-and-egg question: which came first, the capital flows or the growth? Recent empirical research has struggled with these problems but, on balance, concludes that the increased capital flows brought about by capital liberalization spur economic growth. All else being equal, a country that opens up to capital flows can expect to enjoy an increase in its growth rate per capita of half a percentage point or more per year. For example, if an economy is growing at an annual rate of 2 percent, opening up to capital flows would allow its economy to double in size 7 years sooner than otherwise.

There is every reason to expect that in the long run international capital flows will continue to increase in importance, as economies around the world become more interlinked. Continued increases in trade volumes, discussed earlier in the chapter, will require capital flows to finance them. Investors will continue to obtain the benefits of diversification from increasing their international exposures. And, as we have seen, the average investor is still a long way from holding an optimally diversified international portfolio. Finally, although world living standards are improving on average, both the relative and the absolute gap in incomes per capita between rich and poor countries continue to increase. This gap indicates that the rate of return on capital in the world's poor economies is likely to be several times that in the rich economies, providing an enormous incentive for continued—and indeed, augmented—flows. Of course, this will only be true to the extent that productivity gains achieved in the developed economies can be transferred across borders. And most important, it requires that the least developed

economies have sound policies and educated work forces in place, to make effective use of the capital coming in.

The Role of Migration

Migration is another important aspect of the internationalization of the economy. Just as trade in goods, services, and capital allows resources to be used most efficiently, so, too, the movement of people from country to country around the world can enable them to make the best use of their skills and abilities. Thus removal of barriers to immigration allows for more efficient worldwide distribution of workers.

The United States has a long history of accepting people from other countries, as witnessed by the numbers collected by the Bureau of the Census on the foreign-born population. In 2000 foreign-born residents made up 10.4 percent of the U.S. population (although in 1900 they represented an even greater 13.6 percent). Immigrants have been a key building block for the U.S. economy. Our openness to immigration has allowed us to reap the benefits of the presence of newcomers from many countries.

Immigrants benefit the economy in several ways. First, people are a resource, similar to the other resources of our economy such as land or minerals. Immigrants who come to the United States to work allow the country to produce more. It has been estimated that if immigrants make up 10 percent of the population, the net overall gain from their presence is somewhere between 0.01 and 0.14 percent of GDP per year. Given that, in 2000, U.S. GDP was $9.9 trillion, the overall gain is between $1 billion and $14 billion.

The increase in the labor force from immigration also affects prices. The goods and services that immigrants produce tend to become cheaper as more immigrants enter, and all consumers benefit from this reduction in prices. This price drop is an average price drop across all goods and services. Some goods and services—in particular, those that use a lot of unskilled labor—will see sharper drops in prices than others. Household services and services to dwellings are examples. On the other hand, the prices of goods and services that use less unskilled labor are likely to fall by less or stay the same, and may even increase.

Legal immigrants who work may also contribute to government finances by paying taxes on the wages they earn. Because they tend to be younger workers, immigration also improves the current balance sheet of Social Security. Of course, legal immigrants may receive welfare benefits, which impose a cost on the government and taxpayers. Recent research provides some estimates on the balance between taxes that immigrants pay and the benefits they receive. These calculations indicate the ultimate effect on taxpayers of a given legal immigrant now and into the future, taking account of the effects of that

specific immigrant on taxes and benefits, as well as the effects of his or her children into the future. Overall, according to this research, the average immigrant makes a net positive fiscal contribution of about $80,000.

Some Myths About Trade and Globalization

Although globalization, by increasing the movement of goods and services, capital, and people across the Nation's borders, has provided a variety of benefits to the United States, many have expressed concerns about globalization's effects, both in the United States and abroad. This section reviews some of those concerns and explains why globalization is, in fact, unlikely to have the adverse effects often feared.

Trade and the Environment

A variety of concerns have been raised about the impact of globalization on the environment. One is that government action to implement domestic environmental regulations may be interpreted in other countries as protectionism and, consequently, in violation of trade agreements that the United States has entered into. Domestic environmental regulations may then be challenged, and the case adjudicated by international dispute settlement mechanisms. The concern is that the United States might be forced to change or eliminate its own environmental standards.

In fact, environmental regulations do not normally raise issues of consistency with international trade agreements, which are aimed at preventing discrimination against foreign products, not at lowering environmental standards. There is generally no reason for environmental regulations to lead to discrimination against or among foreign products. If a product is judged to inflict environmental harm, its production and use are normally regulated, or prohibited, without regard to its origin; if this is the case, such regulations are unlikely to breach international trade obligations. Even if they did, international trade agreements contain exceptions that allow a country to take environmental measures against imported products that might otherwise violate obligations under the agreement.

For example, Article XX of the 1994 General Agreement on Tariffs and Trade—one of the agreements among members of the World Trade Organization (WTO)—lists a number of general exceptions to members' obligations. One of these confirms that a WTO member may adopt and enforce measures "necessary to protect human, animal or plant life or health" or "relating to the conservation of exhaustible natural resources." These exceptions are subject to a number of conditions, among them that the measures not arbitrarily or unjustifiably discriminate among countries and

that they not constitute a disguised restriction on international trade. (NAFTA incorporates similar exceptions and conditions.) Thus, nothing in these international agreements prevents the United States from establishing and maintaining legitimate environmental measures, so long as it does so in a way that does not unjustifiably discriminate against its trading partners or create unnecessary barriers to trade. In fact, the General Accounting Office concluded in 2000 that, "The WTO rulings to date against U.S. environmental measures have not weakened U.S. environmental protections."

Other concerns about globalization may stem from the fear that growth in developing countries resulting from increased trade may lead to environmental degradation. But in fact, there is no clear relationship between development and pollution levels. Indeed, some evidence shows that organic water pollution intensity falls substantially as a country's income per capita rises from $500 to $20,000, with the decline beginning before the country reaches high-income status (about $10,000 in annual income per capita). Trade may also give countries access to cleaner technologies, allowing them to build their industries in a more environmentally sound fashion.

Trade and Employment

Some argue that globalization leads to the loss of jobs for American workers. It is true that some domestic firms will not be able to compete effectively with imports, and these firms may be forced to reduce their work force or even cease operations. At the same time, however, the opportunity for increased trade will lead other firms to expand their operations and increase hiring, in order to serve the international market as exporters. These firms tend to be the more productive ones in the economy. Exporters also tend to pay higher wages than firms that do not export—in 1992, up to 18 percent higher on a simple average basis, according to one study.

It is also true that the firms forced by import competition to eliminate jobs may be in different sectors from the exporters who are increasing hiring. This can make it difficult for those who lose their jobs to import competition to find new jobs with exporting firms that use the skills they have acquired. But such shifts in employment also reflect one of the benefits of trade for the aggregate economy, namely, that it allows the economy to produce the goods and services that it is comparatively best at producing, and to buy from other countries those goods and services that it is relatively ill equipped to produce. The expansion of trade that may precipitate such a shift of workers may, as a result, lead to an increase in the average income of the American worker, because wages in import-competing industries tend to be below the average, whereas wages in exporting industries tend to be above the average. Workers in export-competing industries such as aircraft and pharmaceuticals earned about 22 to 60 percent more than the average wage in 2000. The reverse is

true for import-competing industries: wages in the apparel industry, for example, were 36 percent lower than the average in manufacturing, those in the leather industry were 29 percent lower, and those in the textile industry 35 percent lower.

The shifting of jobs across sectors may take time, and some workers may face dislocation. However, the displacement of some workers by imports should not be an excuse for discouraging trade, any more than the costs to some workers of technological change should stop the development of innovations. It would have made little sense to discourage the diffusion of personal computers just because it jeopardized the workers of typewriter manufacturers. Imposing trade restrictions in an effort to save those jobs will only destroy, or prevent the creation of, jobs in other sectors. If, for example, government-imposed trade barriers were to hinder access to imported capital goods, the domestic firms that purchase those inputs would be forced to operate at higher costs of production. This would adversely affect their competitive position relative to foreign rivals who have free access to such capital goods. Domestic producers might lose sales, and this might force them to downsize their work forces, or even to shift production to locations abroad where the inputs are freely available.

Of course, finding a new job in another firm or another industry, after losing one's job to import competition, may be difficult. The Federal Government recognizes this possibility and has put programs in place to assist those who lose their jobs because of trade in finding new ones, and to provide them with financial assistance while they make the transition. For example, the Trade Adjustment Assistance (TAA) program provides training, job search aid, and relocation allowances; these benefits are on top of unemployment insurance and other programs. In 1999 close to 130,000 workers were estimated to be in groups certified as eligible for TAA. This Administration is committed to reauthorizing and improving existing TAA programs that are due to expire. The Administration worked during 2001 to strengthen the performance of these programs, so that they are more effective at easing the transition into new employment. In addition, for certain sensitive sectors such as textiles and agriculture, trade liberalization is designed to proceed in gradual stages so that workers have more time to adjust.

Trade and Relative Wages

Over the last three decades, the returns to education, in the form of higher wages, have increased dramatically, although the rise has flattened out in more recent years. In 1979 a male with a college degree could command a 30 percent wage premium over a male with only a high school diploma. This premium had risen to 60 percent by 1995 but has remained relatively constant since then. Because workers with less education often work in

industries that compete most closely with imports, particularly those from developing countries, some have blamed increased trade for these changes in wages. However, although the United States did increase its imports from developing countries over this period, it also experienced a great deal of technological change, which increased demand for workers with higher skill levels. This tends to increase the relative wages of those with higher skill levels. In fact, it appears that this increased demand for more educated workers, and not increased trade with developing countries, has led to the recent change in relative wages.

The Effects of Trade on Developing Nations

Some have suggested that international trade may harm workers in developing countries, because countries like the United States import goods produced under poor working conditions or at very low wages. Those who hold this position argue that the United States should use trade measures, such as withholding access to our markets, as a weapon to force developing countries to improve working standards or to increase wages.

The use of trade policy to force such changes, however, would have perverse effects, actually hurting those it aims to help. For example, if the United States and other countries refused to import from countries where wages are below a certain standard, workers in those countries would be denied the opportunity to work in an export-producing industry. Unfortunately, jobs in other industries may not be readily available in that country, or if they are, may pay even lower wages and impose even worse working conditions.

In addition, to cut off imports from such countries may be to deny them one of their best opportunities for economic growth. A number of recent studies show that participation in an open trading system has a positive effect on a country's income per capita. One study finds that increasing the ratio of trade to GDP by 1 percentage point raises income per capita by 1.5 to 2 percent, and an increase in average incomes is generally associated with higher incomes for the poor. Several studies by the World Bank also point to a linkage between trade liberalization and faster economic growth, as liberalization encourages higher rates of investment and more rapid technological innovation. Thus, limiting trade with developing countries may only serve to keep the poor in their poverty. Perhaps because of the negative effects of linking trade and labor outcomes, many developing countries are strongly opposed to including discussions on labor standards in international trade negotiations.

Many countries, including the United States, do adhere to certain core labor standards, such as the prohibition of exploitative child labor. Trade in and of itself does not cause poor working conditions. Rather, they are more

likely to be the result of domestic policies and economic circumstances. In fact, trade may help to improve working conditions, just as it may facilitate an increase in incomes. Benjamin Franklin summarized it well: "No nation was ever ruined by trade."

International Policy Issues and the Role of International Institutions

An important factor in the continued worldwide growth in trade and capital flows has been the creation and development of international institutions dedicated to promoting that growth. The United States is a participant in these institutions and has benefited from their important work. The United States has also participated in recent efforts to reform some of these institutions. The present section discusses some of the most important of these organizations and recent proposals for their reform.

International Trade Institutions and the Benefits of Trade

International trade institutions and agreements are designed to ensure that all parties are able to enjoy the benefits of free and open trade. These institutions allow many countries to negotiate together to reduce barriers to trade in ways that are acceptable to all. They also create a stable framework for international transactions. If progress is to continue toward the goal of increased trade, it is crucial that the United States encourage its trading partners to maintain the focus of trade negotiations on this main purpose, rather than stray into areas, often very controversial, that could stall greater progress toward free trade.

The international trade agreements in which the United States has participated can be classified into several broad types. Those of the first type are called multilateral agreements, in which a large number of countries around the world agree to reduce barriers to trade among themselves. As a rule, agreements of this type, such as the General Agreement on Tariffs and Trade (GATT), are structured such that each participating country agrees to reduce trade impediments to all other participants. One of the foundations of the GATT/WTO system is the most-favored-nation (MFN) principle, which mandates that if a WTO member extends any benefit (such as a reduction in tariffs) to a product of another WTO member, it must extend the same benefit to like products of all other members.

A second type of trade agreement is the regional trade agreement, examples of which include NAFTA and the trade agreements of the

European Union. In such agreements, each participant agrees to reduce trade barriers only with respect to the other participating countries in the region. So, for example, in NAFTA, the United States reduced its barriers to Mexican and Canadian exports but made no such changes for exports of European or Asian countries. (Such favorable treatment of regional trade might seem to violate the MFN principle for countries that are WTO members; however, Article XXIV of the 1994 GATT explicitly allows for such regional agreements under certain conditions.)

Although regional agreements generally make good progress toward free trade among the participants, they may introduce some distortions in trade patterns. A country may end up importing goods from a country in the region that has high costs of production but is subject to a low tariff, rather than from one outside the region (or a nonparticipant within the region) that has a low cost of production but faces a high tariff. Such trade patterns (called trade diversion) may hinder the most efficient use of global resources. However, an advantage of regional trade agreements over multilateral agreements is that a smaller group of countries may find it easier to come to a consensus on trade liberalization. Also, if the agreement is among countries that would naturally engage in a great deal of trade with each other in the absence of artificial barriers to trade (for example, countries in close geographical proximity to each other), the amount of trade diversion may be very small.

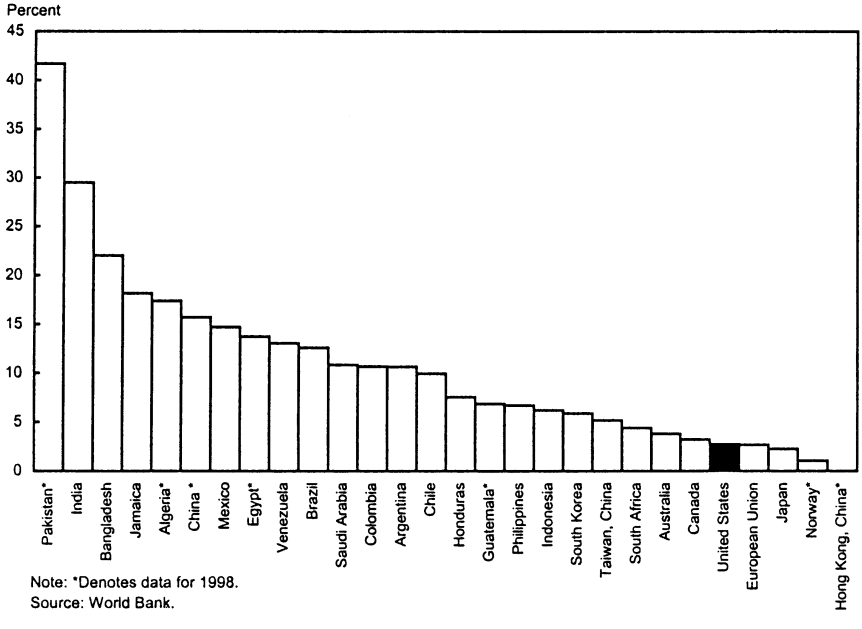
The WTO has reported a massive proliferation of regional trade agreements in recent years, with an average of one per month being notified to the organization. A recent study by the WTO Secretariat identified a total of 172 regional trade agreements currently in force (including some that have not, or not yet, been notified to the WTO), and this number could well grow to about 250 by 2005. On the basis of the 113 regional trade agreements notified to the WTO and deemed to be in force as of July 2000, it is estimated that some 43 percent of world trade occurs within such agreements. This share would rise to 51 percent if all 68 or so of the regional trade agreements currently under discussion and scheduled to be in force by 2005 were already in place.

Economists are divided as to whether regional agreements help or hinder progress toward broader, multilateral agreements. On the one hand, negotiation over regional proposals may divert negotiating resources from multilateral talks, or a proliferation of different regulations under various regional agreements may raise transactions costs for trade. On the other hand, if all countries engage in regional agreements, there will be competition to get the best trade deals, and this competition can lead to bidding down barriers to free trade. It may also be easier for a small country to get larger countries to recognize and understand its needs in a regional than in a multilateral setting.

Finally, a third type of trade agreement is the bilateral trade agreement, such as the recent agreement between the United States and Jordan. Others include the agreement between the United States and Israel and that between Canada and Chile. Such agreements have pros and cons similar to those of regional agreements.

The United States benefits significantly from its participation in international trade institutions, for a number of reasons. For one, because U.S. tariffs on imports are already among the lowest in the world, any agreements to further liberalize trade will likely lower other countries' tariffs more than they lower U.S tariffs. U.S. tariffs average about 2.5 percent on comparable, trade-weighted terms (Chart 7-4), but U.S. producers face extremely high tariffs in many developing countries. For example, average tariffs on U.S.-produced goods are 13.7 percent in Brazil, roughly 17 percent in Thailand, and up to 35 percent in India. (The numbers for Brazil and Thailand are average applied rates; that is, they are averaged over all imports from the United States. The rate for India is a ceiling rate, which means that no tariff is supposed to be higher than 35 percent. However, because of exceptions put in by the Indian government, the applied rate could be higher.) Many of the United States' trading partners, including the European Union and Japan, maintain high barriers on a range of agricultural goods.

Chart 7-4 **Import-Weighted Average Tariffs, 1999**
U.S. tariffs are among the world's lowest; many developing countries impose tariffs at far higher rates.



Note: *Denotes data for 1998.
Source: World Bank.

Thus, multilateral agreements on tariff reduction often disproportionately benefit U.S. exporters.

However, tariffs are not the only artificial barriers to trade. Other barriers include quotas (quantitative limits on import volumes), technical regulations and standards (such as for telecommunications equipment), rules for the valuation of goods subject to tariffs (which affect how the tariffs are calculated), and rules regarding investment (for example, limiting the percentage of foreign ownership of a domestic company). Unfortunately, whatever their stated purpose, such rules are often in fact designed to protect domestic industries from foreign competition. The United States faces discriminatory regulations in many countries. Discriminatory foreign health and safety regulations cost the United States over $5 billion in agricultural exports in 1996, according to the Department of Agriculture.

To circumvent this problem, most trade agreements establish the principle of nondiscrimination, or national treatment. This means that all countries that are parties to the agreement must treat the exports of other parties as if they were domestically produced. Since many international agreements now include provisions on regulatory barriers and government procurement policy, this requirement allows U.S. exporters to avoid such impediments in other countries. As tariffs fall, these kinds of negotiations become increasingly important to the opening of markets.

The United States has participated in a number of different trade institutions and agreements over the years. For example, the United States was a member of the GATT from its inception in 1948 until 1995, when the WTO was formed. Until the WTO came into being, the GATT was both the agreement (which is still in effect) and the international organization formed on an ad hoc basis to support it. The United States benefited significantly from the outcome of the Uruguay Round, a recent major round of multilateral negotiations under the auspices of the GATT. The reduction in U.S. tariffs that emerged from that agreement had an effect on an average American household of four similar to a tax cut of $310 a year, or the equivalent of a per-year income gain of more than $600.

The WTO is an international institution in which the United States negotiates agreements with 143 other members to reduce barriers to trade. In addition, the WTO maintains a forum for dispute settlement that enables its members to resolve trade disputes arising under the WTO agreements. At the fourth WTO Ministerial Conference in Doha, Qatar, in 2001, the members of the WTO agreed to launch a work program that includes further negotiations on trade liberalization. Negotiations will commence in a number of areas, including agriculture, services, industrial market access, a limited set of environmental issues, antidumping and subsidies, and WTO dispute settlement rules; it will also include important work on trade-related capacity building for developing countries. Members also committed

themselves to maintain their current practice of not imposing customs duties on electronic transmissions at least until the Fifth Session of the Ministerial Conference, which is likely to occur in 2003. Negotiations on certain issues, such as investment and competition policy, are delayed until that conference.

Some of the issues slated for negotiation have proved particularly difficult to deal with in the past, suggesting that gains from the new WTO agenda could be large. The new work program will address market access barriers to trade in agricultural products as well as government subsidies in this sector. Some countries, such as those of the European Union, rely heavily on export subsidies. The potential gains to the United States from these discussions are indeed sizable, in part because the multilateral negotiations promise to reduce barriers to U.S. trade around the entire world. One study finds that if a new trade round reduced world barriers on agricultural and industrial products and on trade in services by one-third, the gains to the United States could amount to $177 billion, or about $2,500 for the average American family of four.

The United States is also a founding member of the Participants to the Arrangement on Guidelines for Officially Supported Export Credits, an independent body within the Organization for Economic Cooperation and Development (OECD). The arrangement was established in 1978 to limit the terms and conditions under which governments can finance their exports, with the goal of opening export markets by eliminating official financing subsidies. Financing subsidies close markets by eliminating competition on the basis of price, quality, and service and directing business to those countries willing to spend budget resources to provide below-market export financing. The arrangement is currently operated by 24 OECD member governments and governs official export credits totaling $45 billion in 2000, as well as aid financing of about $9 billion to $10 billion a year. The WTO leaves much of the discipline for such indirect subsidization to the OECD Arrangement, and therefore the U.S. antisubsidy efforts in the OECD are complementary to its broader WTO work to eliminate subsidies. The Treasury Department estimates that OECD disciplines over aid financing subsidies alone have opened export markets worth $5 billion to $6 billion annually, leading to increased U.S. exports of about $1 billion each year. The overall U.S. budget savings from all OECD disciplines on financing subsidies amount to around $300 million a year.

NAFTA has been another important example of U.S. participation in international trade institutions. From 1994, when NAFTA went into effect, until 2000, total trade among the United States, Mexico, and Canada increased from $297 billion to $676 billion, or 128 percent. The share of worldwide U.S. goods exports that has gone to NAFTA partners more than doubled over the same period, from 14 percent to 37 percent. Trade restrictions imposed on U.S. exports by our NAFTA partners have fallen

significantly. For example, in 1993 Mexico's average tariffs on U.S. goods were more than twice as high as U.S. tariffs on Mexican goods. Under NAFTA, Mexico's average tariff on U.S. exports has fallen below 2 percent, and two-thirds of U.S. exports now enter Mexico duty-free. Nearly all of the $406 billion in goods traded between the United States and Canada enters duty-free.

The United States has benefited from this agreement, which when fully implemented will, according to some estimates, yield an increase in U.S. GDP of between 0.1 percent and 0.5 percent, or between $10 billion and $50 billion relative to the size of the economy in 2000. For an average household of four, this translates into a per-year income gain of $140 to $720. The NAFTA liberalization is also roughly equivalent to a tax cut of $210 for the same family. U.S. producers of various commodities also benefit from NAFTA. Exports of beef and processed tomatoes to Canada, as well as of cattle, dairy products, apples, and pears to Mexico, are 15 percent higher than they would have been had the Canada-U.S. Free Trade Agreement, and later NAFTA, not reduced barriers to U.S. goods in those markets, according to the Department of Agriculture.

The United States is currently involved in efforts to liberalize trade with a larger number of our hemispheric neighbors. Discussions toward a Free Trade Area of the Americas (FTAA) began at the Summit of the Americas in Miami in December 1994. Thirty-four countries agreed to construct a free-trade area in which barriers to trade and investment would be progressively eliminated, and to complete negotiations toward the agreement by 2005. The FTAA thus aims to establish free trade across the Western Hemisphere, from Hudson Bay to Tierra del Fuego. The nine FTAA negotiating groups cover a range of areas, including market access, agriculture, services, investment, intellectual property, government procurement, competition policy, dispute settlement, and antidumping, countervailing duties, and subsidies.

The potential market that an FTAA would create is enormous: the combined GDPs of Central and South America amount to $1.57 trillion. (This figure leaves out Mexico, as it is already covered under NAFTA.) And the obstacles currently faced by American exporters in Latin America are formidable, particularly since other countries in the region already have negotiated reductions in barriers with each other. For example, when Chile and Canada recently concluded their bilateral free-trade agreement, Chile's across-the-board 8 percent tariff was eliminated on Canada's exports, but it remains in effect on U.S. exports. Under the MERCOSUR trade arrangement—a customs area agreement signed in 1991 among Argentina, Brazil, Paraguay, and Uruguay—imports and exports among these four countries and Chile are largely duty-free; U.S. exporters to those countries face average tariffs of almost 15 percent. The FTAA promises to eliminate the discrimination against U.S. products in these markets.

The importance of breaking down barriers throughout the hemisphere is epitomized by the experience of Caterpillar Inc. Caterpillar's motor graders made in the United States for export to Chile face nearly $15,000 in tariffs. Yet when Caterpillar manufactures motor graders in Brazil for export to Chile, the tariff is just $3,700. And if Caterpillar's competitors were to produce a similar product in Canada, it could be exported to Chile duty-free under the Canada-Chile free-trade agreement. One result of these high trade barriers against the United States may be to create incentives for U.S. firms to locate factories abroad.

If an FTAA were to eliminate barriers to trade in agricultural and industrial goods and in services among the countries in the hemisphere, the United States could reap a gain of $53 billion, according to one study. An FTAA would also promote greater economic integration and regional cooperation, bringing greater economic opportunity and political stability to the region. Negotiations toward this agreement continue.

As this review has shown, past U.S. participation in international trade institutions and agreements has benefited the United States significantly. Our continued ability to exercise effective leadership in trade negotiations, however, depends on restoration of the President's Trade Promotion Authority (TPA). TPA allows the President to submit a negotiated trade agreement to Congress subject to an up-or-down vote, without amendments. Congress retains the final decision on whether or not the United States signs any trade agreement, but TPA provides the President with more negotiating leverage and gives the United States enhanced credibility in negotiations with its trading partners.

TPA has a long history. In the 1934 Reciprocal Trade Agreements Act, Congress for the first time agreed to give its prior approval to any trade agreement reached by the executive, although it did require that the negotiating authority be renewed every 3 years. Although the Trade Act of 1974 required that Congress approve trade agreements after their negotiation, it also provided a "fast-track" procedure in which Congress would vote in a timely fashion and without amending the agreement. This fast-track procedure has been used to pass legislation implementing the United States' most recent important international trade agreements, including NAFTA in 1993 and the Uruguay Round of the GATT in 1994. These procedures, however, lapsed in 1994 and have not been renewed.

Role and Reform of International Financial Institutions

International financial institutions (IFIs) exist to help countries cope with short-term balance of payments problems and address longer term development challenges. Capital flows have played an increasingly important role in

both these areas, calling for policy responses from countries and from the IFIs themselves.

As already noted, capital flows represent a transfer of resources across time, as savers lend to borrowers today in exchange for repayment plus interest or dividends tomorrow. Increased uncertainty about those repayments can render unattractive an investment that was once attractive. In particular, changes in economic policies or political developments can cause investors to sharply reevaluate the prospects for future payments. Thus their very forward-looking nature can make capital flows subject to abrupt reversals.

Sharp reversals of international capital flows have occurred many times in history. The United States in the 1800s was a developing economy that benefited from European capital inflows. Financial disruptions in the 1850s, 1870s, and 1890s were associated with sharp reversals in these flows. The same situation played out in Latin America in the 1930s. As capital markets collapsed with the onset of the worldwide depression, governments in the region were hit particularly hard. By 1935 almost 70 percent of Latin American national government bonds were in default.

More recently, the emerging market debt crisis in the 1980s was another example of a sharp reversal in capital flows. Rising real interest rates associated with the effort to contain global inflationary pressures made investment projects in developing economies look less attractive. This reversal of capital flows led to a "lost decade" for the Latin American economies until expectations improved when new policies involving structural reform were put in place. Most recently, the crises of the 1990s—in Mexico in 1994-95, East Asia in 1997-98, and Russia and Brazil in 1998-99—again demonstrated how investments based on forward-looking calculations of risk and expected return can quickly reverse, especially when weaknesses in the recipient country's policy framework are exposed.

These abrupt reversals in capital flows are extremely costly. The withdrawal of foreign investment drives up interest rates in the borrowing country, retards domestic investment, and often leads to a sharp contraction in economic activity and a shrinking of future production possibilities. The balance sheets of domestic firms that depended on these flows are considerably weakened, and there is often a wrenching reallocation of domestic resources away from the nontradable goods sector to the tradable sector, to accomplish the current account adjustment necessitated by the drop in capital flows.

Finally, many of the world's poorest economies, plagued by years of economic mismanagement, have had little access to private capital flows of any kind. Investors are unwilling to extend loans without some prospect of repayment. But the possibility of repayment is bleak given an unstable system of governance that cannot guarantee property rights, or establish the necessary legal, financial, and physical infrastructure that would foster the

productivity of their citizens. Often, the result is a cruel paradox: the countries most in need of capital—and that might offer the highest potential rates of return on that capital, were the proper policies in place—are precisely the ones with the least access to international capital flows.

The Evolution of Today's International Financial Institutions

Two of today's principal IFIs were created as part of the post-World War II international financial arrangements that came to be known as the Bretton Woods system. Chief among the IFIs is the International Monetary Fund, established in 1945. One of the original goals of the IMF was to provide short-term loans to countries to help with balance of payments adjustment. Under the system of pegged (but adjustable) exchange rates in place from the late 1940s until 1971, it was expected that countries on occasion would require help to manage a set of macroeconomic policies that was inconsistent with the country's fixed exchange rate. The usual manifestation of this inconsistency was a current account deficit that could not be offset by private capital flows at the prevailing exchange rate. One alternative in such a situation would be to devalue the domestic currency in an effort to close the current account deficit. However, following a series of such devaluations in the 1930s in which countries essentially competed for trade advantage, the IMF was created to provide short-term funding to countries in such distress. This funding was meant to provide countries with the breathing room necessary to implement a more rational set of macroeconomic policies that would allow them to avoid the devaluation option.

With the abandonment of the Bretton Woods system of fixed exchange rates in the early 1970s, the IMF essentially lost its original role. Over the past 25 years, the IMF's mandate has broadened to include promoting international monetary cooperation and orderly exchange arrangements with the aim of fostering economic growth. To carry out this mandate, the IMF undertakes surveillance of the macroeconomic policies of its 183 member economies and provides them financial and technical assistance. In this sense, the IMF no longer functions merely as a crisis lender to economies facing balance of payments adjustments. The IMF has also become involved in supporting development programs, aiding the world's most impoverished countries through loans, help in devising a macroeconomic policy framework, and technical assistance.

The IFIs also include what are known as the multilateral development banks (MDBs), of which the World Bank Group is the largest. The World Bank was established in 1945 and had its initial focus on the reconstruction efforts following World War II. As Europe and Japan rebuilt, that focus shifted toward development, targeting the poorest countries, which were unable to obtain access to private international capital flows. The late 1950s saw the creation of the Inter-American Development Bank, the first of four

regional MDBs. Together the MDBs worked toward the goal of financing the development of the world's poorest economies. However, during the crises of the 1980s and 1990s the scope of the MDBs' mission was broadened, and, often encouraged by governments in the developed economies, they participated in the financial crisis lending packages organized primarily by the IMF. Thus the missions of the IMF and the MDBs have sometimes overlapped, with the IMF providing some nonemergency financing for developing economies and the MDBs contributing to crisis financing packages.

Performance of the International Financial Institutions in the 1990s

The turmoil in the international financial system in the second half of the 1990s indicated a shift in the nature of financial crises. The increase in the size of capital flows during the 1990s, documented earlier in this chapter, led to larger, more sudden crises when those flows reversed. These crises also appeared harder to contain, and the result often was large-scale IMF lending. The nature of these new crises focused attention on the role of the IFIs and raised key questions for policymakers. First and foremost, were the resources of the IFIs adequate to deal with these crises? Second, was the provision of assistance itself encouraging further crises? And finally, were countries becoming overly dependent on crisis financing provided by the IFIs?

From the mid-1980s through the mid-1990s, the IMF's resources available for crisis lending (also called its available liquidity) were adequate. However, over the 6-year period beginning in 1995, the average size of IMF stand-by arrangements (traditional lending programs), relative to the recipient country's IMF quota, more than tripled compared with the 6 years beginning in 1989. This is not surprising given the increase in gross capital flows over the 1990s. The new type of crisis was met with a larger official sector response. As a result, it became clear that, in the second half of the 1990s, IMF resources were shrinking relative to private financial flows. This was especially apparent during the Asian financial crisis, when IMF available liquidity fell to $56 billion in December 1997 from $83 billion the year before. By December 1998, available liquidity had dwindled to $54 billion.

Over the mid- to late 1990s, as crises developed and the size of IMF assistance programs increased, policymakers began to revisit the concern that the provision of official assistance was contributing to the development of new crises. The logic in support of such a proposition emphasizes the expectations of private investors. If investors come to expect that countries will automatically receive assistance in the event of a financial crisis, they are likely to exercise less prudence when making loans. Countries that are pursuing unsound policies may still get loans from private investors, since the investors believe that any future problems are likely to be resolved by the provision of

funds by the IFIs. This is an example of moral hazard: an increase in risky behavior (in this case on the part of the borrowing countries and their lenders) when insurance or a guarantee is provided (in this case by the IMF). Thus the concern is that IFI support can encourage risky activity on the part of private lenders and borrowing countries, which often ends badly in further rounds of crises.

The resolution of the crises of the late 1990s was also complicated by a shift in the composition of capital flows away from syndicated bank loans toward bond issuance. Such a shift protected the banking and payments systems of the industrial countries from the worst consequences of international financial crises. However, it also complicated the task of crisis resolution, because restructuring a country's debt now required dealing with a large number of bondholders spread around the world, rather than a small group of bank creditors. When a country's creditors are few in number, it may prove possible to coordinate an orderly restructuring that does little to interrupt economic activity (although this proved surprisingly difficult with bank loans to Latin American governments in the 1980s). But when the lenders are a large, diffuse group of bondholders, an orderly restructuring may be next to impossible. In fact, the switch from bank finance in the 1980s to bond finance in the 1990s in part may have reflected efforts by creditors to safeguard their positions by making such a restructuring more difficult for borrowers. In addition, the shift from bank to bond finance is part of a larger trend, seen not just internationally but in domestic capital markets as well, away from financial intermediaries to direct finance.

Efforts to Reform the International Financial System

As early as 1995, following the Mexican crisis, it became clear to international policymakers that the set of policies and institutions collectively known as the international financial system might be in need of overhaul, especially the IFIs themselves. Various official bodies commissioned reports that examined ways in which the system could be improved. These reports tended to focus on four key areas: transparency and accountability, strengthening national financial systems, management of crises, and debt relief. The following sections deal with each in turn.

Transparency and Accountability. Market-based transactions work best when parties are fully informed. Absence of important information on the part of the lender or the borrower in a transaction can lead to less than efficient outcomes (a finding recognized in the work of the most recent Nobel laureates in economics). Thus reform proposals have called for additional transparency and accountability both on the part of countries receiving capital flows and on the part of the IFIs themselves. In response, the IMF has established the Special Data Dissemination Standard to facilitate the flow of information from countries. In addition, the IMF has encouraged the publi-

cation of documents related to its surveillance (the annual Article IV consultations on each member's economic policies) and of the supporting documents submitted by the country and the IMF when a financial assistance program is put in place and reviewed. Over the last year, 45 percent of the full Article IV consultation reports were made publicly available.

Strengthening National Financial Systems. Several of the crises of the 1990s involved lax practices in the financial and corporate sectors of borrowing economies (see the 1999 *Economic Report of the President*). As a result, calls for the reform of the international financial system have included measures to strengthen national financial systems through the implementation of best practices in financial regulation. To meet these needs, the G-7 authorized the creation of the Financial Stability Forum (FSF) as a way to coordinate the activities of finance ministries, central banks, financial regulators from key economies, the IFIs, and international standard-setting bodies such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions. The FSF identified key standards and codes for countries' financial systems and has worked toward fostering their implementation. Beginning in May 1999, the IMF and the World Bank introduced the Financial Sector Assessment Program (FSAP) and a key byproduct, the Reports on the Observance of Standards and Codes (ROSCs), in order to assess countries' implementation of these standards. As of September 30, 2001, 57 countries had undergone review of their standards and codes, and reports for 36 had been published. As of the same date, 22 FSAPs had been completed, with 4 assessments published. The IMF has identified 11 main standards and codes that will be addressed in the ROSCs, including the Basel Committee's Core Principles for Effective Banking Supervision.

Management of Crises. As noted earlier, resolving the capital account crises of the second half of the 1990s required much larger IMF programs and caused a dwindling in available liquidity. One aspect of reform efforts was therefore the decision to increase IMF resources in 1998. The IMF resolution required that new commitments by member countries to the IMF be $89 billion. In February 1999 the United States increased its share by $15 billion. For crises affecting the global financial system as a whole rather than that of an individual country, additional funds are available to the IMF through borrowing agreements with a number of IMF members and other institutions. Provisions for a New Arrangement to Borrow (NAB) were agreed to in 1998, to supplement the existing General Arrangement to Borrow (GAB). At the end of 2001, total resources available to the IMF stood at $125 billion, of which $43 billion was available under the GAB and NAB facilities.

Steps were also taken to shorten the response time of IMF programs and to restructure programs to ensure that countries do not become overly

dependent on IFI resources. In 1997 the Supplemental Reserve Facility (SRF) was created, providing another type of loan arrangement for IMF programs. Explicitly short-term in nature (loans are expected to be paid back in 12 to 18 months and required to be paid back in 24 to 30 months) and carrying a higher interest rate than the more traditional stand-by arrangement, the SRF was designed to create incentives that would favor its use only by truly illiquid borrowers. Essentially solvent countries that have temporarily lost liquidity could afford the higher interest rates and would be able to repay any loan in a shorter period. Countries that have more fundamental problems would have recourse to programs with loans that would be paid back over a longer period.

To shorten response times, the IMF in 1999 created the Contingent Credit Line (CCL), a facility that allows countries with sound policies to prequalify for a line of credit that would protect against contagion in a systemic crisis. (Contagion refers to a sudden cutoff of private capital inflows to one country in response to a crisis in another.) Despite subsequent modifications to the terms of the facility, to date no countries have chosen to participate. This lack of interest appears to relate to the stigma that might be associated with seeking a CCL. Countries may worry that their pursuit of a CCL might be taken by market participants as a signal of problems in the country.

The extent to which the private sector should be involved in any solution to financial crises has been the most contentious issue in discussions of international financial system reform. Private sector involvement is generally taken to mean some sort of burden sharing or participation on the part of private creditors in the provision of financing to a country in crisis. Such burden sharing could be a formal part of the official program to aid the country. For example, IFI financing for the second program for the Republic of Korea in 1997 included an agreement by commercial bank creditors to extend the maturity of their loans to Korea. Burden sharing could also come about through a reduction in the value of private sector claims against the distressed country; a reduction in principal was part of Ecuador's restructuring of its debt, for example (Box 7-2). Absent such commitments by private creditors, policymakers worry that crisis financing provided to a country by the official sector may only serve to reduce the losses that private sector creditors would otherwise bear. This might encourage lenders to behave less prudently in the future, raising the moral hazard concerns discussed above.

In September 2000 the IMF released a framework for advancing the discussion on private sector involvement. The framework encourages countries and private lenders to make every effort to forestall crises through a variety of measures. Borrowers and lenders are to use information provided under the transparency and accountability initiatives discussed above, as well

Box 7-2. Crisis and Restructuring in Ecuador

Ecuador's experience in 1999 and 2000 presents an interesting case, in that during this time it became the first country to default on Brady bond obligations. (Brady bonds were issued by 18 governments between 1990 and 1997, under a plan proposed by the then-Secretary of the Treasury. The Brady Plan offered a means for sovereign countries to restructure past-due loans extended to them by commercial banks, by converting the loans to bonds.) Ecuador's decision to default was not taken lightly and was explained by dire economic circumstances. Output had stagnated in 1997 and had fallen sharply in 1998 because of declining oil revenue and agricultural and coastal infrastructure damage due to the El Niño effect. Many firms came under financial pressure, compounding difficulties in the banking sector. Over the first half of 1999, real GDP fell at an annual rate of 15.4 percent.

The decline in economic activity made it difficult for Ecuador to service its external debt. Ecuador's poor prospects, and financial markets that were destabilized by the Russian default in 1998, precluded new private lending. In late August 1999 Ecuador announced it would defer a coupon payment on PDI (past-due interest) Brady bonds, but in September Ecuador made payment on its discount Brady bonds. Creditors disliked the idea that Ecuador had tried to limit default to one type of Brady bond, and shortly thereafter bondholders accelerated their claim for full payment of outstanding interest and principal on all Brady bonds. As a result, Ecuador defaulted on its other Brady bonds and its Eurobonds as well.

At the same time, the IMF announced it would approve a stand-by arrangement if Ecuador would make certain recommended changes to its economic policies and pursue good-faith efforts to reach a collaborative agreement with its creditors. However, no agreement was reached. To facilitate restructuring of the debt, Ecuador established a consultative group consisting of representative institutional bondholders. The group was given economic and financial information, which was simultaneously made public. No confidential economic information was shared with the group, nor was any information about the terms of the planned restructuring. Although there were many one-on-one meetings between the Ecuadorian authorities and major bondholders, in general there were no large-scale negotiations with the bondholders. Unfortunately, this process failed to provide a meaningful forum. With the rapid turnover of finance ministers and a lack of political consensus, it was hard for Ecuador to sustain a dialogue until political stability was restored.

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Box 7-2.—*continued*

Consultations continued over the next several months with no progress. Private investors expressed concern that Ecuador had shown little willingness to engage in open dialogue or negotiations, and about the slow pace of progress. In January 2000 President Jamil Mahuad announced that Ecuador would convert its monetary base from the local currency, the sucre, to the U.S. dollar and adopt the dollar as the country's official currency (the sucre had depreciated more than 65 percent in 1999). Shortly thereafter, Vice President Gustavo Noboa assumed the presidency after President Mahuad was deposed in a popular uprising. President Noboa continued with dollarization, with the support of the IMF. The new political regime made progress in restructuring negotiations, and in March a $2 billion aid package was announced, which was funded by the IMF, the World Bank, the Inter-American Development Bank, and Corporación Andina de Fomento. The loans were designed to assist the implementation of dollarization, to resolve the banking crisis, and to strengthen the public finances.

In mid-May 2000 the Ecuadorian authorities held an open meeting with bondholders to discuss the country's economic prospects. IMF staff also attended and presented key features of the new economic program. Bondholders received the details with interest, and in August, 98 percent of them accepted a debt exchange offer. A combination of exit consents and cash incentives provided the motivation to accept the package. (Exit consents allow the majority of bondholders to exercise their power to amend old debt just before these creditors leave the old debt and accept the new debt. This provides an incentive for all other holders to come along with them.) With the exchange, Ecuador reduced the face value of its debt by roughly 40 percent, realizing a projected cash flow savings of $1.5 billion over the succeeding 5 years.

Since the restructuring of its debt and the implementation of the IMF program, Ecuador's economy has recovered strongly. Real GDP growth for the year ending in the third quarter of 2001 was 5.0 percent. Dollarization pushed inflation down from 91 percent in 2000 to 22 percent at the end of 2001. Interest rates on 10-year bonds were roughly 12 percentage points above those on U.S. Treasuries at the end of 2001, down from 46 percentage points at the height of the crisis in September 1999. Although the banking system has improved, there is room for further reform, such as implementation of key Basel principles. Analysts point to restructuring nonperforming loans and additional structural economic reforms as keys to further boosting economic activity in Ecuador.

as to maintain continuing dialogues, perhaps through the establishment by borrowing countries of investor relations offices. The IMF itself, in July 2000, formed the Capital Markets Consultative Group to enhance communication with the private sector. Lenders are also encouraged to promote the inclusion of collective action clauses in future bond issues (discussed further below), to allow for easier coordination of creditors in the event of a crisis.

The framework stresses that, should a crisis develop, voluntary solutions between debtors and creditors are to be preferred over involuntary solutions that involve unilateral actions. In most cases, it is hoped that policy adjustments and temporary official financing will suffice to restore an economy to sustainability. In a minority of cases, however, the official sector is envisioned as encouraging creditors to reach voluntary agreements to help overcome their coordination problems.

In some such cases, the country may have no choice but to suspend payments on its debt. The IMF has reaffirmed its policy of "lending into arrears" in such cases, that is, providing lending to countries that are experiencing debt-service difficulties before those difficulties are fully resolved. Lending into arrears is to be decided on a case-by-case basis and is to occur only where prompt IMF support is considered essential for a successful adjustment program, and the country is pursuing appropriate policies and is making a good-faith effort to reach a collaborative agreement with its creditors. This policy came into play in the case of Ecuador's 1999 default, mentioned above.

Debt Relief. Finally, reform efforts have also included addressing the debt burdens of the poorest countries. After some gradual efforts in the late 1980s and early 1990s, the IMF and World Bank executive boards, at the request of the G-7, agreed in 1996 to launch the Heavily Indebted Poor Countries (HIPC) initiative. This initiative marked the first time that multilateral, Paris Club, and other official bilateral and commercial creditors joined in an effort to reduce the external debt of the world's poorest and most debt-burdened countries. (The Paris Club is the voluntary gathering of governments of creditor countries willing to treat in a coordinated way the bilateral debt due them by developing-country borrowers.) The HIPC initiative is funded by both bilateral and multilateral creditors. Originally, 41 countries were identified as candidates for the program, and so far 24 of these have debt relief agreements in place. To qualify for assistance under the HIPC initiative, a country must meet three conditions: it must have a low enough income per capita to qualify for concessional lending from the IMF and the World Bank; it must have an unsustainable debt burden even after the exhaustion of available debt-relief mechanisms; and it must have demonstrated a commitment to economic reform and poverty reduction with a track record of good performance and drawn up a Poverty Reduction

Strategy Paper (PRSP) showing how the country intends to use debt relief to improve living standards for its poor.

The first 3 years of the initiative did not prove as productive as had been hoped: only seven countries qualified during that time. In September 1999 the program was enhanced to provide deeper and faster debt reduction. The HIPC initiative will allow 24 countries to reduce the net present value of their debt by a total of $22 billion—roughly half of what they owe—and when combined with traditional debt relief and additional bilateral debt forgiveness, it will reduce their debt by almost two-thirds. The IMF and the World Bank expect average social spending in the HIPCs to increase by 45 percent in 2001-02 from 1999 levels, with savings from HIPC debt relief accounting for a sizable proportion of this increase. In 2001-02 these countries are expected to spend three times more on social services than debt service.

Critiques of Reform Efforts

As the above discussion makes clear, many changes have been made to the international financial system over the past 7 years in an effort to improve its stability and performance. However, fundamental problems remain, and new proposals have been put forward by both private sector and public sector entities. Critiques of the efforts to date can be broken down into the same four key areas discussed above: transparency and accountability, strengthening national financial systems, management of crises, and debt relief.

Reform efforts appear to have made the most progress in enhancing transparency and accountability and strengthening national financial systems. Nevertheless, several complaints have been raised. With regard to accountability, critics often raise objections to "mission creep" on the part of the IFIs, which can lead to an overlap of efforts that hinders accountability. Without a precise understanding of each IFI's responsibilities, it is difficult to judge the degree to which each IFI is accomplishing its objectives. The IMF draws on its expertise to consult and provide helpful advice on such matters as the appropriate stance of monetary and fiscal policy as well as the related choice and operation of an exchange-rate regime. At the same time, the MDBs have considerable expertise in development issues, both at the individual project level and in providing fundamental public goods such as health and education. Most recently, the MDBs have contributed substantial sums to programs for such middle-income economies in crisis as Argentina and Turkey, which, until their crises broke, had benefited greatly from private capital inflows. The MDBs should not be used as a source of immediate emergency financing. Rather, their role in crisis countries is to provide support to address longer term policies and institutional capacity building, to help cushion the impact of crises on the poor.

Thus almost all observers have argued for a clearer delineation of the IFIs' responsibilities, allowing each institution to focus on its core mission and expertise. Mission creep into other areas only serves to divert scarce expertise away from its best use. The IFIs have responded to this criticism and have taken steps to better coordinate their assistance, most noticeably through joint participation in the preparation of ROSCs and FSAP reports.

Progress on transparency has also been uneven, both on the part of borrowing countries and on the part of the IFIs. As mentioned earlier, the IFIs have made great strides in making information available to the public; nonetheless, market participants remain critical of what they regard as the scant and untimely release of information from the official sector during crisis resolution and negotiations. These criticisms have been directed toward the IFIs and even more pointedly toward the Paris Club. Without sufficient information and coordination, private creditors worry that their claims on a borrowing country will be treated less favorably than the claims of government and other official creditors. The Paris Club has begun taking steps to improve information flow, with the launch of a website disclosing the terms of debt restructurings and other information. The Paris Club has also initiated a dialogue with private sector creditor organizations in an effort to improve communication.

Efforts to strengthen national financial systems have focused on using agreed standards and codes aimed at implementing best practice in financial regulation. This effort has been judged quite promising, although implementation remains an area of concern. In particular, it may be expensive for developing economies to find and develop the expertise necessary to observe the standards and codes. For example, recruiting, training, and retaining skilled bank examiners may be difficult. The standards also require certain supporting institutions. In a country where the rule of law is weak, it may be difficult for financial examiners to make a real difference in financial institutions' practices. Finally, there has been some concern over the appropriate body to judge an economy's compliance with a standard. Local authorities may be too prone to find their own country's institutions in compliance, and the same might be true for IFIs that happen to be lenders to the country. There is no reason why private markets could not provide the necessary evaluation of compliance; indeed, this option has been advocated by many but has not yet been fully realized.

Efforts to reform the management of financial crises have generated the most criticism and the most additional proposals. The criticisms have focused on essentially two areas: the structure of IFI programs, and mechanisms for facilitating private sector involvement. Much attention has been paid to the conditions imposed on borrowing countries as part of IFI lending programs, called "conditionality." Some observers have argued that such conditions have too often involved overly restrictive austerity policies, which

have deepened economic slumps and postponed recovery. IMF programs during the East Asian crisis, which required fiscal austerity of economies, are often cited in this context. Critics have also argued that IMF programs should have allowed for more accommodative monetary policies, on grounds that high interest rates made it harder for debtors to service their debt, heightening investors' concerns and worsening the economic downturn. However, the IMF still argues that high interest rates, in relation to both expected inflation and interest rates on U.S. dollar-denominated assets, were necessary to stabilize currencies, whose depreciations also made it difficult for debtors to service their foreign currency-denominated debt.

According to another view, IFI programs too often went beyond macroeconomic (fiscal and monetary) conditions to impose unnecessary structural economic reforms. This view claims that the problems of debtor countries largely require macroeconomic solutions, and that therefore it is reasonable for the IFIs to insist on macroeconomic performance criteria to be met as a condition for loan disbursements. But in the late 1990s, some observers feel, the IMF often overstepped these bounds—and its own expertise—by placing too much emphasis on micromanagement of the recipient economies. An often-cited example is the Indonesian program, which required the elimination of the Clove Marketing Board and changes in the structure of the sugar, flour, and cement markets. Defenders of the existing approach have responded that, without a change in structural conditions, changes in macroeconomic policies are likely to have little effect. They also note that involvement of the MDBs in crisis lending provides whatever microeconomic and structural expertise is required. In any case, in response to these criticisms, the IMF has recently sought to streamline the conditionality attached to its lending programs, and to focus that conditionality on core macroeconomic and financial concerns.

Frustration with a lack of progress in some countries, as evidenced by repeated IMF programs over a prolonged period, raises another issue concerning the structure of these programs. For example, since 1980 the Philippines has been under six IMF programs, with disbursements made in 17 of the past 21 years. This example raises the concern that more attention should be paid to the nature of the crisis facing an economy. It may be necessary to tailor program lending differently for liquidity crises than for insolvency crises. In a liquidity crisis, where an otherwise healthy borrower is incapacitated by a cutoff in private financing, programs would appropriately involve short-term lending at penalty interest rates, to encourage and facilitate the borrower's quick return to private capital markets. In the case of an insolvent borrower, in contrast, where private funds are cut off because of poor economic prospects, the IFIs should not provide financing to avoid a debt restructuring. However, in such cases the IMF may still have a role in helping to support the country and facilitate the rebuilding of reserves, as

happened in Ecuador (see Box 7-2). Although the IFIs have different types of lending facilities for each of these two purposes, the repeated occurrence of "crises" in some economies suggests that sufficient attention was not paid to the possibility that recipients were insolvent rather than illiquid.

The issue of private sector involvement in the resolution of crises remains the most contentious, as evidenced by a recent flurry of proposals and analysis. Proposals to enhance private sector involvement range from the very modest (limiting involvement to the voluntary modification of sovereign bond contracts), to somewhat structured proposals involving standstills (temporary suspension of debt service), to formal proposals calling for an international recognition of standstills in a manner similar to an international bankruptcy proceeding.

Many observers, including the IMF, continue to urge that new sovereign bond issues include collective action clauses. One type of clause allows for a majority or supermajority of creditors to make changes in the financial terms of a bond's contract; bonds issued under United Kingdom law typically contain such provisions. These clauses attempt to foster an orderly negotiation process that would allow the debtor country to reach agreement with its creditors on a restructuring that permits a return to a sustainable situation. However, many sovereign bonds are issued under jurisdictions, including that of New York, where collective action clauses are not customary. These bonds often require the unanimous approval of creditors to modify the payment terms. In this situation, a single holdout creditor, in hopes of obtaining more favorable treatment than the other creditors, can block a restructuring that is in the best interest of both the creditors and the debtor. It remains a bit of an economic mystery why more recently issued bonds do not include less restrictive collective action clauses; empirical work finds that borrowers do not face a higher interest rate on instruments that have this flexibility. One explanation may be simple inertia.

The modification of sovereign bond contracts in a sense represents an attempt to facilitate restructuring of private debt by creating an appropriate legal framework. Two other ideas have been advanced along the same lines. One proposal calls for more widespread use of rollover clauses in lending contracts, representing a precommitment by lenders that could be invoked during a crisis. This proposal would make automatic the rollover of bank loans like that negotiated in the case of Korea in 1997. Another recent proposal would generate private sector involvement before a crisis, by taxing the stock of cross-border claims to create a fund that could then be used for lending in the event of a crisis. All cross-border investors would thus contribute to the resolution of a country's crisis.

A recent joint proposal from the Bank of Canada and the Bank of England advocates the use of standstills by insolvent debtor economies. The proposal calls for tight limits on IMF lending for all but exceptional cases, in an

attempt to force a distinction between insolvent and illiquid borrowers. A borrower that could not meet its obligations through this limited IFI support would declare a payment standstill and begin negotiations with its creditors on a debt restructuring. This would put the borrower in violation of the payment terms of its loan agreement, opening the door to legal action by creditors that might disrupt the negotiations. However, the proposal argues that fears of such disruption are overstated. Private creditors find it difficult to execute judgments against a sovereign borrower, especially when the borrower does not have readily identifiable assets, such as those of state-owned enterprises, outside its borders. Critics of the proposal counter that the cloud of legal action could nevertheless weigh on negotiations during the standstill, especially if cooperative creditors fear that any new payment arrangements agreed to could be subject to attachment by holdout creditors. The recent experience with the holdout creditor Elliott Associates in the case of Peru is cited in this regard (Box 7-3).

At roughly the same time that the Bank of England/Bank of Canada proposal was announced, the First Deputy Managing Director of the IMF called for a framework that would create the analogue of bankruptcy at the sovereign level, providing legal protection for a necessary restructuring. The proposal cites specifically the troubling implications of the Peruvian case. Legal protection from holdout creditors would be offered under two conditions: the country must be negotiating in good faith with its creditors to restructure its debt burden, and it must agree to follow sound policies to avoid similar problems in the future. The proposal also envisions that participating borrowing countries would likely impose temporary exchange controls, to ensure that capital did not flee the country while negotiations with creditors were under way. The protection from litigious creditors, in effect a formal standstill, would be sanctioned by the IMF and would have legal standing in national courts.

Implementation of the IMF proposal might take many years, because the IMF's Articles of Agreement would have to be amended, as might national legal codes around the globe. Some criticism of the proposal has focused on the impracticality of implementing these changes. Other critics argue that because the IMF might well be one of the creditors in the case, an IMF-sanctioned standstill would create a potential conflict of interest. (In domestic bankruptcy cases, the judge who presides over the resolution may not be one of the creditors of the troubled firm.) Other observers, however, note that any internationally sanctioned proceeding would not be able to remove the "management" of the debtor economy (that is, its government), also unlike in domestic bankruptcy proceedings. In that case involvement of an official creditor, such as the IMF, that can impose conditions on new lending programs may make sense. In any event, the IMF proposal has generated a great deal of interest and calls for further study.

Box 7-3. Elliott Associates versus Peru

In October 1995 Peru announced an arrangement under the Brady Plan (see Box 7-2) to restructure loans extended to two Peruvian banks that had been guaranteed by the government in 1983. The plan culminated in November 1996 with 180 creditors agreeing to exchange the old debt for a combination of Brady bonds and cash. Under the agreement, coupon payments on the new Brady bond were to begin in March 2000, with the second coupon to be paid in September 2000.

From January through March 1996, as details of the plan were being negotiated, Elliott Associates, an investment fund specializing in the purchase of securities of distressed debtors, bought Peruvian bank loans with a face value of $20.7 million for $11.4 million. After sending a formal notice of default on the bank loans, and shortly before the Brady exchange, Elliott Associates filed suit in New York State's Supreme Court seeking payment. Elliott did not participate in the Brady exchange, thus becoming a "holdout creditor." Elliott's suit was removed to Federal district court where, after a trial, the claim was dismissed in August 1998.

In dismissing Elliott's claim, the district court ruled that Elliott had purchased the Peruvian bank debt with the intent and purpose of bringing suit. This was found to be a violation of Section 489 of the New York Judicial Law, which is based on the long-standing legal concept of champerty. (Champerty is defined as maintaining a suit primarily in return for a financial interest in the outcome.) However, in October 1999 the U.S. Second Circuit Court of Appeals overturned the district court's ruling. The case was remanded to the Federal district court, which in June 2000 awarded Elliott a judgment of $55.7 million, representing principal and past-due interest on the bank claims.

To enforce this judgment, Elliott sought to attach the September 7, 2000, coupon payment that was to be made to the creditors that had participated in the Brady exchange. Elliott obtained a restraining order to prevent the New York fiscal agent for the Brady bond from making the coupon payment, and the firm tried to obtain a similar order against the European fiscal agent. After arguing in the Belgian courts without Peru's attorneys present, Elliott was granted the restraining order on appeal on October 5, 2000. By this time Peru was close to defaulting on the Brady bond, as the 30-day grace period for the coupon due on September 7 had almost expired. Rather than default, Peru settled with Elliott by paying the firm $56.3 million (the judgment amount of $55.7 million plus interest). Thus the case was not litigated to a conclusion, leaving market participants uncertain about any precedents that the case might have set.

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Box 7-3.—*continued*

In issuing the restraining order, the Belgian court accepted the argument that, by paying the Brady bondholders but not paying Elliott, Peru would violate the pari passu clause in the bank loans held by Elliott. (The Latin phrase *pari passu* means "with equal step" or "side by side.") The court interpreted the pari passu clause as meaning that if a debtor does not have enough money to pay its creditors in full, they all should be paid on a pro rata basis. This interpretation has proved controversial, however, with some legal scholars arguing that the clause relates only to the act of subordinating one class of creditors to another and should not be interpreted so as to force pro rata payments. These scholars base their arguments on the interpretation of pari passu clauses in domestic corporate bankruptcies.

This case is economically important for the effects it might have both on other developing economies' attempts to restructure their debt and on future capital flows to these economies. The incomplete resolution of the case leaves open the possibility that other creditors might follow the example of Elliott Associates in holding out on future debt restructurings by developing economies—and that they might succeed. In particular, some argue that the Belgian court's acceptance of Elliott's pari passu argument could complicate Argentina's current effort to restructure its debt. Creditors may hesitate to participate in any restructuring offers if they believe that holdout creditors might be able to attach payments or even get paid in full. Most observers argue that the relative balance of power between creditors and distressed sovereign borrowers would have been unchanged had the pari passu argument failed.

With regard to future capital flows, the concern is that if Peru had prevailed in the case on its champerty defense, it could have made it easier for sovereign countries to default on their debt. In that event, creditors might have contemplated curtailing lending to developing economies, or charging a higher interest rate. The Second Circuit Court of Appeals decision cited these concerns in overturning the district court's champerty finding. In any event, both market participants and legal scholars agree that a final legal resolution of the issues raised in this case would eliminate a source of uncertainty now complicating transactions in the market for developing-country debt.

Finally, with regard to debt relief, although the HIPC initiative has already provided significant relief, it will not ensure a lasting exit from debt problems unless the countries receiving relief sustain growth far in excess of their historical averages. Real GDP growth in 22 eligible HIPCs averaged only 3.1 percent from 1990 through 1999, yet the IMF projects that they will grow at an annual rate of 5.6 percent from 2000 through 2010. Skeptics find little reason to be so optimistic, as many of these countries were already on IMF programs and receiving disbursements to begin with. If growth falls well short of the IMF's projections, it could be difficult for these countries to reduce their debt burden, even with HIPC debt relief. Most of the HIPCs depend heavily on exports of a narrow base of primary commodities, such as coffee or cotton, to service their external debt. Commodity prices can be quite volatile, leaving these countries vulnerable to price shocks. What might help this situation is if the industrial economies, which now spend $360 billion a year on subsidies to protect their own agricultural sectors, lowered these barriers to trade, thereby allowing the HIPCs and other developing countries to diversify their export base.

Advancing International Financial System Reform

The need for continued reform of the international financial system has generated a rich debate. Clearly, the benefits of global economic integration must be made available to all the world's citizens, and the support of the official sector is key to ensuring the smooth operation of the global trading and financial systems that underpin continued integration. At the same time, it must be recognized that official sector resources are finite and do not come out of thin air. Resources may be provided in the form of loans to developing economies, but these resources still come from public funds. As such, they are obtained from taxpayers across the globe and have an opportunity cost in terms of other governmental priorities. Both of these considerations argue for a careful assessment of costs and benefits when designing and using the international financial system.

With these ideas in mind, a set of principles for the IFIs can be identified. First, all of the above arguments and examples point to the need to differentiate between those countries that are temporarily illiquid and those that are insolvent. Although this distinction can be difficult in practice, it is crucial for good stewardship of official sector resources. Shortening the maturity of official loans may help make this distinction. Some observers have claimed that short maturities for official loans are too constraining, arguing that it is hard to help an economy by extending a loan that must be repaid in 12 to 18 months. However, if it is clear that such a loan is unlikely to be repaid, then it is more likely that the economy is insolvent rather than just illiquid. An illiquid economy should be able to regain access to capital markets in this

period of time; an insolvent economy will not be able to. Insolvent economies require more drastic treatment, such as a restructuring of debt obligations coupled with limited and longer term official sector lending once the restructuring is well under way.

Official funding can also be leveraged with private sector involvement. Future design changes to the international financial system must continue to focus on incentive mechanisms that encourage involvement of the private sector. Financing that is dedicated to encouraging a voluntary restructuring is one example of such a mechanism. Such financing can serve as a catalyst in returning a troubled economy to a sustainable footing.

In the first half of the 1990s, a set of International Development Goals were developed from agreements and resolutions adopted at world conferences hosted by the United Nations. The goals found a new expression in the Millennium Declaration of the United Nations in September 2000. Most of the world's poorest countries, particularly those in Sub-Saharan Africa, are falling well behind in achieving these International Development Goals in basic education, health, and poverty reduction. The President has called for a bolder move away from loans toward grants for the poorest countries. This approach, coupled with the progress under the HIPC initiative, holds the promise of higher living standards for the least fortunate, as it would facilitate productivity-enhancing investments without adding to their debt burden. In addition, grants to the poorest economies should be targeted toward those basic needs, such as education and health, that are vital to a growing and vibrant economy. In particular, grants can lead toward a redirection of resources to combating scourges such as HIV/AIDS that tear at the very fabric of society.

Consistent with the Administration's efforts to shift the MDBs' emphasis toward grants for low-income countries is its continued efforts to make these institutions more efficient and more focused on productivity growth in developing countries as a core objective. Careful selection of programs and a greater attention to results are the two key principles underpinning the U.S. MDB reform exercise. This means that the MDBs must do a much better job in sharpening the focus of their activities, concentrating on basic development work and working collaboratively among themselves and with other donors to ensure a development framework that is consistent and efficient.

The United States has also accorded particular importance to a comprehensive review of the pricing of MDB loans, to explore the possibility of greater differentiation of lending terms. Price differentiation is crucial to achieve greater lending selectivity based on differences in the development impact of individual operations and in borrowers' income per capita and creditworthiness, with preferential treatment for priority core social investments.

Finally, tying official support to efforts at creating trade can dramatically leverage any financial assistance provided to illiquid economies. As this chapter has made clear, trade is a powerful engine for economic growth and improvements in living standards. If assistance packages allow an economy both to regain access to capital flows and to invigorate trade flows, all of the developing world will share in the improvement of world living standards.

Conclusion

International flows of resources, goods, and services have played an increasingly important role in the world economy. The citizens of the United States, living in one of the most open economies in the world, have seen their well-being improve dramatically with this increased economic integration. So have the citizens of many other countries that were willing to open their borders to flows of goods, services, and capital. The gains from trade are the result of an improved allocation of resources. A more efficient global allocation of productive inputs such as capital and labor translates into an increase in global output and consumption.

To ensure that economic integration continues, constant attention must be devoted to the institutional infrastructure that supports market-based exchanges of goods, services, and capital. The past year has witnessed signs of a slowing global economy, as well as violent threats to the freedom that is essential to a well-functioning economic system. These dangers make it more important than ever to ensure continued progress toward the free flow of resources and output across national borders.

It is therefore critical that the United States remain an active leader in the continued liberalization of trade in goods and services, both on a bilateral and on a multilateral basis. At the same time, the United States must continue to encourage efforts to strengthen the international financial system that supports production-enhancing cross-border flows of capital. Strong U.S. leadership on both these fronts will help safeguard and enhance both our own economic prospects and those of the rest of the world.