

REPORT

Will Straw and Alex Glennie
with foreword by Lord Mandelson

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IPPR

THE THIRD WAVE OF

GLOBALISATION



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Report of the IPPR review
on the Future of Globalisation
led by Lord Mandelson

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ABOUT IPPR

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EXECUTIVE SUMMARY

- **Over the course of the last century, the progressive integration of the global economy has helped drive the economic growth that has contributed to lifting millions of people out of poverty around the world.** In the developed world it has brought down the cost of consumer goods, driven productivity increases in many sectors, and created new markets for goods and services where western firms have comparative advantages. Many people have unprecedented opportunities to travel and work abroad, and the increasing cultural and political dialogue between individuals has helped to spread the acceptance of universal values like democracy, liberty, and human rights. Since the second world war, flows of goods, services and capital have rapidly increased. Knowledge, ideas and values have also spread across borders like never before. The movement of people – both economic migrants and tourists – has vastly expanded, although perhaps surprisingly it has stayed static as a percentage of the global population.
- **Globalisation is not new.** The first wave of contemporary globalisation, which began around 1870 and was dominated by the UK, heralded a period of sustained economic growth stimulated by the increased use of manufacturing and transport technologies developed during the Industrial Revolution and facilitated by the process of colonial empire-building. While there were advances in living standards, much of the wealth went to the owners of capital and levels of inequality remained high in most regions of the world. The first wave was brought to an end by the two world wars and great depression.
- **After world war II, a second wave of globalisation commenced and was dominated by the United States. It consisted of two distinct phases.** First, in the era following the creation of the Bretton Woods institutions, growth in global output averaged 5 per cent and both poverty and inequality fell rapidly. But oil shocks and stagflation in the 1970s discredited the Keynesian macroeconomic post-war settlement. A new economic paradigm of liberalisation, deregulation and privatisation to boost growth came to dominate the economic policy of the UK and US, and strongly influenced the International Monetary Fund (IMF) and World Bank. Global growth continued, but at a more modest rate of 2.8 per cent from 1974 to 2009. Over this period the nature of trade itself began to change, rapidly becoming integral to the production process

itself, with intermediate goods shipped between different markets, and supply chains circling the world. Poverty continued to fall and inequalities between countries narrowed. But inequality within countries rose rapidly as rewards became increasingly concentrated on those at the top. Meanwhile, in developed countries real growth in median wages stagnated or slowed.

- **The world now stands at the start of a third wave of globalisation.** As during the first and second waves, advances in technology and falling transport and communication costs will continue to make the world increasingly connected. It will be defined by different models of trade, continuing the trend of the last decade which has seen the rise of intra-company trade – effectively, the creation of cross-border supply chains – as an important mode of international trade. This drives home the need for advanced economies, like those in Europe, to focus on their strengths in high end technology and component goods across international chains of production. This third wave of globalisation holds out considerable economic opportunity but it will also be – indeed, it already is – the subject of intense criticism and anxiety, especially in the developed world.

Experience now offers plenty of scope for a new, more nuanced understanding of the positive and negative effects of globalisation

- **We have known for some time that there is a strong correlation between trade and growth, but trade alone is not enough to guarantee growth.** While there are few examples of rapidly growing countries that have not opened themselves to foreign trade, the academic evidence shows that free trade is not the right prescription in all times and places. Indeed, trade liberalisation works only when accompanied by other policies that are necessary to ensure growth. It is not a prerequisite for growth, but an essential tool for achieving it.
- **Trade encourages higher productivity and helps drive technological innovation, but it can also lead to job losses and pressure on wages.** Getting the best out of this rising productivity means ensuring that opportunities exist for those whose employment is displaced by global competition.
- **Globalisation has helped lift millions out of poverty. But globalisation – particularly financial globalisation and the impact that trade has on technological change – has contributed to increased levels of inequality within countries.** Without active strategies for mitigating this impact, globalisation creates many losers. For example, only Brazil of the BRIC countries has managed to reduce inequality in recent years, in part due to its successful *bolsa familia* (family allowance) policy.

- **Access to international investment is one of the key benefits for states in a globalised economy but capital market liberalisation and short-term portfolio investment flows can also be a source of instability.** For example, banking crises caused by over-exposure to financial services tend to cause longer and deeper recessions with a greater risk of contagion. Another problem is that a heavy reliance on financial services or large volumes of capital inflows can contribute to an appreciating exchange rate, which makes exporting sectors less competitive. Finally, the risk of capital market volatility creates incentives for the build-up of foreign reserves, which creates global imbalances.

A changing balance of economic power: one set of principles, many recipes?

- **The composition of global growth and wealth has changed dramatically since the 1990s. China's rise has been well documented but it is not alone.** From 2001 to 2010, the 'Growth 8' countries – Brazil, China, India, Indonesia, Korea, Mexico, Russia and Turkey – have contributed the same additional output to world GDP as the G7 group of rich nations. Flows of goods and services, commodities, people, remittances, and portfolio and direct investments are all on the increase between countries of the global south.
- **However, the reality is that while countries like China, India and Brazil will soon have the largest economies in the world, living standards have a long way to go before they catch up with those in Europe, the US and Japan.** Only 31 per cent of people in Latin America and 13 per cent of people in Asia are part of the 'global middle class'. The emerging economies are catching up but doing so more slowly than is often realised.
- **What this shift implies is that unlike the two previous waves of globalisation – dominated in turn by the UK and US – the current 'third wave' is not characterised by one underpinning economic paradigm or a single dominant country, although the rise of Asia will loom large.** Indeed, the world is becoming increasingly diverse in its approaches to economic policies. Where this creates a market for testing new policy responses, it is to be welcomed. But it needs to be anchored by a commitment to a set of basic principles shared between the developed and emerging economies to ensure that it does not erode global cooperation and a sense of a shared global interest.
- **The institutions that provide the glue of rules-based multilateralism need to undergo a process of adaptation based on a simple principle. They need to broaden their governance to take in and reflect new states and their growth paths, widen**

the scope of their intellectual and empirical frameworks, and ensure, at all costs, that they remain relevant to the emerging powers which are redefining the global economy. This high road requires collaboration and partnership between nation states and an urgency of decision-making which manages short-term needs in the long-term global interest. The recommendations below set out a number of ways in which this could be achieved.

Legitimate concerns, intelligent responses

- **People, particularly in the developed world, are understandably concerned about whether this third wave of globalisation is essentially in their interests. They fear that as the east emerges, the west will become ‘submerged’.** However, as they grow, these economies create new markets for high-value goods and services from the west. The challenge for developed countries is to be smarter and more specialised, more innovative and more energetic, if they want to secure their share of the world’s rising demand. This will require both personal and corporate entrepreneurialism and adaptability, and the support of intelligent government in building the capabilities in education, science, skills and infrastructure on which individuals and firms compete.
- **There is little doubt that globalisation, through its positive impact on growth, is contributing to the increased demand for commodities and creating resource constraints, particularly of food and water.** Increased international trade in goods can also contribute to climate change through increases in shipping and aviation. But the spread of ideas and technologies can also help solve these problems. Information and communications technology makes it easier to conduct business remotely, mitigating the need for travel. Meanwhile, technology is helping to decarbonise growth by reducing emissions in the energy, transport and manufacturing sectors. The answer is not to dismantle globalisation, but to make growth itself sustainable.
- **Understanding that there is a potentially more benign path ahead does not guarantee that it will be followed.** Ensuring that the benefits of globalisation are shared as widely as possible and that future growth is sustainable is a collective responsibility that requires collective action. Mapping out this path – and then following it – requires an ambitious programme to change the international architecture around current account balances, capital flows, trade negotiations, international taxation and the G20. Some of this is under way, and much has been subject to debate since at least 2008, but there is much more to be done to turn debate into action.

Recommendations: international action

- One of the principal causes of the global financial crisis was the build-up of serious current account imbalances. Deficit- and surplus-bearing countries are equally responsible for these imbalances. Deficit countries need to rebalance their economies away from debt-fuelled domestic consumption and towards savings and exports, while surplus countries need to do the reverse by reducing their dependence on exports and building domestic consumption. To help achieve this we recommend that **the IMF should assess both deficit and surplus countries against a ‘symmetric’ current account target of plus or minus 3 per cent of GDP. To help reduce global imbalances, the time has also come to take forward the creation of a global reserve currency through the reform, and expansion, of its special drawing rights.**
- Narrow growth strategies focused entirely on exports will entrench existing global imbalances and prevent advances in living standards in developing countries from being shared equitably. Social safety nets are an effective means of alleviating poverty and, in some cases, reducing inequality. In turn, they help to increase consumption in countries with small domestic markets. We recommend that **middle income countries which have made great strides in reducing poverty should focus on the provision of universal access to basic healthcare and more widespread adoption of conditional cash transfers like Brazil’s *bolso familia*. Meanwhile, development aid should be more focused on social protection programmes to help unlock domestic entrepreneurship and demand.**
- Global capital market liberalisation can create instability. International negotiations are underway to regulate more effectively the financial services sector, but some problems persist. Although the IMF and Organisation for Economic Cooperation and Development (OECD) have begun to rethink their approach to capital controls and now consider their use to be legitimate under certain circumstances, the rules of other institutions severely limit their application. We recommend that **all multilateral organisations should ensure that legitimate and consistent principles are developed and agreed to govern potentially destabilising short term portfolio inflows, while preserving openness to valuable foreign direct investment. Efforts to regulate more effectively the financial sector should continue along the basis of Basel III, countercyclical macroprudential regulation and a more precautionary approach to financial innovation.**
- There is a need to distinguish between healthy tax competition and competition that undermines the revenue mix needed to

support national finances, pushing the burden unfairly and counterproductively on to personal and consumer taxpayers, and giving international companies an advantage over domestic firms. A combination of new accounting measures, international rules and support for tax collection authorities is necessary to get a grip on this problem. We recommend that **the European Union should implement the Common Consolidated Corporation Tax Base and work with the G20, International Accounting Standards Board and Financial Action Task Force to introduce new transparency measures in accounting practices.**

- The world has so far avoided a protectionist spiral of the kind seen in the 1930s. Nonetheless, there has been an increase in protectionist measures, public support for trade in a number of countries, notably the US, has fallen dramatically, and the WTO's Doha trade round has stalled. These unwelcome developments are undermining the WTO's multilateral framework. To breathe life into the international trade agenda, we recommend that **plurilateral agreements in selected sectors such as services should be advanced by interested and ambitious states. Above all, the WTO should be preserved as the preeminent forum for global trade rules and negotiations on future trade liberalisation. Trade liberalisation should increasingly focus on resource scarcity and food security.**
- Since the high watermark of the G20 London Summit in 2009, multilateralism has had few successes. WTO negotiations, subsequent G20 meetings and most climate change negotiations have ended in relative disappointment. Reforms are clearly needed to increase the legitimacy and effectiveness of the world's international institutions. To stop this stasis, we recommend that **a formal G20 secretariat should be created with specific responsibilities to help set the agenda, monitor progress against agreed action points, consider future composition and formalise the relationship with civil society groups. To improve their legitimacy, the IMF and World Bank should be reformed to ensure that voting shares better reflect current global economic realities. But as the fastest growing economies obtain more rights in international institutions, they should absorb more responsibility for reaching agreement.**

Recommendations: domestic policy

- Even if these new solutions can be agreed, individual governments need to be active in helping to equip businesses and individuals to prosper in the global economy. If they do not take on this role, globalisation will only benefit the few, not the many, and this will fuel a public backlash and, potentially, a resurgence of nationalism and protectionism.

- Prosperity in the decades ahead for the advanced market economies in Europe, North America and Asia will more than ever before rest on their ability to generate and apply knowledge to provide the world's consumers with high-value-added goods and services. It will need to be a journey of perpetual movement up the value chain. As a case study of a medium-sized economy trying to earn a living in the world, we have examined some of specific policy measures that Britain should adopt.
- For the UK in particular there is a need to move firmly beyond the now-dated 1980s mindset that the best industrial policy for government is 'no policy'. Markets, private business and entrepreneurs will continue to set much of the pace, but governments and public agencies are going to play roles that go far beyond the 'neoliberal trinity' of property rights protection, contract enforcement, and sound money. We recommend that **the government should set out an industrial strategy for every sector in which Britain has an existing or potential comparative advantage. The Green Investment Bank should be broadened to become a National Investment Bank given borrowing powers for marketable services.**
- The aim of national skills strategies should be to create well-skilled and adaptive workforces, capable of responding quickly to changes in the global economy, and properly utilised by employers. Governments need to ensure that the overall skills level of the working population is as high as possible to allow them to compete. But this compact works two ways. The skills already existing in the economy should be being properly utilised by businesses, with those in lower-skilled sectors given access to 'good' jobs with opportunities for progression and development. Meanwhile, immigration policy should ensure that short-term skills shortages in particular sectors can be filled by migrant workers. We recommend that **efforts should continue to improve education and skills provision in the UK but greater priority should be placed on ensuring that skills policy utilises the existing skills of the domestic workforce. Migration policies should support the development of a better-skilled workforce by promoting more circular forms of migration, rather than closing down entry routes for the most highly skilled migrants to work and study in the UK.**
- Effective mitigation of globalisation's negative consequences requires the creation of social protection systems that can meaningfully support workers and help them to thrive in the global economy, while also giving them a much stronger safety net in times of hardship, such as ill health, unemployment, and old age. In conditions of fiscal constraint, there are no easy options for

welfare reform. Tough choices must be made between different services, benefits and programmes. But policymakers who seek to combine economic openness with social justice should be guided by the core principle that welfare reforms focus on maintaining high levels of employment. We recommend that **the government should introduce a national salary insurance scheme designed to provide individuals with higher levels of support if they lose their job, but requiring this support to be repaid when they return to employment. This should sit within a broader suite of measures to decisively reorient the welfare state to deal with the key risks that individuals face, including income loss and unemployment.**

- Managing globalisation to ensure that the upsides are maximised and the downsides minimised requires an acceptance that globalisation is a means to an end, rather than an end in itself. If we accept that those ends are the essential progressive aims of sustainable growth, rising prosperity and receding inequality then the current model of globalisation has significant weaknesses. Governments cannot stand back and assume that the outcomes from global economic integration and rapid economic change will be benign. Instead, they must come together at the international level to forge a fairer and more sustainable multilateral order, while working domestically to ensure that their people are equipped to benefit from global opportunities and protected from insecurity. **The reforms proposed in this report are therefore essential if the third wave of globalisation is to be one of sustainable growth, shared prosperity and growing opportunity.**

GLOBALISATION: A POLITICAL VIEW

FOREWORD BY LORD MANDELSON,
FORMER EU TRADE COMMISSIONER AND
UK SECRETARY OF STATE

I cannot remember when I first became aware of the term ‘globalisation’. In the Labour party of the early 1990s and then in government after 1997, there was a powerful conviction that Britain needed a new social and political settlement to help people deal with rapid economic change. As seen in the large heavy industries that had seen jobs lost to technological change, changing patterns of energy generation or international competition, it was clear that the UK faced a challenge of economic adaptation which would affect hundreds of thousands of individuals and families.

Most politicians asked fewer questions then about what was driving that transformation. There was, of course, a general understanding that ‘the world was changing’, with a shift of economic forces and countries. The spectre of Japanese economic competition had been a persistent theme through the previous decade. There was a feeling that the revolutions of 1989 and the end of the cold war period had both vindicated a certain economic model and ushered in an era when closer economic integration between national economies was both good and inevitable – an inevitability that the closed economies of the cold war and short-sighted nationalism had stalled and deflected, but could not defer forever.

It is easy to forget that just 15 years ago China was still a peripheral player in global trade, the BRICs not even an acronym, and the Asian financial crisis still in the future. The prospect of global economic integration still held a much greater sense of promise than any nagging doubt about the attendant risks or costs. In the UK, our dynamic creative industries, our financial and business services sector, our open market and global outlook seemed to suggest that this was a world in which we would, or at least could, do just fine.

Having spent the bulk of the last decade travelling and working in the emerging economies, I do not think that this optimism was misplaced. The expansion of trade since the end of the cold war in particular has not just been a key driver of European and American growth but also an integral part of export-focused growth models that have allowed hundreds of millions of people in Asia and Latin America to rise out of poverty on the back of global economic demand. Supply chain models that are able to exploit global factors of production can produce

more goods and services more cheaply than ever before, and all of us benefit from this, at least in the cost of what we buy and consume. Globalisation widened and continues to widen opportunity for many, in both the developed and the developing world. If you spend any amount of time travelling in the developing countries that have been transformed by globalisation, you do not hear people calling for a return to grinding agricultural poverty, however complex the challenges of their lives are becoming as they urbanise and industrialise.

Although we bridle at some of the homogenising aspects of the globalisation of popular culture, it is easy to overstate this. The benefits of a globalised information culture for science, innovation, creativity and – ultimately – political dissent are powerful positives. The flipside of having a Starbucks in the Forbidden City is a world in which we have an increasingly shared vocabulary of human rights, corporate governance and personal and civic freedoms, and the social networking technology to speak this vocabulary with people around the world. Is the Arab spring a product of globalisation? I would argue that indirectly it is, but it is not the kind of thing we are usually talking about when we talk about globalisation.

The aim of this report is to examine why it is that so many of us, despite its obvious successes, now have nagging doubts about aspects of globalisation. We live in a world where the presidential frontrunner for the US Republican party advocates increasing tariffs against China. In the UK, which has long based its prosperity on openness to trade, opinion polls show that support for globalisation has declined. Increasingly, people fear the insecurity that global competition places on jobs and wages, and discount the positive benefits provided by cheaper goods from the same regions.

I have spent the last year working with IPPR considering the future of globalisation. As part of this work, I have headed delegations to the leading emerging economies of Brazil, China and India. In each of these countries we met with a range of business leaders, policymakers, politicians and academics to discuss how their countries are managing growth and development in the global economy. In the UK, we travelled to the north east of England to visit my former parliamentary constituency of Hartlepool to understand how the local economy is being shaped by globalisation. Teams from the IPPR have been to Germany and the US to get a different perspective on how leading economies are dealing with these questions. In June, we released a call for evidence and have been grateful for the responses that we received, and to the long list of experts who agreed to speak with us in London and elsewhere.

Efficiency vs insecurity

The picture that emerged from this work is a complex one. It focused, predictably, not on the big changes in transport or telecommunications

that have laid the foundations for globalisation in the 20th century or the processes of cultural interaction that have followed, but on the impacts on everyday lives of global competition and rapid economic change – and, behind that reality, on the conceptions of the market and economics that have defined the way we think about globalisation and the ways in which we have typically described its benefits.

Broadly speaking, we have spent two decades thinking about globalisation in terms of efficiency, just as we have in the realms of economics and public policy more generally. We have focused on globalisation's ability to allocate resources around a global market in a way that reduces costs and raises productivity. This is an important part of the case for economic integration at both the regional and global level. But as this important and timely report makes clear, it is not the whole story. Globalisation cannot be an end in itself. It is a means to a set of wider objectives such as a sustainable global growth model which creates opportunity, reduces inequality, and generates good quality jobs.

From the point of view of urban migrants in Chongqing, post-industrial workers in Hartlepool and poverty campaigners in Brazil, it is impossible to ignore the fact that the direct and indirect consequences of creating markets for goods, services and capital at the global level are a mix of new economic opportunities and disruption, volatility, and insecurity for individuals and families. There is growing evidence that global economic integration brings rising inequality within economies if the balance between those who benefit from globalisation and those who bear the burden of the adaptation it demands is not actively addressed. The negative aspects of globalisation are a problem, and we have to take them seriously.

No less important is the fact that the political consensus for globalisation is being challenged in many western countries. People simply do not want to live in a world that puts abstract economic efficiency or 'liquidity' in financial markets above their personal sense of economic security for themselves and their families. It is hard to argue that they are wrong, even if they are better at describing the costs of globalisation in their lives than the benefits in cheaper goods, and liquid markets, that they take for granted.

At the very least, we need to make globalisation work better to reduce the costs that some people face and ensure that the benefits are as widely disbursed as possible. If we fail to do this, the political pressure to reverse the deepening economic integration of the last two decades will grow. Globalisation so pervades our economic lives that it is hard to have a political debate 'about' it. But that does not change the fact that people feel insecure and are demanding that politicians act to mitigate that. That is a debate that can go in many directions, not all of them useful by any means.

When did we give up on governing globalisation?

To get this debate right, we need to understand how we got here. One of the central arguments of this report is that it is possible to identify two key historic waves of globalisation. The first grew out of the increasing integration of the economy of the late 19th century – when London was the nexus of a global system of trade and investment – and came to an end with the world wars and the chaotic combination of autarky and depression of the 1930s. The second grew out of the efforts to rebuild a stable international economic system in the decades after the second world war, based on the expanding reach of the GATT open trade accords and the Bretton Woods system of exchange and capital controls.

The liberalising trend in this post-war system survives to this day, both intellectually and institutionally in the form of the WTO. The parallel system of ‘Keynesian’ exchange rate and capital market management did not survive the disruption of the 1970s and the effects of the oil crisis. But the Bretton Woods system broke down not only because the US was unable or unwilling to maintain the value of the dollar as the centrepiece of the system – it also succumbed to an intellectual and political shift in thinking about markets and the inadvisability of interfering with their ‘natural’ operation.

By the 1990s, it was entirely commonplace to argue that it could only be counterproductive to interfere with market allocations of resources, whether at the level of national economies or in the massive sloshing tides of the global capital markets. The two serious attempts to govern globalisation of the first two-thirds of the 20th century – negatively through isolationistic, autarkic policies during the 1930s and more positively through the Bretton Woods system between 1945 and the early 1970s – were both accounted to be failures.

So we embarked on a third attempt, not to govern globalisation as such, but to actively expand its reach, with governance restricted chiefly to managing the social and economic consequences rather than trying to define and impose the desirable scope of globalisation itself. To some extent this approach was intellectually underwritten by the IMF, World Bank and OECD, and in many – but not by any means all – of the economics departments and business schools of western universities. In the Anglo-Saxon world, it simply became the conventional wisdom.

Looking back, we can see that this approach did neither us, nor globalisation itself, any favours. It was intellectually abstract and inflexible. In political terms, it often ignored the basic fact that preserving the conditions of open trade and open global markets is possible in a democracy only if we make those conditions sufficiently tolerable and beneficial that people do not vote to end them. It oversold globalisation, and ultimately made it harder to make a pragmatic case for openness. It is not enough to pretend that globalisation is simply irreversible and

has to be tolerated. The reversals of the 1930s show that the direction of globalisation can be changed by political and economic choices over which we have no shortage of control, if we choose to take them.

Reclaiming the argument for governance

The last three years have been defined by a huge and catastrophic failure in financial markets, both of market participants and the governments that failed to regulate them effectively. But the case for this report does not lie in the banking crisis itself, but in the wider process of globalisation of which the financial markets that failed in 2007–2008 are merely a symptom. Even without the financial crisis as a stark reminder of our global interdependence and our badly imbalanced global economy, this report's recommendations would be as relevant as ever.

This report argues that in the increasingly multipolar world in which we live, it is arguable that no single world view will emerge to define the way we manage globalisation. But, while the end of a world in which the west dictated the terms of globalisation is not necessarily a tragedy, a world without a shared set of principles for managing globalisation would be. This report is not naïve about the prospects for global governance, but it argues for new rules accepted by developing and developed countries alike, because 'no rules' is not a sustainable option.

All of the recommendations in this report are directed towards that set of principles. They aim to learn from the various failed attempts to govern globalisation, including protectionism, which failed absolutely, and the Bretton Woods system, which failed only in part and for more subtle reasons. All of our recommendations start from the assumption that the tools of international and domestic governance need to be used strategically, to preserve the good in globalisation and to counter and minimise the bad.

It argues that we must learn (or re-learn) the simple fact that we need effective states and governance to get the best out of globalisation. Governance is needed both to define the parameters in which open markets will be left to deliver benefits and to determine the policies we put in place to equip people to live in security and confidence in a world of rapid economic change. This means a new approach to managing global imbalances, changes at the IMF, WTO and World Bank that both widen their governance to new powers and ensure they remain relevant, and a new, more defined role for the G20. It means policies which help to avoid a 'race to the bottom' on international taxation or a downward spiral of new protectionism. This report also sets out a toolkit for progressive governments which could apply to most western economies, including Britain's. This includes new activist approaches to industrial policies, education and skills, and welfare provision.

Quite consciously, this report attempts to adopt a perspective outside the dominant thinking of the last 20 years. As we were reminded during

our conversations with counterparts in the emerging economies, it is worth remembering that this is how thousands of talented policymakers in China, South East Asia and Latin America already see the world. They do not completely reject the western outlook on trade and liberalisation – in fact they are often strong supporters of it. But they also tend to be more pragmatic about the potential consequences of financial innovation, or the risks attached to asset bubbles or liberalised capital markets, or of the balance between openness to international competition and the policies required to strengthen their domestic economy to get the best out of the subsequent force of economic change. One of the key arguments of this report is that these perspectives need to be an integral part of a new consensus on how to shape globalisation in ways that ensure it delivers greater benefits than costs.

Making this work will put some new demands on politicians in the west. Politicians and NGOs who have made hay out of simple arguments that globalisation just means lost jobs and unfair competition have always misrepresented what is good about integration into a global economy. There is not a lot of comfort for them in this report, or for the ‘anti-globalisers’. It is not realistic or right simply to argue that the answer is to pull up the ladder of trade and international competition which many in the emerging economies have used to climb out of poverty.

The more subtle challenge lies in taking on some of the other barriers to thinking differently about globalisation. This means developing a new confidence in talking about what the state can do both to manage globalisation and to equip its citizens to get the best out of it. We need to treat this as an argument not for ‘big government’ but for smarter government and targeted public spending rather than an increase of it. It deserves intelligent engagement on the right as well as the left. After two decades in which regulation has become a touchy subject on both sides of the political spectrum, we need to resurrect the idea that it is precisely by effectively regulating both global and national markets that we make the most of their potential and ensure they do not fail.

In that respect the power of national governments to shape outcomes from globalisation remains strong, if they and their voters choose to use it. It is also worth remembering that as globalised as the global economy has become in some respects, it is too easy to overstate this. We are still local and national political and social beings. Just 1 per cent of letters sent by mail cross national borders and less than 2 per cent of phone minutes involve international calls. Just 2 per cent of all university students are individuals studying abroad. Even trade integration is less intense than might be assumed: the proportion of goods and services exported across national borders (measured as a percentage of GDP) reached a high point of 29 per cent in 2008 before falling to 23 per cent the following year. It is a mistake to think that we are being swept into

a global world in which the national and the local no longer matter. Nothing could be further from the truth.

The fundamental argument of this report is for a more 'personcentric' view of globalisation, as well as a more political view. That is ultimately why I believe that the best place to start is in seeing globalisation not from the perspective of an economic model, but from the ground, as it is experienced by billions of people every day. We need to understand what, from their perspective, is good about the economic world we have spent the last 20 years building and what urgently needs rethinking or fixing.

Lord Mandelson

London, January 2012

1. WHAT IS GLOBALISATION?

While the word ‘globalisation’ was coined relatively recently (in Levitt 1983), the concept itself is not new. The idea goes back at least as far as the 19th century, but gained traction in the 1990s as the Clinton and Blair administrations sought an accommodation with the expansion of markets to the global level after the end of the cold war and rooted their politics in a belief in ‘openness’ through trade and investment. This was followed by a civil society backlash by those who associated it with a ‘neoliberal’ market ideology and raised concerns about the power of multinational companies to subvert domestic regulatory requirements through their global reach and use of regulatory arbitrage.¹

This report aims to take a fresh look at globalisation, to consider its impact on the objectives of generating sustainable growth and broad-based increases in living standards in every region of the world, and to set out a new policy agenda to enhance its ability to achieve – and win political support for – these goals. We begin by examining the different strands of globalisation and then by assessing the record of two previous periods of globalisation.

Different strands of globalisation

The economist Joseph Stiglitz characterises globalisation as ‘the closer integration of the countries and peoples of the world which has been brought about by the enormous reduction of costs of transportation and communication, and the breaking down of artificial barriers to the flows of goods, services, capital, knowledge, and (to a lesser extent) people across borders’ (Stiglitz 2002). This broadly sums up the view of globalisation underpinning our research. In an effort to assess the extent to which each of these flows has contributed to global integration, we consider each in turn.

Transportation and communication technologies

The role of transportation and communications technologies as the twin engines of globalisation is clear. Between 1840 and the first world war, transport costs fell in response to inventions such as the telegraph and the steam engine, and the development of rail and water networks. Aided by the colonisation process, this enabled the emergence of large-scale trade between distant countries based on their comparative advantages. After 1950, increased product specialisation and further

¹ The ability of companies to take advantage of different regulations in different countries to, for example, reduce the cost of compliance with environmental or financial regulations.

falls in the costs of transportation made it even easier for countries to trade in goods and services.

Technological innovations and steady growth in the performance of new technologies have transformed the speed and ease of global communication over the past half century. The take-up of these technologies has also grown exponentially. In 1990 there were around 530 million fixed or mobile telephone subscriptions – now there are thought to be nearly 5 billion (although levels of mobile penetration vary considerably between different regions and countries). Internet access is not yet as advanced, with fixed broadband penetration currently at around 3.5 per cent in the developing world and 23 per cent in the developed world. That said, high-speed internet access is now available in almost every country in the world and its availability is continuing to rise (United Nations 2010). Figures 1.1 and 1.2 (over) show these increases over the 2005–2011 period for different regions.

Trade in goods and services

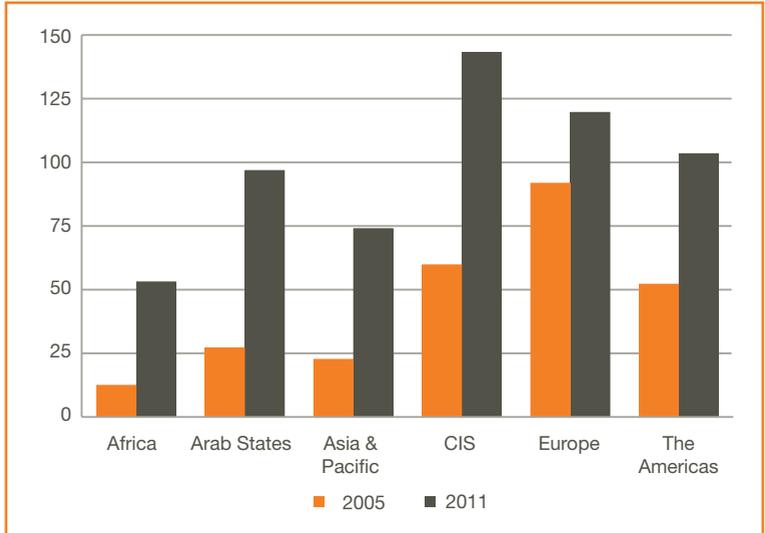
Between 1870 and 1913, trade grew at an average rate of 3.5 per cent per annum, while output grew at 2.7 per cent. As a result, the share of trade in output (a useful proxy for openness) rose steadily, peaking in 1913 at a level which was not surpassed until the 1970s (see figure 1.3 over).

Since surpassing the previous peak, international trade in goods and services has increased dramatically and at a rate that has outstripped levels of global output. In 2006, the value of world merchandise exports was close to US\$12 trillion (compared to just over \$5 trillion in 1995), while the value of global commercial services reached \$2.71 trillion (UNCTAD 2008). These flows are, however, vulnerable to shocks. For example, the proportion of goods and services exported across national borders (measured as a percentage of GDP) fell from a high point of 29 per cent in 2008 to 23 per cent in 2009 following the global financial crisis (Ghemawat 2011).

Capital

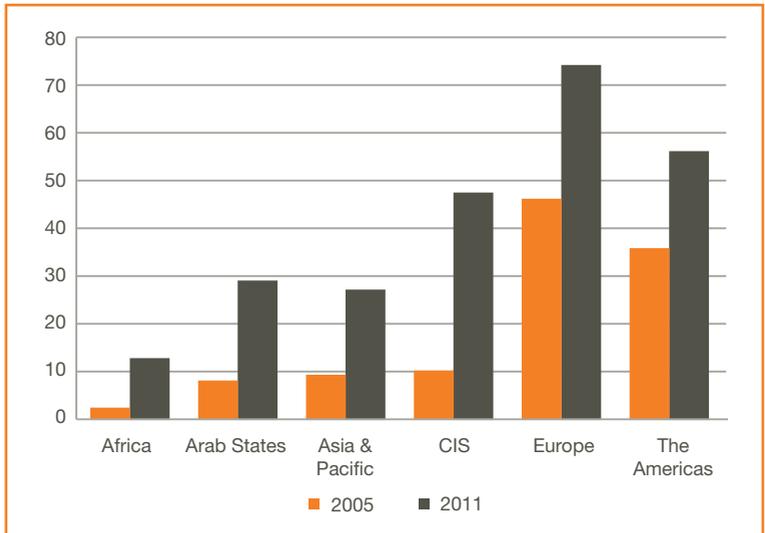
Between 1870 and 1913, the integration of financial markets increased significantly. For example, the growth of foreign portfolio investment exceeded the growth of trade, foreign direct investment and output. By 1913, the volume of international capital flows had reached 5 per cent of the GNP of the capital exporting countries (Bairoch and Kozul-Wright 1996) while the share of foreign assets to world GDP peaked a year later at 20 per cent. As with trade, it took some time to return to those levels after the depression and world war I. As figure 1.4 (over) shows, stocks of foreign capital were just 5 per cent of global GDP in 1945 and did not recover to pre-war levels until the mid-1970s (Obstfeld and Taylor 2004).

Figure 1.1
Mobile telephone
cellular
subscriptions
(per hundred
inhabitants)



Source: International Telecommunication Union 2011
Note: 2011 figures are estimates; CIS = Commonwealth of Independent States.

Figure 1.2
Internet users
(per hundred
inhabitants)



Source: International Telecommunication Union 2011
Note: 2011 figures are estimates; CIS = Commonwealth of Independent States.

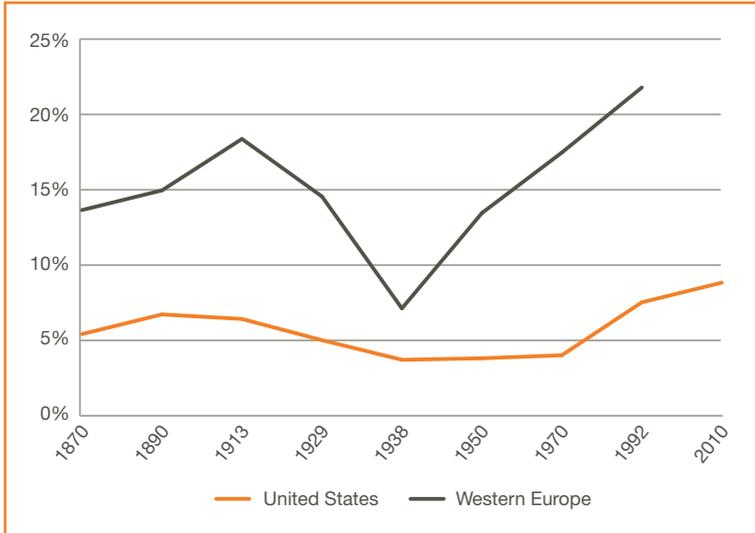


Figure 1.3
Merchandise exports, 1870–2010 (% of GDP)

Source: Bairoch and Kozul-Wright 1996; US data for 2010 is calculated from World Bank and US Bureau of Economic Analysis statistics

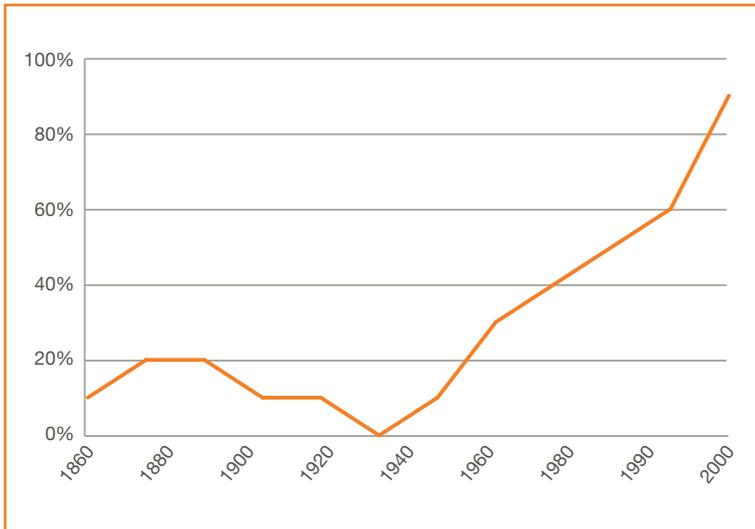


Figure 1.4
Foreign capital stocks, 1860–2000 (% of GDP)

Source: Obstfeld and Taylor 2004

Since then, stocks of foreign capital have shot up, reaching more than 90 per cent of global GDP in 2000. This has been driven by a large increase in the size of gross global capital flows (which jumped from less than 7 per cent of world GDP in 1998 to more than 20 per cent in 2007), stimulated by increasingly loose controls on the free movement of finance in some countries and the unprecedented pace of financial innovation. It also reflects a significant increase in net capital movements, particularly in flows of private capital.

It is estimated that international capital flows increased by about three times as much as world trade between 1994 and 2007 (OECD 2011a). While the majority of this capital has circulated through and between developed economies, emerging markets (particularly in Asia) have attracted a much greater share of these inflows over the last decade. Calculations of the scale of these vary, with the IMF suggesting that net private capital flows to emerging market economies increased from US\$90 billion to \$221 billion between 2002 and 2006, and the World Bank estimating an increase of US\$169 billion to around \$571 billion over the same period (IMF 2007a, World Bank 2007).

Financial globalisation has been more volatile than trade globalisation, with total *gross* capital flows having fallen from around \$US9 trillion in 2007 to about \$1 trillion in 2009 (IMF 2010). The financial crisis has exerted a clear brake on the movement of capital, although flows are bouncing back more quickly in some regions than in others, and particularly in emerging markets in Asia and Latin America (Milesi-Ferretti and Tille 2010). This is also true of *net* capital flows, with recent data indicating that flows to the fast-growing markets of the developing world soared to \$1.1 trillion in 2010, marking a return to their 2007 pre-crisis peak and putting them on track to double the \$675 billion recorded in 2009 (World Bank 2011b).

Migration

The movement of people has been more constrained than the flows of goods, services and capital described above. In absolute terms, there has been a considerable rise in the number of international migrants in recent decades, with 214 million international migrants in 2010 compared to around 75 million in 1965. Migrant workers² and their families account for about 90 per cent of total number of international migrants (ILO 2010). Students abroad, by contrast, account for just 2 per cent of all university students (Ghemawat 2011). This suggests a correlation between the falling costs of transportation and communications technology, the growth of the global labour market, and increased levels of international migration.

That said, the relative proportion of the total global population classified as international migrants has stayed close to 3 per cent for most of the

2 Defined as those who move abroad for a period of a year or more.

last century. This is partly the result of controls placed on migration by national governments, with many countries (particularly more developed ones) enacting tough legislation in recent years to prevent rapid net increases in migration. We are still far from the borderless world envisaged by early globalisation theorists. Labour remains much less mobile than capital, as we shall explore in greater detail in chapter 4.

Globalisation has also had a significant impact on internal migration within countries. Although the data is extremely patchy, estimates suggest that there are currently around 740 million internal migrants worldwide: almost three-and-a-half times the number of international migrants (UNDP 2009). Some estimates suggest that there are around 150 million internal migrants in China's cities alone, despite the restrictions on movement imposed by the national *hukou* system (Shaw and Stancil 2011).

Ideas and values

The flow of ideas is difficult to measure, but what data exists supports the argument that new communications technologies have made it much easier and faster for individuals and companies both to share and develop new forms of knowledge. For example, there has been a steady increase in the number of international patent filings in recent decades, with the proportion of worldwide patent filings by non-residents rising from 35.7 per cent in 1995 to 43.6 per cent in 2006 (WIPO 2008). This has started to level off in the past few years as investment in research and development (R&D) has dropped – a development which has been hastened by the financial crisis – but as shown in the most recent annual report by the World Intellectual Property Organization, it has varied considerably between different regions and countries. In 2009 there was a fall in the number of resident patent filings in the US, but an increase in the number of non-resident filings (WIPO 2010). A number of emerging economies have seen record numbers of international patent filings, with more than 90 per cent of total filings in China and Mexico (alongside Hong Kong, Singapore and Israel) being submitted by non-resident applicants in 2006.

Beyond the more commercial aspects of the flow of ideas, globalisation has prompted a significant and positive convergence in international values and norms over the past half century.

The establishment of the United Nations and a series of international treaties and conventions setting out the indivisible civil, political, economic, social and cultural rights to which all citizens are universally entitled have helped to develop a strong framework of international law. More recently, globalisation has enabled the emergence of doctrines like the UN's 'responsibility to protect', which requires the international community to protect populations from genocide, war crimes, ethnic cleansing and crimes against humanity in instances where their

governments are either unwilling or unable to do so themselves. These standards are not always perfectly upheld, and in many minds the concept of 'liberal interventionism' was set back in the case of Iraq, but they nonetheless remain an important step forward in creating a genuinely global culture of respect for human rights and the protection of lives.

The first and second waves of globalisation: a short history

As noted above, globalisation is not a new phenomenon. Since roughly 1870 there have been two broad 'waves' of globalisation, with periods or peaks of rapid growth followed by troughs where growth slowed markedly, as figure 1.5 shows. The first wave of globalisation was dominated by the UK, which before 1914 was at the forefront during a period of sustained economic growth stimulated by the increased use of manufacturing and transport technologies developed during the Industrial Revolution. Underpinned by the spread of the gold standard, a form of capital control which made exchange rates less volatile and trade patterns more predictable, there was an increase in international trade in western Europe and the US at this time, as figure 1.3 above shows. This was also facilitated by the process of colonial empire-building, which gave the UK and other major European powers privileged access to developing markets and increased the web of interconnections between far-flung parts of the world.

Despite similarities in levels of global financial flows between this period and the 1980s–2000s, this first 'wave' of globalisation was qualitatively different in a number of ways. Crucially, the process of trade liberalisation was much less advanced than is often assumed, and very much confined to Europe. For example, high tariffs and other protectionist measures were commonly used by the developed powers to protect key industries, while free trade agreements were imposed on colonies and other developing economies (Bairoch and Kozul-Wright 1996). In addition, the ownership of equities on which foreign income was derived was also very narrow.

While the period saw rapid urbanisation and some reductions in poverty, inequality was higher in most countries than it is today, as the bulk of the growth went to the owners of capital. Even countries now associated with high levels of equality, like Sweden, saw large concentrations of wealth in the top 1 per cent (Atkinson et al 2011). Growth was also concentrated in the industrialising world and there was little alleviation of poverty in poorer regions of the world. In essence, the first peak of globalisation was characterised by a form of growth by which the rewards ended up being held by the wealthiest in the richest countries. In what is now called the developing world, there were few gains in poverty or inequality.

Although the first wave of globalisation did see relatively high levels of growth until the onset of the first world war, the accompanying concentration of rewards means that there is little in it that we should seek to emulate.

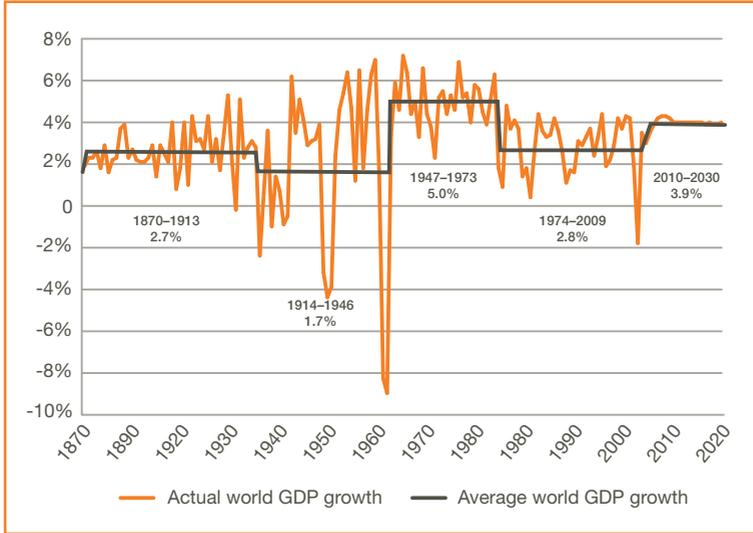


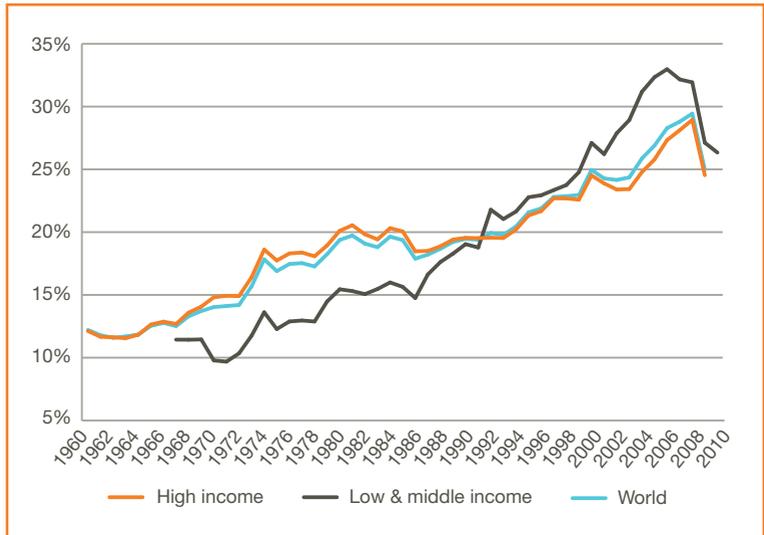
Figure 1.5
The three waves of globalisation

Source: Standard Chartered

A second, US-dominated wave of globalisation took place from the end of the second world war until the latest financial crash. The peak began following the creation of the Bretton Woods institutions and the increase in global demand aided by the Marshall plan and post-war reconstruction. While trade barriers remained in place during this period – at least until they began to be eroded by successive rounds of GATT negotiations – trade flows increased steadily, as figure 1.6 shows. As seen earlier, the flow of capital also increased during this period, stimulated by the deepening integration of the global financial system that resulted from the creation of trade credits and export insurance.

The latter part of this second phase of globalisation was also characterised by changing patterns and structures of trade. Where cross-border trade in the first and early second phases of globalisation was chiefly in finished goods and raw materials, by most estimates around 40 per cent of modern trade is in intermediate goods (and much of it intra-company trade in unfinished goods). The clear implication of this is that trade is now an integral part of the production process itself, with production chains spanning national borders, rather than simply the act of selling or moving finished goods. Supply chains stretch around the world, distributing processes at those various points in the value chain where they can be undertaken most cheaply or effectively.

Figure 1.6
Global exports
of goods and
services
(% of GDP)



Source: World Bank 2011a

Notes: Exports of goods and services represent the value of all goods and other market services provided to the rest of the world, including the value of merchandise, freight, insurance, transport, travel, royalties, license fees, and other services, such as communication, construction, financial, information, business, personal, and government services and excluding compensation of employees, investment income and transfer payments.

This second phase of globalisation is marked by impressive economic transformation, first in the developed world and latterly in parts of the developing. After 1945, poverty levels began to fall in many regions, not least in the European states, which were rebuilding their economies after the war, and in the US, where unquestioned global economic leadership translated into high levels of employment and rising pay. Meanwhile, inequality, which had plummeted in many countries due to the effects of the second world war, came down further still. The US, UK and Canada all saw inequality fall in the period after 1945, until it began to rise again in the mid-1970s.

This period of stable and relatively optimistic growth in the developed world lasted until the mid-1970s, when the end of the Bretton Woods system, oil shocks and stagflation discredited the Keynesian macroeconomic post-war settlement and a new economic paradigm began to emerge around the so-called Chicago school. The policy remedies of monetarism to control inflation together with ‘supply-side’ reforms, including programmes of liberalisation, deregulation and privatisation to boost growth, came to dominate the economic policies of the UK, US and, crucially, the IMF and World Bank.

Applied to development policy, this agenda was sometimes summarised (and parodied) in a 10-point plan by John Williamson of the IMF in 1990, which came to be known as the ‘Washington

consensus'. This focused on a policy reform programme of privatisation, liberalisation of product and capital markets and deregulation as prerequisites for economic development.

On the face of it, this period has been strikingly good for the global poor. Global poverty levels have fallen dramatically over the past two decades. Using World Bank estimates, the United Nations (2011) believe that its Millennium Development Goal 1, which aimed to halve the proportion of people living in poverty (defined as \$1.25 per day in 2005 prices) between 1990 and 2015, will be exceeded. By 2015, the number of people living in poverty is projected to fall below 900 million – representing a fall from 46 per cent to 15 per cent. In an even more optimistic study – which takes the most recent household survey data for each country, and generates poverty estimates for the years 2005 to 2015 using historical and forecast estimates of per capita consumption growth – Chandy and Gertz (2011) estimate that global poverty fell below 900 million in 2010, and project that the number could fall to 600 million by 2015.

However, even allowing for discrepancies between the two studies, poverty reduction has not been experienced by all countries or regions equally. Indeed, much of the progress has been due to rapid decreases in the number of poor people in a few countries. For example, China and India will, according to Chandy and Gertz, cut poverty by 203 million and 368 million respectively between 2005 and 2015, representing around 75 per cent of the total reduction (*ibid*).

While south Asia's share of those living in poverty is expected to fall from two-thirds to one-third between 2005 and 2015, Africa's share will likely double to around 60 per cent during this period (*ibid*). This is not necessarily a problem in absolute terms, as long as the total number of poor people continues to fall. But poverty rates in sub-Saharan Africa still appear to be falling more slowly than in other regions, albeit after a long period of hovering stubbornly above 50 per cent. This has implications for policymakers as they refine their approach to the delivery of development assistance, as is discussed in chapter 4.

Inequality of the global population *taken as a whole* also fell during this period, with a Gini coefficient of 0.676 in 1970 falling to 0.651 in 1990 and 0.633 in 2000 (Pinkovskiy and Sala-i-Martin 2009). But while inequality of the world population as a whole fell as more people were lifted out of basic poverty, inequality rose in most developed and developing countries as the gains of growth became more markedly and disproportionately skewed towards the owners of capital.

Conclusion

These headline numbers are part of the reason why we have become accustomed to seeing the latter part of the 20th century as a time of considerable economic progress.

Certainly the dramatic lifting of hundreds of millions of Asian people out of poverty is a cause for celebration, as ultimately are many of the positive effects of Asian competition on the productivity and innovation of western industries, discussed in more detail in chapter 2. The impact of easier travel and cultural globalisation during this period helped create a greater awareness than ever before of a set of shared values and political and civic rights.

However, it is also the case that while there were global growth rates of 2.8 per cent in the period from 1974 to 2009, this compares unfavourably to the 5 per cent rate achieved during the mid-century Bretton Woods period as a whole. Although it is necessary to account for the growth effects of European post-war recovery and the absence of emerging economy competition, and while it is nowhere near as bad as was the interwar period, the most recent phase has been, in essence, the trough of the second wave of globalisation. While modest growth and falling poverty are on the positive side of the ledger, rapidly rising inequality has meant that these advances have not been broad-based. Many ordinary workers in the developed world have seen their wages stagnate in real terms, even as the very wealthiest in their societies have continued to see theirs rise dramatically. A series of financial crises in Asia, Latin America, Russia, and finally on a global scale have also created considerable volatility, linked in large part to capital market liberalisation. Inevitably, globalisation's critics try to implicate it in these trends. Part of the purpose of this report is to assess some of those charges.

We believe that we may be standing at the start of a third wave of globalisation. As during the first and second waves, advances in technology and falling transport and communication costs will continue to make the world increasingly connected. However, distinct from the waves that came before, the third wave is unlikely to be dominated by a single region or country, although the rise of Asia will loom large. It will also be defined by different models of trade, continuing the trend of the last decade which has seen the rise of intra-company trade – effectively, the creation of cross-border supply chains – as an important mode of international trade, alongside trade in finished goods.

Crucially, this drives home the need for advanced economies, like those in Europe, to focus on their strengths in high-end technology and component goods across international chains of production. It also means that advanced technology producers in Europe will need to look more carefully at the synergies and combined strength they can derive from continental collaboration, in order to match the scale and growing sophistication of Asian and other emerging economy producers. This third wave of globalisation holds out considerable economic opportunity, but it will also be – indeed, it already is – the subject of intense criticism and anxiety, especially in the developed world.

The purpose of this report is to reflect on some of the reasons why this is the case and to examine the evidence for globalisation's positive and negative impacts. The next chapter starts by looking at some of the economic theory that underlies the case for supporting globalisation and asks how well it has fared in practice over the past two decades.

2. ASSESSING THE BENEFITS OF GLOBALISATION

Chapter 1 set out our understanding of what is meant by globalisation and sketched out two phases of globalisation that carried the global economy from the late 19th century to the present day. Far from being a single phenomenon, globalisation is, in fact, a set of interlinked processes. Over the last century, trade and capital flows first fell from pre-first world war peaks before rising again after the second. Migration has risen in absolute terms, but only in line with wider population trends. The flow of ideas, although less easy to measure, has been rapid due to the increasing interconnectedness of the world.

From the perspective of politics and policy, the direction and pace of these flows is less interesting than their effect. This too can be measured in a very large number of ways. But because the claims for globalisation are so often rooted in its ability to spread and distribute economic benefits, it makes sense to measure it against the goals of faster, sustainable economic and employment growth, poverty alleviation, and lower inequality in every region of the world. The question we should be asking is to what extent globalisation contributes to these aims.

This chapter examines what the academic evidence tells us about the impact that globalisation has had on these areas. This question is complex for a range of reasons. For instance, data on the economic impacts of globalisation is relatively limited, even now. More importantly, demonstrating clear links between particular policies and specific outcomes is difficult. There are, however, some conclusions that we are now better able to draw than we were even 15 years ago.

With respect to growth, poverty reduction and inequality, globalisation has brought both benefits and costs. But the conclusion that we draw is that it is not so much globalisation itself that guarantees these outcomes but more the way in which the forces it brings with it are managed. In particular:

- The undoubtedly strong correlation between trade and economic growth should not lead us to assume that comprehensive free trade is the right prescription for all countries at all times in their development.
- Trade encourages higher productivity and has helped drive technological innovation, but both of these lead to job losses. Getting the best out of rising productivity means ensuring that meaningful opportunities exist for those whose employment is displaced by global competition.

- Globalisation has helped to reduce inequality between countries but, while reducing poverty, it can increase levels of inequality within countries.
- While access to international investment is one of the key potential benefits for states in a globalised economy, capital market liberalisation and portfolio investment flows can be a source of instability where they are not undertaken carefully and with an eye to the potentially destabilising effects of sudden reversals in flows.

This chapter examines each of these points in turn.

The correlation between trade and growth is more complex than it seems

Many academic studies have examined the relationship between free trade and rates of economic growth. During the 1990s, various studies used cross-country indicators of trade openness to identify the degree to which different countries had integrated with the global economy, arguing that there was a causal link between higher levels of international trade and increased levels of growth (Dollar 1992, Edwards 1998, Frankel and Romer 1999). Another influential study analysed data from a sample of 135 developed and developing countries and identified a strong association between openness and growth. For the period 1970–1989, this data showed that open economies had outperformed closed ones both in terms of economic growth rates and their ability to avoid extreme macroeconomic crises.³ This was found to be true of both developed and developing economies (Sachs and Warner 1995). The policy implication was that convergence for developing countries towards income levels of more developed countries was not automatic, but depended instead on how open a country is to trade.

Not all practical experience reinforces this, at least not at face value. China experienced consistently faster growth rates than other emerging and developed countries before WTO entry, and while far from economically open to the outside world. Meanwhile, convergence in living standards between developed and developing countries has not occurred to the degree expected if free trade between open economies was really all that was required for global income levels to equalise. While progress has been made in some parts of the world – particularly east Asia – in other places, notably Africa, the trend has been towards divergence rather than convergence (Stiglitz 2008). Those sceptical of the idea that trade openness leads directly to growth argue that the positive correlation between these two factors is likely to be contingent on the specific characteristics of each economy and affected by external factors (Rodriguez and Rodrik 2000).

³ In this study, a country was judged to have a closed economy if it displayed one or more of the following characteristics: (i) non-tariff barriers covering 40 per cent or more of trade, (ii) average tariff rates of 40 per cent or more, (iii) a black market exchange rate that is depreciated by 20 per cent or more relative to the official exchange rate, on average, during the 1970s and 1980s, (iv) a socialist economic system, and (v) a state monopoly on major exports.

Much of the evidence suggests that the key benefits of trade lie in its ability to allow an economy to tap into sources of external demand greater than are available in its own domestic market, and to bring the benefits of international competition to bear on its own firms in a way that generates greater specialisation and higher productivity. The success of both of these strategies will inevitably be linked to the underlying capabilities of the economy in question and the nature of the competition it faces. A government that actively supports a coherent set of supply-side and developmental policies in an institution-building growth strategy – even one which contains ‘protectionist’ elements, such as transition period for market opening – are more likely to achieve economic growth than those that simply pursue extreme trade liberalisation. Ultimately, integration into the global economy is a necessary phase in a successful growth and development strategy, but it is a means to growth, not an end in itself.

Trade encourages higher productivity so can lead to job losses

There is good microeconomic evidence that the intensification of international competition resulting from increased levels of trade has helped to make many firms in developed economies more innovative and productive. Recent research on the impact of Chinese import competition has suggested that it increases levels of innovation, total factor productivity and R&D, and improves management quality within surviving firms. Indeed, one study suggests that Chinese import competition accounts for around 15 per cent of European technology upgrading between 2000 and 2007 (Bloom et al 2011). There is no question that import competition has exerted a powerful competitive check on both US and European industry, forcing both business failure but also a wave of strengthening rationalisation, innovation and renewed specialisation as a competitive strategy. Needless to say, the short-term collateral impact of this rising productivity is workers looking for new jobs. While there is broad academic consensus that, over the long term, trade does not have a significant impact on employment levels, because new jobs are created to replace the jobs lost to greater competition, this cannot be taken for granted (Hill et al 2008).

For example, greater exposure in the US to Chinese import competition has been linked to increased unemployment, lower levels of labour force participation and a reduction in wages in some local labour markets. This has caused knock-on effects in employment and household incomes, enrolment in benefits programmes and transfer payments for social welfare (Autor et al 2011). Rising Chinese import competition has also been linked to falls in employment, profits, and the proportion of workers who are unskilled. This may be due to the direct effect of competition from Chinese firms, or to such trade stimulating technical and process innovation, which in turn increases the demand for

skilled labour at the expense of unskilled (Bloom et al 2011). While the potential benefits of the increases in productivity and incentives to focus production on comparative advantages are clear, it is also apparent that the resulting churn in the labour market creates a need for active policies to assist in the redeployment of workers, especially where there is a need to increase their skill levels.

Globalisation affects levels of inequality between and within countries

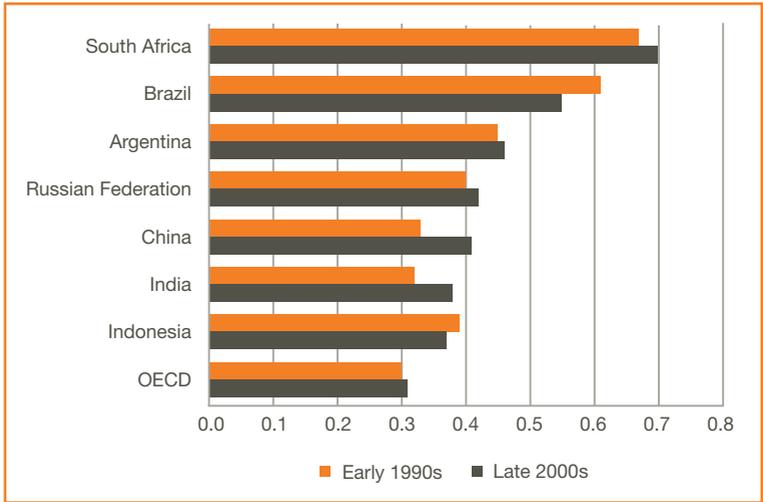
There is little doubt that inequalities between countries have fallen over the last 30 years. As chapter 3 shows in more detail, an increasingly large share of global growth is coming from developing countries, as they catch up with developed countries. Measuring income levels of the global population as a whole without regard for national borders shows that global inequality fell during the 1980s and 1990s (Sala-i-Martin 2006). That is, however, where the consensus ends.

Early trade theories argued that since openness and growth appear to increase incomes across the board, the same should also be able to reduce inequalities between countries and within developing countries (see Stolper and Samuelson 1941, Kuznets 1955, Dollar and Kraay 2001). It was expected that countries with an abundance of low-skilled labour would see inequality reduced as a result of falling tariffs, since the price of low-skill intensive exports (and therefore wages of those who produced them) would increase, and the price of high-skill intensive imports would fall. In developed countries, it became widely accepted in the 1990s and 2000s that those increases in inequality that had occurred were more to do with the role that technology was playing in rewarding high skills ('skill-biased technical change' in the jargon) and less due to increases in trade.

By contrast, the data shows that inequality has risen in most emerging economies over the past few decades, as figure 2.1 shows (over). Indeed, a recent OECD report suggests that, while poverty levels have fallen, income inequality in India has doubled over the past two decades, with the top 10 per cent of wage-earners currently making 12 times more than the bottom 10 per cent, compared to six times 20 years ago (BBC News 2011).

This reinforces findings of the IMF (2007c) showing that income inequality had risen across most countries and regions in the previous two decades, but that the average real incomes of the poorest population groups had still experienced a relatively steady increase. More significantly, it observed that while increased trade and export growth were associated with *lower* levels of income inequality, increased financial openness was associated with *higher* levels of inequality (IMF 2007b).

Figure 2.1
Changes in inequality levels in OECD and selected emerging economies (Gini coefficient of household income)



Source: OECD 2011b

Notes: Figures for the early 1990s generally refer to 1993, whereas figures for the late 2000s generally refer to 2008.

What conclusions can we draw from this picture? First, technological change does appear to have had a much greater impact on inequality than the combined impact of international trade and finance (ibid). This occurs because new technology, in both advanced and developing economies, increases levels of task automation and raises the premium on skills, except in the most basic industries. Low-skilled workers lose out; higher-skilled workers, who can command higher wages, benefit. Trade almost certainly plays an important role in this process, acting as a spur for greater efficiency and inducing faster technological change. Some recent studies have refined this argument and argue that trade has a dynamic effect on skills selection by inducing faster technical change. Trade with China, in particular, has speeded up this process (Van Reenen 2011).

As long as the incomes of all groups within a society are rising in real terms, does it matter if higher earners are experiencing much faster wage growth than those at the bottom of the distribution? Some will argue that inequality is a price worth paying if growth is taking place anyway and rapid increases in income at the top are offset by increases at the bottom which lift people out of poverty. The problem with this argument is that it misses the dynamic effects of inequality on growth. Recent research by the IMF has found that longer growth spells are robustly associated with more equality in the income distribution (Berg and Ostry 2011).

The evidence suggests that inequality should worry us, both economically and because of the corrosive effects of a high level of

inequality on social solidarity and cohesion. The concentration of wealth and power in the hands of a small proportion of society typically leads to a highly inefficient allocation of resources as the wealthy tend to spend a lower proportion of their disposable income. Moreover, behind their high aggregated levels of per capita income, highly unequal societies are likely to fail to deliver on the broad promise of rising living standards for all, because of the self-reinforcing nature of wealth and opportunity accumulation at the top of society. As chapter 3 outlines in more detail, greater income inequality also makes the task of poverty alleviation far harder (Ravallion and Chen 2004). In the future, broad-based advances in living standards are much more likely to result from a more equal distribution of opportunity and wealth.

Capital market liberalisation can bring risks to the global economy

A belief in the importance of financial market liberalisation has been a central plank of many arguments in favour of globalisation over the last three decades. Economic theory certainly suggests that capital mobility should allow for savings to flow to the most productive investment opportunities in the world, despite the puzzling observation that capital often flows ‘uphill’ to the richest economies, where the marginal product of capital tends to be lower but where there are better institutions and lower levels of risk. Yet concerns have been raised in recent years about the impact of financial globalisation on growth and economic stability. Three academic findings in particular are worth considering.

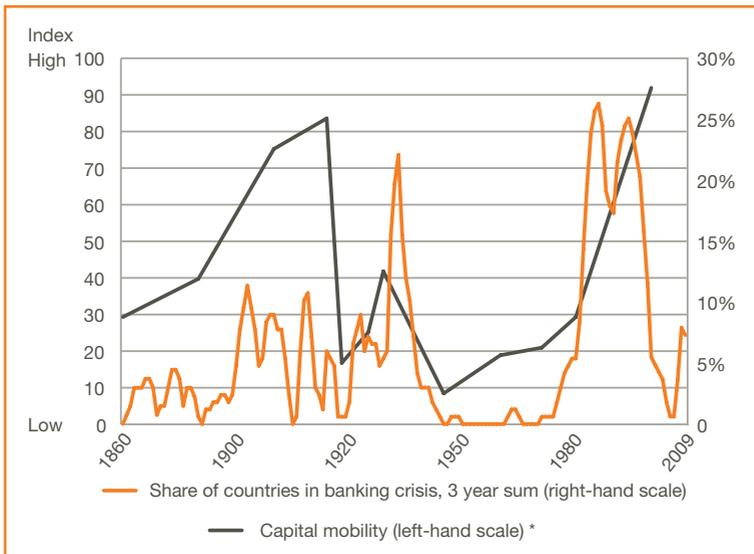


Figure 2.2
Capital mobility and the incidence of banking crises

Source: Reinhart and Rogoff 2008, Obstfeld and Taylor 2003
* Judgemental index on the extent of capital mobility constructed by Obstfeld and Taylor

First, both the IMF and OECD have concluded that large portfolio capital inflows are associated with increased risks of overheating, loss of competitiveness, the creation of credit and asset price bubbles, and increased vulnerability to the impact of crises (IMF 2007b, OECD 2011c). It is important to differentiate here between fast-moving speculative capital flows, which cause higher levels of financial instability, and more stable inflows of longer-term foreign direct investment (FDI). This volatility is not a new phenomenon. In recent centuries, as shown in figure 2.2 (previous), increased capital mobility has often been followed by a string of domestic banking crises (Reinhart and Rogoff 2008). Recessions caused by banking crises are, in turn, more likely to be long-lived (Bhagwati 1998, Koo 2003). Both the Asian crisis of 1997–1998 and the current crisis are indicative of how financial crises can cause substantial damage to the real economy.

Second, there is a positive correlation between capital inflows and the average overvaluation of a country's exchange rate for non-industrial countries. This can create a version of 'Dutch disease'⁴, in which the impact of inflows of capital on the exchange rate make exports more expensive and therefore harms and restricts the growth of other sectors in the economy. Indeed, countries that were less reliant on capital inflows in the period 1970–2004 grew faster than those that were more reliant on imports of capital, implying that the benefits of large speculative flows are a mixed blessing at best (Prasad et al 2007).

Third, capital mobility encourages the build-up of reserves and, as a result, the creation of dangerous global imbalances. Since the early 1990s, there has been a rapid rise in the levels of foreign reserves held by fast-developing countries, and by China in particular. As figure 2.3 shows, by 2005 these had risen above 20 per cent of developing countries' GDP, from an average level of less than 6 per cent in the 1980s. In China, total reserves hit 30 per cent of GDP in 2004 and now hover around 50 per cent. By comparison, the reserves of OECD countries have risen only incrementally during this period, and remain below 10 per cent of GDP.

A strategy of reserve accumulation is partly one of insurance against the negative effects of large-scale reversals in capital inflows. Evidence suggests that higher levels of liquidity can help to offset the risk of a financial crisis caused by such reversals. Indeed, in 2001, the IMF recommended that developing countries should hold reserves that were at least equal to short-term debt, if not much higher (Fischer 2001). That said, the massive accumulation of reserves by some emerging economies (and particularly by China) has been linked to more commercial motives, including a desire to prevent the appreciation of

4 The economic term which describes an apparent relationship between the increase in exploitation of natural resources and a decline in the domestic manufacturing sector (see for example Corden and Neary 1982).

their currencies so that their exports remain competitive. However, as Roubini and others note, letting the renminbi (¥) appreciate is ultimately in the long-term interest of China, since this will help to shift their economy away from large-scale investment in export manufacturing and towards the domestic consumer market (Roubini 2011, Kroeber 2011).

Figure 2.3
Total reserves
(% of GDP)



Source: World Bank

This evidence leads us to conclude that the arguments for capital market liberalisation need to be treated separately from wider arguments about the liberalisation of trade. Capital mobility, especially short-term speculative flows of portfolio investment, can be a source of volatility and vulnerability as much as a source of valuable investment. When this concern contributes to the build-up of imbalances – as we have seen become a defining condition of the global economy – the danger multiplies. This does not suggest that all forms of capital mobility should be restricted, but that greater care should be taken in determining which precise elements of global financial flows are beneficial and which pose risks that ultimately outweigh the contribution they make to prospective growth. As the distinction between foreign direct investment and portfolio investment implies, this is a question of differentiating to the greatest extent possible between longer-term cross-border investment in hardware and capability, long-term cross-border investments in sovereign debt or equity, and purely speculative short-term investment. It also requires careful assessment of the risks attached to cross-border lending, especially in foreign currencies. This can be a source of instability in crises, especially if international banking groups choose to retrench or call in lending at such times of heightened stress, as they are currently doing.

Conclusion

These four findings raise important questions about the optimal design of policy approaches to globalisation. The evidence suggests that trade and growth are linked, but that trade liberalisation is not a silver bullet for growth. To produce sustainable growth, trade liberalisation needs to be managed in a way that reflects the specific needs and capabilities of individual markets and economies. This is not to argue that if trade liberalisation causes disruption or forces adjustment it should be ruled out. Part of the benefit of trade liberalisation derives from its ability to drive increases in productivity or shifts in specialisation. But that process of adjustment will have costs and these must be explicitly weighed and addressed. In the short run at least, international competition will lead to job losses and dislocation. Social safety nets and active labour market and skills policies are therefore critical if we are to get the most out of greater openness.

Financial globalisation, as distinct from trade, is a more ambiguous prospect. The evidence suggests that it can cause instability when poorly controlled. Economies that have undertaken high levels of financial liberalisation also exhibit higher levels of inequality, partly because of the very high incomes of those working in the globalised financial sector. It is therefore increasingly clear that financial openness should not be an end in itself and needs to be managed to ensure that it balances access to important capital, with policies to manage any likely sources of volatility or vulnerability.

Two further important points emerge when we assess the data on the impact of globalisation on western economies over the last 20 years. The first is that we need to draw a distinction between the impact of China's re-emergence as a global economic power and the wider phenomenon of globalisation, because these are not one and the same thing. China's size and enormous store of available labour has meant that it has dominated global production patterns and exerted great competitive pressure on European and American producers. But these impacts need to be seen in the context of the unique challenge of integrating an economy such as China's into the global trading system, not simply as a proxy for globalisation more widely.

It is also important to recognise from this experience that the kinds of economic and political challenges associated with globalisation are not *simply and only* problems of *globalisation*. Stubborn poverty, technological change and rising inequality can and are driven by a range of factors, and global economic integration is only one of them. A world without globalisation would not be free of these problems. In fact economic history suggests the very opposite. These are phenomena that can be exacerbated by globalisation, but they are not limited to a globalised world economy or innate to it. Indeed

globalisation can be a tool in addressing poverty and inequality, as we have seen. As much as anything, these conditions result from the actions that governments take to mediate or mitigate the impacts of economic change. We return to this point in more detail in chapter 5, taking the UK as a case study.

Chapter 3 now looks in greater detail at the current state of globalisation, what defines it as it enters its next phase, and what this implies for the future.

3. THE THIRD WAVE OF GLOBALISATION

The previous two chapters have set out some ways of thinking about globalisation, and assessed some of the related academic evidence. We have suggested that the first two waves of globalisation over the past 100 years or so have brought a combination of costs and benefits: rapid economic change for most, increased opportunity for many, anxiety and disruption for some.

This essentially disruptive quality of globalisation – in both the positive and negative senses – is likely to characterise globalisation in the future as well. In terms of trade volumes and the intensity of cross-border movements of capital, the third wave of globalisation is set to deepen further the rising levels of interdependence and exposure to international risk that have characterised financial and product markets over the last quarter of a century.

What has also defined the first two waves of globalisation is the extent to which they have been dictated from within the western world, first by the UK and then by the US. In this sense at least, the next wave of globalisation will be very different. This difference is part of what makes it a source of so much anxiety in the developed world.

It is to this third wave of globalisation that we now turn.

New power dynamics: the changing nature of the global economy

The third wave of globalisation will be dominated by non-western growth, notably but not exclusively in Asia. In 2009, China alone contributed 18 per cent of global growth, compared to 14 per cent from the US. The country is now the world's largest exporter of goods and the second-largest importer. IMF data shows that, in terms of purchasing power of the whole economy, China may overtake the US as the world's largest economy as soon as 2016. Allowing for all the uncertainties associated with such predictions, it seems likely that this will happen by 2030.

While China's scale makes it the one to watch, its trend growth is paralleled across many so-called 'emerging markets'. From 2001 to 2010, the 'Growth 8'⁵ countries contributed the same additional output to world GDP as the G7 group of rich nations (O'Neill 2011). By 2020, their share of global GDP will be virtually the same. Spreading the net even wider,

5 The 'Growth 8' refers to the following fastgrowing countries that make up more than 1 per cent of global GDP: China, India, Brazil, Russia, Korea, Mexico, Indonesia, and Turkey.

emerging and developing economies' share of world gross domestic will exceed that of advanced economies as soon as 2013 (Zhu 2011).

Table 3.1 summarises three recent reports by PricewaterhouseCoopers (2011), Citigroup (Buiter and Rahbari 2011) and Goldman Sachs (O'Neill and Stupnytska 2009), which make projections about the global economy in 2050. Each suggests a fundamental realignment over the next four decades. Some of these changes have already taken place. Even on a nominal GDP basis, China is now the world's second-largest economy, Brazil is larger than Italy, and India is larger than Canada. By 2050, even the most cautious of the three reports suggests that, of current G7 countries, only the US, UK and Japan will remain in the global top seven.⁶

Rank	Today	2050 rank, according to...		
		PwC (2011)	Citigroup (2011)	Goldman Sachs (2009)
1	US	China	India	China
2	China	India	China	US
3	Japan	US	US	India
4	Germany	Brazil	Indonesia	Brazil
5	France	Japan	Brazil	Russia
6	UK	Russia	Nigeria	UK
7	Brazil	Mexico	Russia	Japan
8	Italy	Indonesia	Mexico	France
9	India	Germany	Japan	Germany
10	Canada	UK	Egypt	Italy

Table 3.1
The world in 2050?

As a result of this, flows of goods and services, commodities, people, remittances, and portfolio and direct investments are all on the increase between countries of the global south (Lyons 2011). For example, the share of world goods trade among developing countries has more than doubled in the past two decades, from 7 per cent in 1990 to 17 per cent in 2009.⁷ From a value of \$2.1 billion in 2000, trade and investment between the two regions is expected to rise to \$30 billion by 2012. While exports to Europe and the US have fallen from accounting for 45 per cent of India's exports in 2000 to 30 per cent in 2010, they have grown (from a low base) by 65 per cent in a year to Brazil and 100 per cent to Africa.

⁶ These projections are not, however, accepted by all. Dani Rodrik (2011a) argues that there is a short list of countries that have sustained per capita growth exceeding 4.5 per cent a year over a period of three decades or more at any time since the early part of the nineteenth century. PwC's own analysis is premised on 40 years of annual per capita growth above 4.5 per cent for both India and China. This historical precedent suggests that the third wave is bound to have some bumps along the way. Indeed, growth is currently slowing in Brazil, India and China.

⁷ Reported in *Emerging Markets*, see at <http://www.emergingmarkets.org/Article/2819827/SOUTH-SOUTH-TRADE-Tricks-of-the-trade.html>

In the corporate world, there is a clear upward trend in activity from and between the fast-growing emerging economies. For example, India's Bharti Airtel (part-owned by Singapore Telecommunications) recently acquired Zain Africa from Kuwait-based Zain in a \$10.7 billion deal. Meanwhile, the Oman Investment Corporation is engaged in a US\$1 billion joint venture with Sembcorp Utilities of Singapore to create an Independent Water and Power Plant in Oman (ibid). Chinese firms now make up 46 of the Fortune 500 companies, up from just nine in 2001 (Li 2011). Box 3.1 outlines the changing nature of the state-owned enterprise in China, which constitutes over 85 per cent of the country's Fortune 500 companies.

Sovereign wealth funds (SWFs) now manage \$4.8 trillion of wealth, with 40 per cent concentrated in Asia and 35 per cent in the Middle East.⁸ The majority of these funds are generated by oil and gas revenues but China's five non-commodity funds – all established since 1993 – manage a total of \$1.4 trillion.

Another relatively new form of capital flow is global remittances. In 2011, remittance flows to developing countries totalled US\$351 billion, with an additional \$55 billion going to high-income countries. This marked the first year that remittance flows to all developing regions had grown since the financial crisis. India (\$58 billion), China (\$57 billion), Mexico (\$24 billion) and the Philippines (\$23 billion) were the largest recipients (Mohapatra et al 2011).

Box 3.1: View from China – state-owned enterprises

A key issue in China, and one our delegation discussed in a number of different forums, is that of state-owned enterprises (SOEs). China currently has just over 110,500 SOEs, administered at both the central and provincial level. While the overall number has fallen significantly and now makes up less than five per cent of all businesses, their significance is still huge. Thirty per cent of assets held in the industrial and service sectors are held by SOEs. Meanwhile, the average asset size of industrial SOEs increased from ¥134 million in 1999 to ¥923 million in 2008 (Gao 2010a).

This shift has been primarily due to the 'grasping the large and letting the small go' policy which was adopted in September 1997. Since that point, most small SOEs have been privatized or have filed for bankruptcy. Most SOE profits now derive in sectors where they have a monopoly such as tobacco, oil extraction or electricity. Some estimates suggest that SOEs make up 70 per cent of all business profits in China. Meanwhile, performance tends to be poor in sectors with low barriers to entry (Gao 2010b).

8 See <http://www.swfinstitute.org/fund-rankings>

These issues are creating tensions inside the Chinese government. A senior government advisor described these state monopolies to IPPR as ‘terrible’ and called for more competition in most sectors. He said that the opportunities for small businesses in the private sector were reduced because SOEs hoovered up capital, and noted that the five-year plan included 36 items to help develop the private sector – including proposals to ‘expedite reforms of large SOEs [and] deepen the reforms of monopoly industries’ – but that these were proving hard to implement.

In contrast to these concerns, we were given a rosier view at a meeting with officials from the State-owned Assets Supervision and Administration Commission (SASAC). One official told us that SOEs would be the backbone of the economy and become world-class enterprises by 2015. She rejected the idea that they were ‘privileged’ and said that the Chinese market was ‘completely open’ to the outside world. It is indeed the case that many SOEs are open to cooperation with global firms.

For example, General Motors and the state-owned Shanghai Automotive Industry Corporation (SAIC) have partnered in the South Korean venture GM Daewoo, which builds cars and sells components to GM’s US operations (Woetzel 2008). Recent government reforms include a new anti-monopoly law in 2007, revisions to open up monopoly industries to private investment, and continued revision to investment catalogues to allow foreign investment, for example, in the financial sector.

Professor David Li, director of the Center for China in the World Economy (CCWE) at Tsinghua University, offered a more prosaic view, suggesting that reforms would only happen if and when non-SOEs started to eat away at SOEs’ profitability. But his colleague, Joel Ruet, a visiting scholar from France, said the Chinese economy was a ‘competitive oligopoly’ and described a power game taking place between those SOEs controlled by central government and those controlled at the local level.

Another suggestion was that a new source of leadership in the Chinese communist party will be former CEOs of state-owned enterprises. For example, two members of the current Politburo Standing Committee, Jia Qinglin and Zhou Yongkang, are former general managers of SOEs, while others occupy positions in the Politburo. This may well entrench SOEs in the Chinese economy for years to come.

These shifts in the global economy provoke a number of questions. Will the ‘rise of the rest’ translate into the creation of a global middle class? Will the new global economy be more equal? Does the emergence of Asia and other regions mean that the west will become submerged? Does the third wave of globalisation imply an unsustainable race for resources? This chapter turns to each of these questions in turn.

A global middle class?

What is this new global economy likely to achieve in reducing poverty and inequality? It is often claimed that globalisation is helping to create a new global middle class. How credible is this?

The most recent estimates suggest that poverty reduction will continue in the third wave as it did in the second (see for example United Nations 2011, Chandy and Gertz 2011). Indeed, it is not outlandish to suggest that the narrow \$1.25 definition of poverty may be all but eradicated outside Africa by 2050. The next question is whether the third wave can emulate the 1945–1973 period in the developed world and deliver broad-based increases in living standards – alongside rapid poverty alleviation – through reductions in inequality.

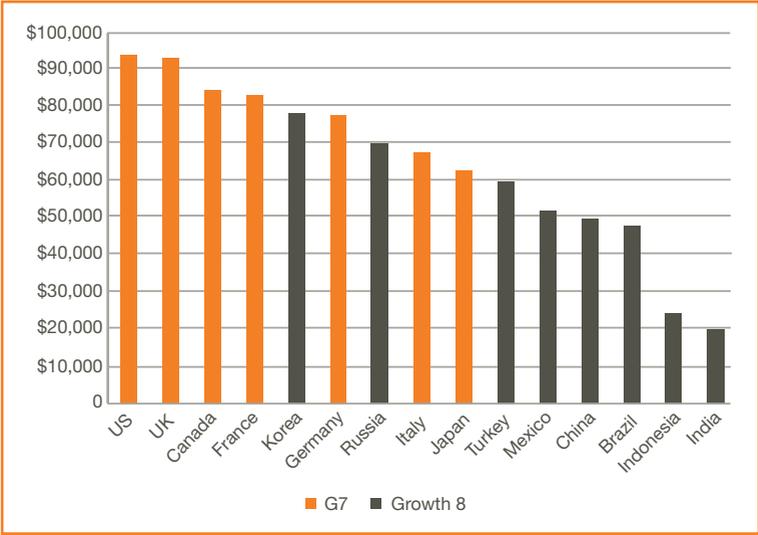
Despite the rapid progress on both growth and poverty, the most successful developing countries, like China and India, will still be far behind developed countries in relation to living standards for years to come. As figure 3.1 shows, even in terms of local spending power per capita income in China will still be half that of the US in 2050, while India’s will be just over a quarter (PricewaterhouseCoopers 2011).⁹ With the exception of South Korea and Russia, people in the industrialising ‘Growth 8’ will continue to be poorer than those in the G7 group of rich countries.

Related to this, there are concerns about how broad-based global development will be, on current trends. Analysis for the OECD estimates that there are currently 1.8 billion people in the global middle class (Kharas 2010). This is defined as those earning between US\$10 and US\$100 per day, using purchasing power parities (PPP).¹⁰ Over four-fifths of this global middle class is concentrated in Europe (664 million), Asia (525 million) and North America (338 million). As figure 3.2 shows, this means that while the middle class has reached near saturation in the developed world, it only makes up a small minority of the population in emerging economies and is virtually non-existent in the least developed regions of the world. Indeed, a report by the African Development Bank (Ncube et al 2011) shows that the percentage of the total African population earning more than \$10 per day has fallen modestly over the last 30 years, from 9.94 per cent in 1980 to 9.54 per cent in 2010.

9 Interestingly, the UK is projected to have the second highest per capita income in the G7.

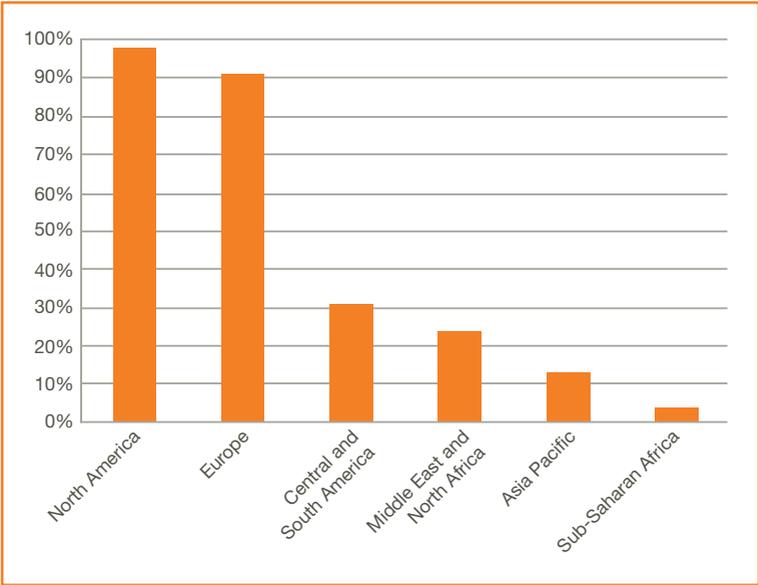
10 A minimum of \$10 per day is regarded as the point at which the risk that an individual falls back to an income less than \$4 per day falls to 10 per cent.

Figure 3.1
GDP per capita
levels in 2050
(US\$, 2007)



Source: Goldman Sachs

Figure 3.2
Proportion of
people in the
global middle
class



Source: Kharas 2010, Geohive

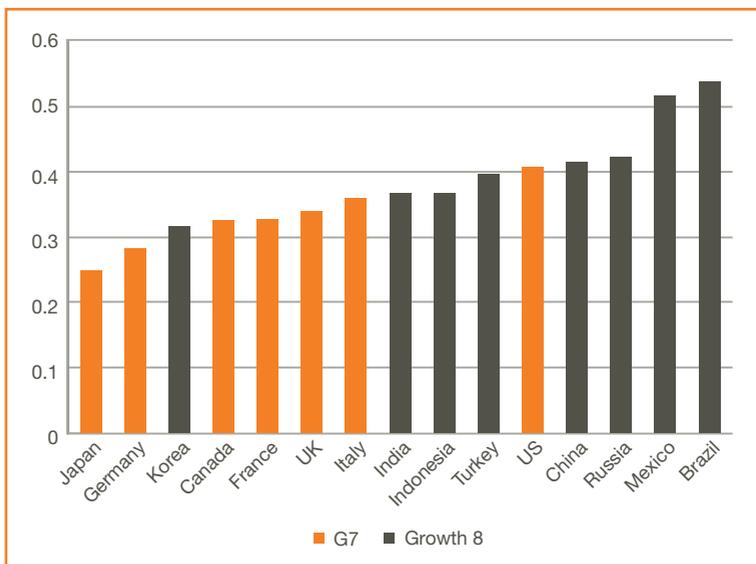
Nonetheless, the volumes alone are impressive. The middle class market in Asia is now bigger than that in North America and will surpass Europe in the coming years. McKinsey (Court and Narasimhan 2010) estimates that spending by the expanding global middle class will increase from \$6.9 trillion annually to \$20 trillion during the next

decade. China has contributed more than any other country to the expanding numbers in the global middle class: by 2015, it is expected to be the world's largest luxury market, with a 20 per cent global share (Atsmon et al 2011).

A more unequal world?

As discussed in chapter 2, inequality is high and rising in many parts of the developing world. As figure 3.3 shows, with the exception of the outlying US and Korea, income inequality is generally lower in the G7 than in the 'Growth 8'.

Figure 3.3
Inequality
in selected
countries (Gini
coefficient)



Source: UNDP 2010 and 2011

Of these countries, only Brazil and France are significantly more equal now than they were 15 years ago. The OECD notes that, 'while progress on overall poverty reduction has been made, income inequality has often increased'. They acknowledge, however, that successful policies in Brazil have started the process of reducing these inequalities after they increased over a period of 25 years (OECD 2010). This example is instructive, as we shall discuss in chapter 4.

Growth rates do not necessarily translate into progress on other measures of development. For example, despite the expected rapid reductions in poverty outlined above, India is falling behind its south Asian neighbours on a range of key development indicators. Compared to Bangladesh, Bhutan, Nepal, Pakistan and Sri Lanka, India has dropped from third in 1990 to sixth in 2009 on life expectancy, from second to fifth on infant mortality, and from second to fourth on female literacy (Dreze and Sen 2011).

In addition to these concerns about inequality and the limits of broad-based increases in living standards, restrictions on migration reduce individuals' ability, by placing geographical constraints on them, to realise their potential. For example, in developed countries, restrictions on inward migration – often necessary to meet public concerns – hold back talented and hardworking individuals in the rest of the world. This becomes a 'lose-lose' situation, since it reduces the circulation of migrants in and out of their countries of origin and prevents skills shortages being met in the host country (Chappell and Mulley 2010). In the developing world, migrant workers are often exploited directly by their employers or lose access to key safety nets. For example, in China, access to social insurance is on the basis of where an individual is formally registered and not where they currently live. This pressure is as much related to migration within countries as it is between countries. Box 3.2 (over) looks at the differing approaches to urbanisation and internal migration in China and India.

While the pace of overall growth in the developing world is dramatic, there is still a long way to go before any developing country is able to match western living standards. Inequality, meanwhile, is a drag on the overall development level in most fast-growing countries. Ensuring that the third wave of globalisation delivers broad-based increases in living standards will mean a more equitable distribution of the gains from growth. Without some of the social policy reforms set out in chapter 4 the task will be far harder to complete.

A zero-sum world?

What does the rise of countries in Asia and the other emerging economies imply for the developed world? There is a tendency in the developed economies to see this process in zero-sum terms: as the east rises, the west must decline. While proportional shares of the global economy will inevitably be reshaped by this changing dynamic, what it actually implies for prosperity, job creation and inequality in the developed world is a more complex picture.

Globalisation has brought huge benefits in terms of cheap consumer goods which have kept inflation low by reducing the cost of electronics, clothing and other consumer products. Rising productivity from globalisation has meant that people and resources can be redeployed effectively to new jobs and new production.

But there has been a downside too. As chapter 2 outlined, there is no question that the pressures of international competition from markets with lower costs of labour and production has imposed painful change on many industries in the developed world – effectively a 'supply shock'. Some of this change would have happened anyway with technological development and changing patterns of consumption, but globalisation has accelerated and intensified this process and led to job losses and downward pressure on wages.

Box 3.2: View from China and India – urbanisation and internal migration

Our delegations' trips to China and India were concentrated in the megacities of Beijing, Chongqing, Delhi and Mumbai. Each country has a distinct approach to urbanisation and its links to economic growth and social pressures, which we explored during our visits.

China

In China, where the urban population is currently 49.7 per cent of the national total, the Ministry of Housing and Urban-Rural Development estimates that 300 million Chinese now living in rural areas will move into cities by 2025. By this time, China is expected to have 219 cities with a population of 1 million or more. In 2011, plans were mooted to create the world's largest megacity in the Pearl River delta from nine existing cities including Shenzhen and Guangzhou. The new city would be twice the size of Wales, with a population of 42 million.

While in China, IPPR visited Chongqing. In 1997, Chongqing became China's fourth direct-controlled municipality with its own mayor (after Beijing, Shanghai and Tianjin). The wider region has a population of 32 million and the city is thought to be the fastest-growing in the world, with 500,000 new arrivals every year by some estimates. Economic growth in 2010 was a staggering 17 per cent.

Bo Xilai, the charismatic party secretary of the region, is overseeing a 'five Chongqings' programme to improve the wellbeing of those living in his province. The city government has spent close to ¥20 billion (£2 billion) on improving its roads, railways and light rail to reduce commuting times (Convenient Chongqing), planting hundreds of trees (Forest Chongqing), developing sports and medical facilities (Healthy Chongqing), providing new public rental housing (Liveable Chongqing), and driving an anti-corruption and crime crackdown (Safe Chongqing).

At Mr Bo's invitation, we visited a new housing development. Those earning less than ¥3,000 per month (around £310) can apply for gongzu fang (public rental housing) at around 80 per cent of the commercial rent. After three years, they will be allowed to buy at a price which covers the construction and financing costs. But although progress is being made with housing, many of China's 220 million migrant workers face a form of social apartheid due to the hukou system, which tends to tie social benefits to an individual's original place of residency.

India

In India, just 30 per cent of the population live in urban areas, with an urbanisation rate that is no faster than China's. In order to avoid creating any 'megacities', India is building another 100 cities to add to the 600 already in existence. Many of these – like the new business centre of Gurgaon – will fall on the Delhi–Mumbai industrial corridor. A study by the Overseas Development Institute found that, other things being equal, smaller towns tended to grow faster than larger towns in India (Cali 2008).

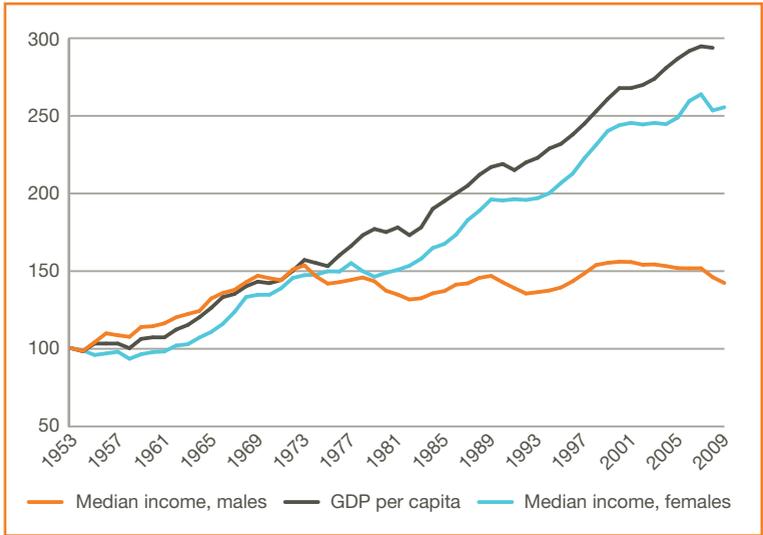
Under the leadership of the chief minister of Delhi, Sheila Dikshit, much progress has been made in modernising the city. Delhi airport is recognised as one of the best mid-sized airports in the world, half a dozen new hospitals have been built, and the Delhi Metro, which first opened in 2002, now incorporates 142 stations and 190 kilometres of track. Nonetheless, as with many urbanisation projects, the new developments may not help the most vulnerable. Despite the slowest population growth in 90 years, the National Capital Territory of Delhi remains overcrowded. Indeed, some estimates suggest that half the population live in slums and at current house-building rates Mrs Dikshit's social housing obligation, which requires 38 per cent of new residential development to be built for poor households, barely scratches the surface.

More widely, India's political system is ill-equipped for the coming urban transition. Aside from Delhi, which is the smallest state in India, with an urban concentration of 93 per cent, key decision-makers do not sit at the city level. Devolving proper powers to the mayors of cities like Mumbai would be an important reform.

Urbanisation is a necessary, but not sufficient, condition of growth and broad-based living standards. But with it comes huge housing, transport and development challenges. The different approaches taken by the world's two most populous countries show that there is no off-the-shelf solution to these tensions.

For example, figure 3.4 (over) shows how male median earnings growth has stagnated in the US since 1970. In the UK, male wage growth has been slower than GDP per capita growth since the early 1980s and has stagnated since roughly 2004.

Figure 3.4
Wage stagnation
in the US (index
100 = 1953)



Source: Plunkett 2011

But as developing countries continue to emerge and the global middle class expands, globalisation will move into a phase akin to a ‘demand shock’ as new markets for their goods and services emerge. Of course, developed countries have no automatic right to benefit from this increased demand. Indeed, as table 3.2 shows, over the last 10 years countries like the UK and France have seen dramatic falls in their export performance, while the US and Germany have held firm.¹¹

Looking even more closely at the UK, it is clear that part of its fall in the table is due to a poor performance exporting to the BRIC economies. Britain contributes just 0.8 per cent of the goods imported by China, while the US contributes 6.7 per cent and Germany 3.8 per cent.

Meanwhile, Rubens Barbosa, former Brazilian ambassador to the UK, has suggested that economic and trade relations between Brazil and the UK – which used to be extensive – have weakened considerably in recent years. Brazil is currently the seventh-largest economy in the world, but it only ranks 23rd on the UK’s list of export markets. As a result, there is a growing sense that the UK government and British businesses lack either the capacity or the interest in building a stronger partnership with their Brazilian counterparts (Barbosa 2011).

¹¹ It is worth noting that trade statistics are fraught with methodological issues due to the high volumes of intermediate goods. See for example Maurer 2011.

Rank	2000	2010
1	US (12.3%)	China (10.4%)
2	Germany (8.7%)	US (8.4%)
3	Japan (7.5%)	Germany (8.3%)
4	France (4.7%)	Japan (5.1%)
5	UK (4.5%)	Netherlands (3.8%)
6	Canada (4.3%)	France (3.4%)
7	China (3.9%)	Republic of Korea (3.1%)
8	Italy (3.7%)	Italy (2.9%)
9	Netherlands (3.3%)	Belgium (2.7%)
10	Hong Kong (3.2%)	UK (2.7%)

Table 3.2
Leading exporters,
by percentage
of world
merchandise trade

Source: WTO 2001, 2011a

Indeed, as figure 3.5 shows, if the UK increased its share of BRIC countries' imports from their current levels to 3.4 per cent (the UK's current share of world trade), this would generate £32.6 billion of extra UK exports: £24.8 billion to China, £3.6 billion to India, £2.5 billion to Brazil, and £1.8 billion to Russia. That said, some exports from southern countries are based on plants that are owned by western firms or joint ventures, meaning that the trade figures do not always give the clearest indication of Britain's actual performance in the global economy.

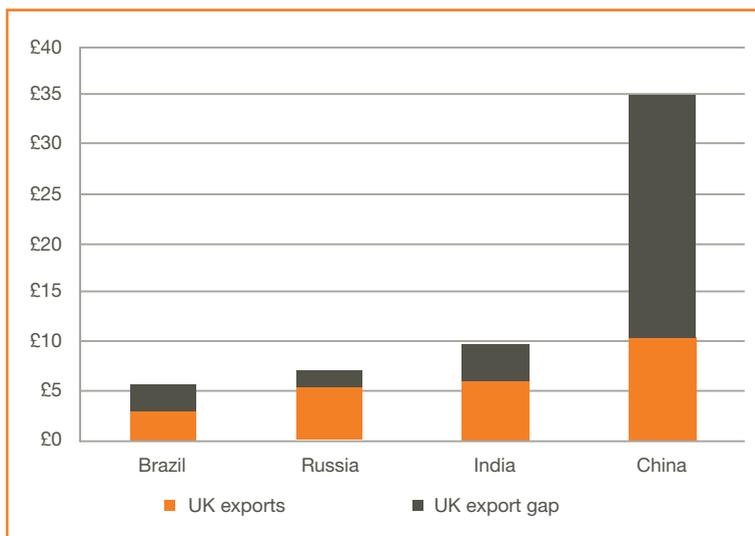


Figure 3.5
UK export gap to
the BRICs (£bn)

Source: WTO 2011b, ONS 2011

Looking specifically at the UK, there are a number of sectors where global demand is on the rise and Britain has a comparative advantage. Aerospace, pharmaceuticals, and financial services are often mentioned in this regard. To this list we would add other business services, such as accountancy and legal services, education services (particularly higher education and vocational skills), health services, retail, architecture and design, creative industries and tourism. In the manufacturing sector, we would include hi-tech and electronic, marine industries and some forms of green energy, such as car batteries.

Figure 3.6 maps a selection of sectors on a matrix showing the extent of Britain's comparative advantage against expected global demand, each measured on a scale from 1 (low) to 5 (high). Drawing on evidence from a number of academic and industry sources, it highlights some of the opportunities currently available to the UK.

It is important that this matrix is not viewed as something static. Sustainable future growth will depend in part on the UK economy becoming more adaptive and developing new sources of comparative advantage. It does, however, clearly show that services sector exports are an important part of Britain's future prosperity, and that any efforts to strengthen some of the UK's key manufacturing sectors should not be at the expense of maintaining a highly competitive services sector. This is borne out by the statistics, which show that service sector exports are growing twice as quickly as goods exports. Indeed, the UK's surplus in service trade now makes up half the gap in the goods deficit.

There is clearly a risk that as emerging economies develop they move up the supply chain and begin to encroach on these new comparative advantages, in the same way that they eroded the west's production of low-skilled manufacturing products in the past. This points to the clear need for developed countries to continue innovating, investing, and increasing the level and effective deployment of workers' skills. We will return to these issues in more detail in chapter 5.

A sustainable planet?

Given the growing recognition of the cost that human behaviour is imposing on our natural environment, it is impossible not to ask if the current model of globalisation is environmentally sustainable. Rapid growth in the developing world has had a dramatic impact on both carbon emissions and demand for commodities over the last two decades. While the US is still the largest emitter by some margin, Russia is the second-largest of the countries covered in figure 3.7 (over). Korea is then in third place, having overtaken Japan, the UK and Germany in recent years. Given that the latest data is for 2008, China may already have overtaken France. To the extent that globalisation has been a driver of this growth it is implicated in serious environmental damage.

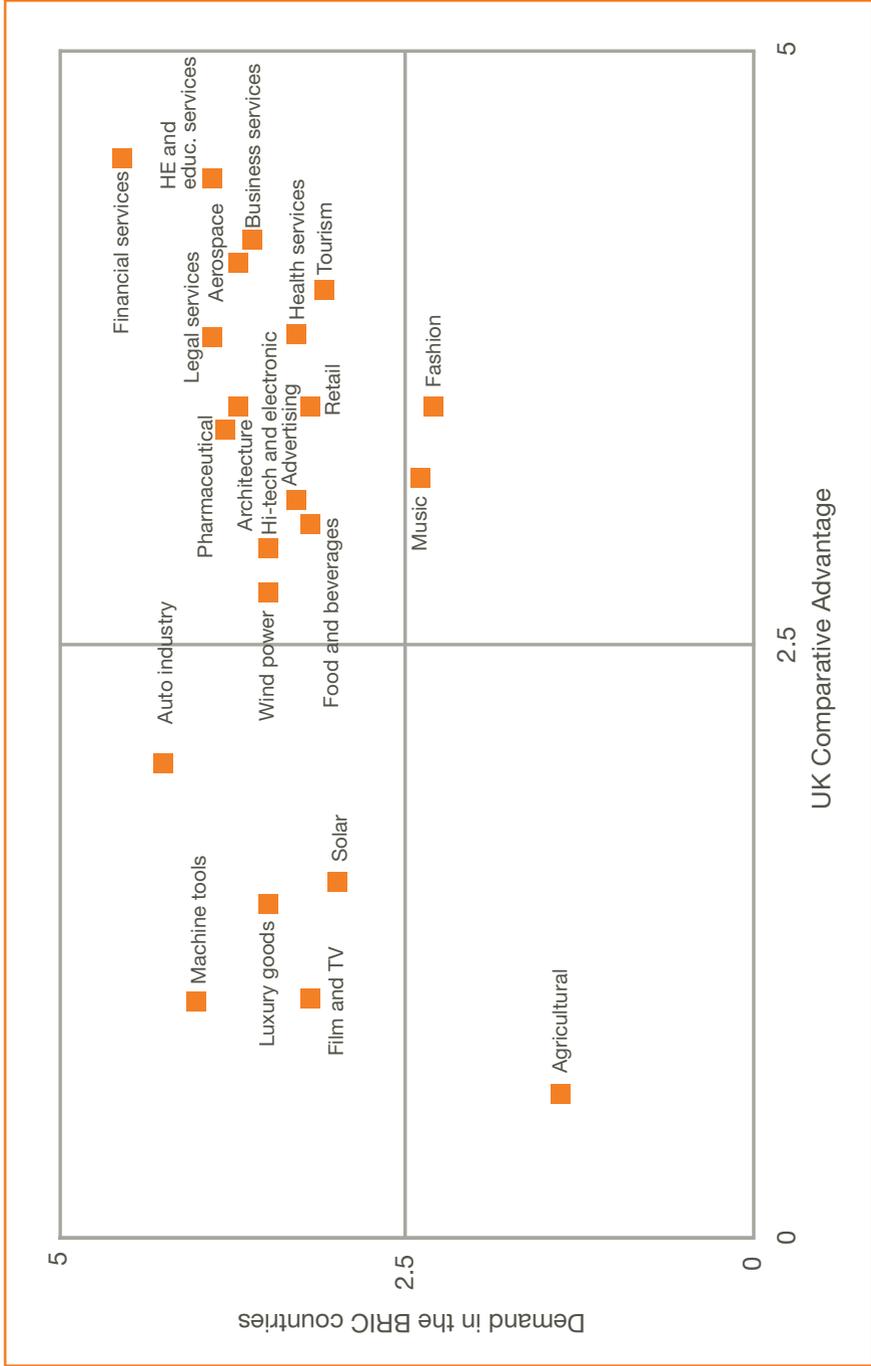
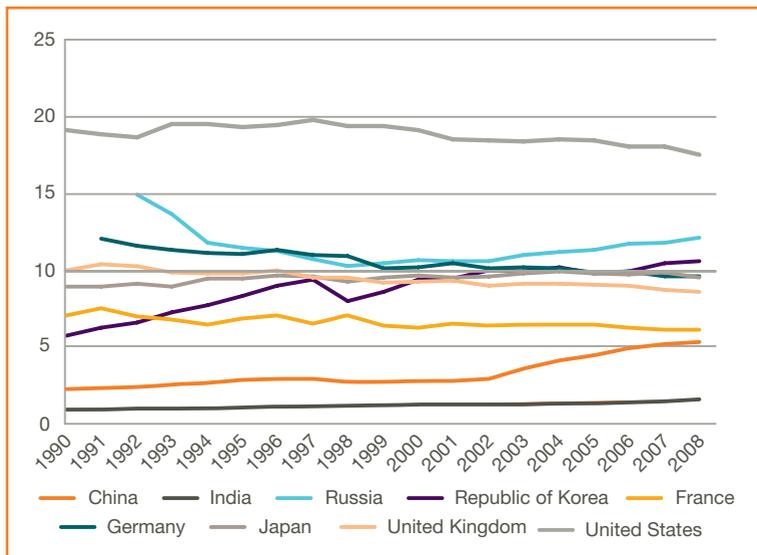


Figure 3.6
Britain's comparative advantages in a global context. Source: IPPR analysis

The transport that is at the centre of global trade is clearly implicated in global carbon emissions. For example, international shipping contributed about 2.7 per cent of global emissions in 2007 (International Maritime Organization 2009) although this is much less than the oil-powered road transport and the coal-and-gas fired electricity that are the mainstays of ordinary life in the west.

But even to frame the question this way is to recognise that it is not about globalisation, but about growth itself on the hydrocarbon-based model of the 20th century. If the expectations of billions of people in the developing world to achieve standards of living are even slightly comparable to those of the developed world, some level of growth is necessary. How these expectations could be denied is hard to see. So the answer to climate change is not to reverse globalisation, but to decarbonise growth.

Figure 3.7
CO2 emissions
per capita
(metric tons)



Source: United Nations Statistics Division

The more important question is to ask to what extent globalisation can help or hinder the problem of addressing high-carbon growth. The rapid dispersal of new information and communication technologies are acting to reduce carbon emissions. For example, 47 per cent of companies in the UK have reduced the number of business flights they have taken in the past two years, with videoconferencing often used as an alternative (WWF 2011). This suggests that increases in trade in services need not increase carbon emissions in a linear fashion. Meanwhile, the global transfer of new technologies and funds to help their mitigation and adaptation can help countries to reduce their climate emissions. As low-carbon technologies proliferate, a global market will be by far the most cost-effective and efficient way of diffusing them throughout the global economy.

Another aspect of rising living standards in the developing world is the new demand for commodities. Between the mid-1970s and the turn of the millennium, global commodity prices were largely flat. While there were periods of significant short-term gain and decline, such as when oil prices collapsed in 1986, prices were broadly stable over the quarter century. This meant that real commodity prices, after adjusting for general inflation, fell sharply, with a corresponding reduction in the purchasing power of commodity-producing nations.

Since 2003, the story has been very different. As figure 3.8 shows, commodity prices have soared in both nominal and real terms. They only fell back temporarily during the global recession and have since moved to new record highs. These gains have been widespread, suggesting that, while supply constraints help to explain the degree of price movement in individual commodities, demand was the main cause of this surge.

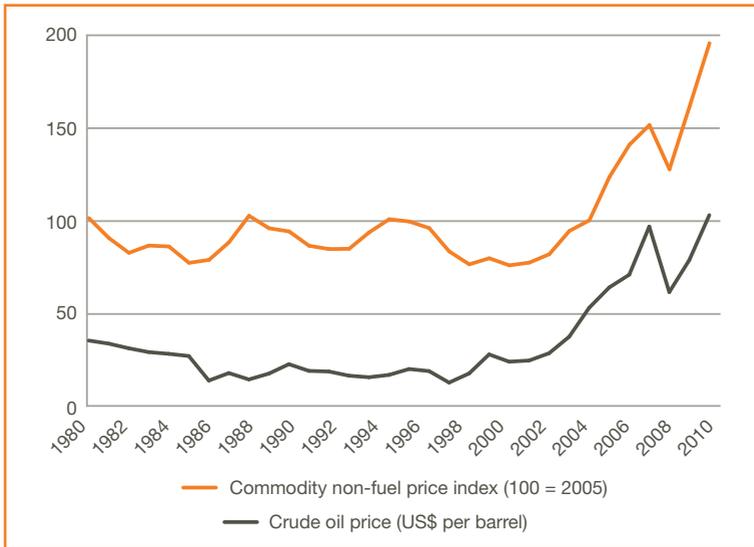


Figure 3.8
The rising costs of commodities

Source: IMF 2011

The third wave of globalisation is now characterised by very rapid growth in a number of less developed countries with very large populations. Reflecting the stage of development they have reached, this rapid growth is translated primarily into demand for goods, with the result that these countries are placing extraordinary demands on global commodity markets. For example, demand for oil and food are projected to rise by 40 and 50 per cent respectively by 2030 (Evans 2011). This is likely to have a profound impact on real commodity prices in the future, as well as affecting the politics and stability of poor countries.

In western economies, rising demand for commodities is likely to increase inflation and place downward pressure on living standards.

Initially, the rapid integration of China into the global economy – along with developments in other emerging economies – led to falling prices for manufactured goods. This held down aggregate consumer price inflation in the west and made it easier for central banks to achieve their inflation objectives. However, in the second half of the 2000s, this effect was swamped by the effect of higher commodity prices. Food and fuel prices, in particular, drove inflation rates higher and are largely responsible for the fact that inflation in the UK is still, despite the weakness of the economy, at 5 per cent, some 3 percentage points above its target rate.

This also has distributional effects. Those on the lowest incomes spend proportionately more of their income on essentials like food and fuel and less on fancy electronic products. As a result, they are likely to be losers from this aspect of globalisation, whereas someone on a much higher income probably still makes a net gain, despite higher commodity prices. But globalisation can also provide a solution to resource constraints, as chapter 4 discusses in more detail.

Conclusion

Even allowing for periodic breaks in the growth of rapidly industrialising countries, the next 40-year period is likely to be characterised by a global power shift from west to east. What is less clear is whether this wave will be characterised by a ‘win-win’ for people in developed and developing countries alike.

This chapter has examined some of the tensions inherent in the new global economy. While poverty is being eradicated in every region aside from Sub-Saharan Africa and Asia now represents a bigger market for consumer goods than North America, living standards have a long way to go before majorities in developing countries can count themselves part of the global middle class. While inequalities between countries have fallen, inequality has increased within countries, except where public policy has been used explicitly to create a more equitable distribution of wealth or to strengthen the ability of workers to extract benefits from globalisation in the same way as the owners of capital.

The emergence of new economies does not mean that developed countries will become submerged, but each of those countries will have to be smarter and more specialised, more innovative, and more energetic if they want to meet the rising demand in the world. By contributing to rising global growth, globalisation is contributing to climate change, increasing demand for commodities and exacerbating resource constraints, but the spread of ideas and technologies can also help to solve these problems.

The remainder of this report now turns to the policy solutions necessary to cement a global ‘win-win’ in the third wave of globalisation. Chapter 4 examines six threats that public policy must overcome if it is to ensure that the third wave is characterised by sustainable and broad-based rises in living standards worldwide.

4. RETHINKING GLOBAL ECONOMIC GOVERNANCE

The previous chapter described how the third wave of globalisation is shaping up and re-examined critical questions about the origin, equity and sustainability of future growth. Ensuring that sustainable and broad-based increases in living standards across the world come to define the third wave of globalisation will not be easy. But without that shared gain, the politics of globalisation will become more unstable.

The emergence of strongly growing economies outside Europe and North America, and the chaos caused by the global financial crisis, inevitably present a significant challenge in the west to the authority of some of the basic prescriptions for global economic growth that have dominated debate for the last three decades. One of the arguments of this report is that the world is moving into a period where there will be a more plural debate about the recipes for growth and how these will be governed in a globalised economy. Many of those recipes will inevitably be based on the experience of the current emerging economies, not simply on the existing prescriptions of the developed world. In this new world, the effectiveness of a policy rather than where it was developed should become the grounding principle. Indeed, many of the ideas in this chapter and in chapter 5 (which presents the UK as a case study for a medium-sized developed economy trying to make a living in the globalised world) have been developed in some of the growth and export strategies of developing countries.

What will matter, above all, is anchoring that debate in a set of principles about the best means to drive growth and prosperity to ensure that greater pluralism does not simply become a damaging cycle of self-interested or short-sighted disengagement, protectionism or nationalism. The aim must be new rules, not 'no rules'.

There are implicit and explicit choices we now face that present two distinct paths. First, states could take a 'low road' that will erode much of the progress made in forging multilateral rules and processes over the last 50 years. This would only prevent the global population from achieving its full potential. At its worst, it could see the WTO, IMF, World Bank and United Nation's climate change negotiations stripped of credibility and authority, or an emergence of the kind of protectionist spiral seen in the 1930s. Perhaps more likely, we could see a new stasis built around insular positions of national self-interest.

The alternative is for the institutions that provide the glue of rules-based multilateralism to undergo a process of adaptation. This would mean broadening their governance to take in and reflect new states and their growth paths, widening the scope of their intellectual and empirical frameworks, and ensuring, at all costs, that they remain relevant to the emerging powers which are redefining the global economy. This high road requires collaboration and partnership between nation states and an urgency of decision-making which manages short-term needs in the long-term global interest.

Doing this will require policymakers to set out a path ahead which addresses six key threats:

- the instability of continued global imbalances
- narrow growth strategies that suppress domestic consumption and investment
- the excessive volatility in some forms of short-term capital mobility
- the race to the bottom on international taxation
- the downward spiral of new protectionism
- the failure of nation states to agree and enforce multilateral agreements.

Mapping out this path – and then following it – requires an ambitious programme. Some of this is under way, and much of it has been subject to debate since at least 2008, but there is much more to be done to convert debate into action. Politicians and policymakers are currently limiting themselves too narrowly to what national governments think they are able to defend within their sovereign systems of government. To avoid global governance remaining a perennial disappointment and object of cynicism, leaders need to make clear decisions about the practical measures which the global architecture can and should deal with at the present time. As noted above, governments must also agree the reforms needed to make systems of global governance much more effective in delivery.

This chapter considers each of the six threats set out above in turn, sets out the dangers of inaction, and makes recommendations for specific steps that nations, collectively, should take to ensure a high road to broad-based rises in living standards for all.

Avoiding the instability of continued global imbalances

One of the precipitate causes of the global financial crisis was global imbalances that built up over a number of years as a result, above all, of the terms of the economic relationship between the US and China. After remaining roughly in equilibrium for most of the 20th century, global imbalances began to increase during the 1990s and into the 2000s. There are two sides to this story.

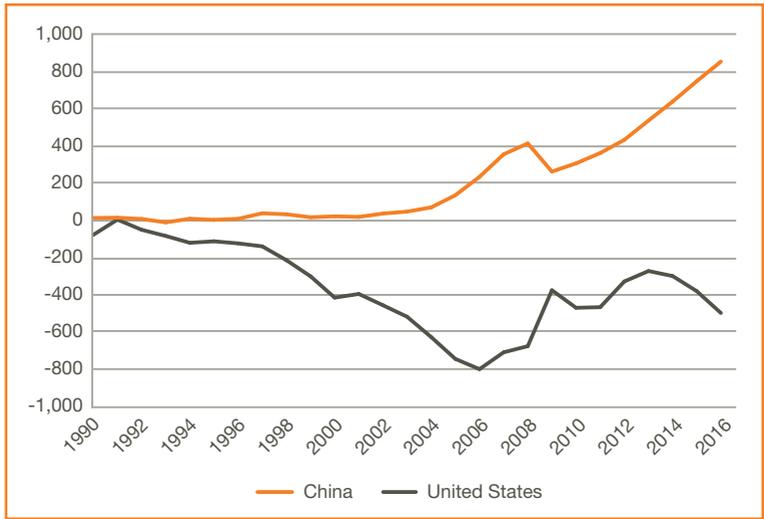
First, as chapter 2 outlined, current account surpluses began to build up in many developing countries. This was partly a result of export-led growth strategies, partly due to the foreign reserves that were accumulated to alleviate the adverse impact of a rapid slowdown of private capital inflows, known as a 'sudden stop',¹² and partly due to low consumption and high savings levels, as well as the continuing commodities boom. China's reserves have been of particular note, building to assets now worth US\$3.2 trillion, or around 50 per cent of Chinese GDP (People's Bank of China 2011). It is believed that 70 per cent of these reserves have been invested in dollar-denominated assets, including US Treasury bonds. This increased demand for US debt has increased the price and therefore put downward pressure on the yields that each bond delivers. In short, the corollary of high levels of official sector saving in fast-growing emerging markets like China was a surplus of global liquidity which fuelled historically low borrowing costs in countries where capital markets were deep and open like the US and the UK.

Second, many developed countries built up large current account deficits. In the US, the savings ratio fell from 12.2 per cent in 1981 to 1.0 per cent in 2005 (Bureau of Economic Analysis 2011). Because of stagnating growth in median wages in the US, many citizens chose to use the cheap and abundant credit to pay for mortgages and the purchase of (primarily foreign) consumer goods, while savings dried up. Rises in US housing prices exacerbated this trend by encouraging households to take out loans against the rising equity in order to finance higher consumption. Meanwhile, financial entities like the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) were encouraged by government in the 1990s to make loans to people who would not normally gain access to credit, in order to make the US's 'property-owning democracy' more inclusive of poorer people. Perfectly rational house-buying decisions, which individuals may not have taken if they had been aware of all the risks, created an overall imbalance when added together. The combination and build-up of these factors directly caused the subprime mortgage crisis of 2007, which led to the collapse of Lehman Brothers and other banking failures which sparked the ensuing global recession. Although less dramatically so, the savings ratio fell in the UK too, from 10.3 per cent in 1995 to 2.7 per cent in 2007. We in Britain also became an excessively credit-driven, over-leveraged society.

Unfortunately, the world has not yet learned its lesson. Figure 4.1 (over) shows how the current account balances of China and the US are expected once again to widen, after they fell in the immediate aftermath of the global financial crisis.

¹² A sudden stop in capital flows is defined as a sudden slowdown in private capital inflows and a corresponding sharp reversal from large current account deficits into smaller deficits or small surpluses (see Calvo 1998 for more details).

Figure 4.1
Current account
imbalances of
China and US
(\$bn)

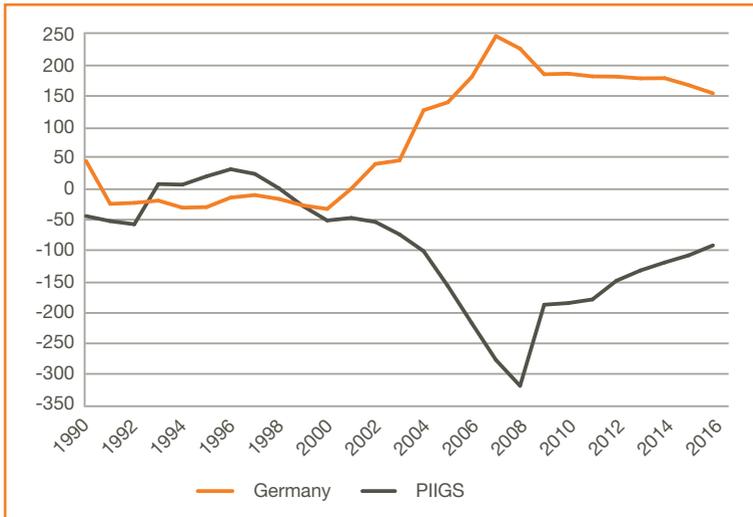


Source: IMF

Meanwhile in Europe, a misalignment in the values of currencies entering the eurozone has created a permanent current account surplus in Germany roughly equivalent to the combined deficits of Portugal, Ireland, Italy, Greece and Spain – the so-called PIIGS nations – as figure 4.2 shows. Assuming that the eurozone does not break up, an adjustment will be necessary, with Germany raising median wages relative to periphery countries in order to boost its domestic consumption and reduce its surplus in net exports. Meanwhile, periphery countries need to transform their competitiveness and export potential, and reduce domestic consumption. In some cases, they will also need to suffer a deflationary adjustment as prices fall.

This logic is true more generally, both for Europe and the world. Deficit countries need to rebalance their economies away from debt-fuelled domestic consumption and towards savings and exports, while surplus countries need to do the reverse by reducing their dependence on exports and building domestic consumption, thus helping to lift demand and growth. It is down to individual countries to adopt the policies that work best for them to achieve this rebalancing act. Nonetheless, the international community has a significant responsibility to improve the coordination of these national actions. The existing G20 process to address global imbalances is a mixture of specific diagnosis and vague prescription, with little sense given that the problem will be resolved any time soon. While acknowledging that ‘global imbalances persist’, the communiqué for the recent G20 Summit (2011) in Cannes said only that: ‘[We] support the Managing Director’s proposal to publish multilateral assessments of external balances, and we recommend timely publication of surveillance reports.’

Figure 4.2
Current account
imbalances within
the eurozone
(\$bn)



Source: IMF

As an observatory and arena for debate, the G20 has helped to construct an understanding of and explanation for the problem. As a vehicle for collective decision-making and effective action, it has, to date, been found wanting. The G20's London Summit in 2009 was a high point but, once the immediate crisis passed, some of the difficult decisions were not followed through. The result is that that the problems have returned with speed and potentially greater hazard. To avoid persistent global imbalances causing a further crisis, a greater level of ambition is now needed by G20 countries. Two ideas, which can be traced back to the original Bretton Woods negotiations, should be considered.

First, the IMF should seriously consider options for the eventual creation of a new global reserve currency. A version of the idea has been revived in recent years and centres around the IMF's current system of special drawing rights (SDRs). The proposal would allow for the issuing of SDRs to countries that would otherwise be expanding their foreign currency reserves. This would act as a disincentive against the building up of large trade surpluses and help ensure that the US is not subject to a credit glut in future. This proposal has received the support of China and the United Nations' commission of experts on reforms of the international monetary and financial system (2009).

Critical to making this work will be outlining the destination of the funds deposited in the IMF. Much of this could be deployed to support development goals. For example, Ethiopian prime minister Meles Zenawi has called for the money to be invested in infrastructure in Africa, as a means of reducing global imbalances and increasing global demand (Maasho 2010).

Second, the G20 should consider ‘symmetric’ current account targets that place equal weight on bringing surplus and deficit countries back towards balance (King 2011). In 1941, some Bretton Woods negotiators suggested an International Clearing Union, with penalties to be placed on countries holding large surpluses or deficits. In 2010, the idea of symmetric current account targets of 4 per cent was floated by the US Treasury secretary. In a letter to G20 finance ministers and central bankers, Timothy Geithner (2010) wrote:

‘G20 countries should commit to undertake policies consistent with reducing external imbalances below a specified share of GDP over the next few years, recognizing that some exceptions may be required for countries that are structurally large exporters of raw materials.’

Taking an even stricter view of excessive current account imbalances, with an acceptable margin of just 3 per cent, Canada, Italy, Spain, Turkey and the US would all breach the deficit target in 2011 – on the other side of the ledger, China, Germany, Russia and Saudi Arabia would all breach the maximum surplus target.¹³ On a practical level, there is evidence that China would join the US in supporting the initiative, although Germany is likely to be opposed (Wolf 2010).¹⁴

Recommendation 1

To accompany its multilateral assessments of external balances, the IMF should develop a global reserve currency through the reform and expansion of its special drawing rights.

The IMF should assess deficit and surplus countries against a symmetric current account target of plus or minus 3 per cent of GDP. Countries found to be in breach of the symmetric target should be asked to set out a road map explaining how they plan to reach the target over the medium term.

Avoiding narrow growth strategies that suppress domestic consumption and investment

As outlined in the section above, persistent and unsustainable current account imbalances pose a grave risk to the stability of the global economy. One explanation is the high saving rates in some developing countries, particularly in Asia. In 2010, Singapore, Korea, Taiwan and Hong Kong all had gross national savings rates at or above 30 per cent of GDP, as did Vietnam, India and Malaysia. China topped the list with 53 per cent. By contrast, the savings ratio was 25 per cent in Russia, 19 per cent in Brazil and France, and 13 per cent in the US. As would

13 Though under Geithner’s proposal, Russia and Saudi Arabia might be exempt as ‘large exporters of raw materials’.

14 Although not formally a member of the G20, Spain has attended all recent G20 meetings and is the world’s 12th-largest economy.

be expected from the national accounting identities, figure 4.3 shows the close correlation between countries with high levels of savings and a current account surplus. Each point on the graph represents a country.

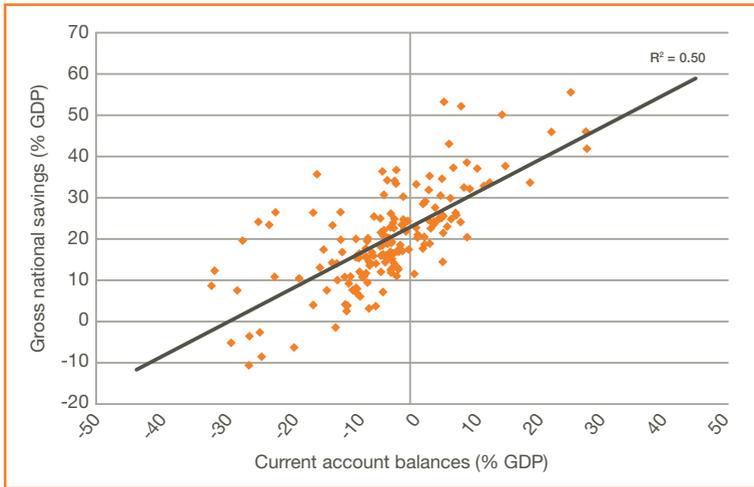


Figure 4.3
National current
account balances
against gross
national savings

Source: IMF

The corollary of high savings is low consumption. Domestic consumption in China, for example, makes up only 35 per cent of GDP. A significant cause of this is the high propensity to save among Chinese workers, due to the inadequacies of social protection systems and a lack of access to borrowing for households and small businesses. Many economic migrants living in urban areas are not enrolled in pension programmes or social security schemes (Samans and Jacoby 2007). The IMF has shown that a sustained increase in public expenditures of 1 per cent of GDP – distributed equally across education, health, and pensions – would result in a permanent increase in the household consumption ratio of 1.25 percentage points of GDP (Baldacci et al 2010). This in turn would help to reduce global imbalances and raise growth.

An interesting precedent for this can be found in the immediate aftermath of the second world war. The US European Recovery Plan, or the ‘Marshall plan’, distributed close to \$13 billion (equivalent to \$100 billion in today’s prices) to western Europe. Across Europe, the plan contributed to unprecedented government ownership of utilities and heavy industry, redistribution of income, and the creation of social safety nets and protection programmes, in what has been described as ‘history’s most successful structural adjustment programme’ (De Long and Eichengreen 1991).

Growth rates in western Europe in the two decades that followed the Marshall plan were twice as fast as for any comparable period before or since. This was not, however, inevitable, and such growth cannot be

attributed simply to either the technological spillovers of manufacturing advances or the low base from which European economies were rising after the end of the war. Argentina, which had been as rich in the years before and immediately after the war as industrial Western Europe, grew far more slowly than Europe after peace returned. Rapid growth and increases in productivity to American standards after the war were to a large degree specific to western Europe, and therefore to the countries that received Marshall plan aid (ibid). The plan created a virtuous circle whereby industrial policies helped to establish new jobs, social safety nets such as health services and unemployment benefits gave people the confidence to spend, and new domestic markets for consumer goods were created in what came to be known as the 'age of affluence'.

As well as contributing to rapid growth, the social protection programmes helped countries to reduce inequality. Among Marshall plan recipients for which there is data, the share of income held by the top 1 per cent of earners fell or stayed flat between 1945 and 1965 in Germany, Ireland, the Netherlands, Norway, Sweden, Switzerland and the UK. The converse was true only in France (Atkinson et al 2011). This ensured that resources were channelled towards those who needed them most, with the highest propensity to spend. While there is a legitimate debate about the best and most sustainable design of social welfare programmes, there is little doubt that they perform a vital function in shaping people's perception of personal economic and health risks that enable them to spend and invest rather than conserve economic resources against future uncertainty.

In a modern context, the Chinese government recognises the challenge and the necessity. China's 12th Five Year Plan calls for a more sustainable social security system covering both urban and rural residents, full coverage of the old-age insurance system for rural workers and wider provision for urban workers and residents, and improved primary health care. Nonetheless, experts have warned that progress may be slow. IPPR was told at a roundtable discussion at Tsinghua University in June 2011 that the government had failed to reform the social sector over the last 20 years and that it would now be expensive to make the necessary reforms to education, pensions, health and social security system at the same time (Straw and Glennie 2011).

Social safety nets have also been used as an effective means of alleviating poverty and, in some cases, reducing inequality. The World Bank is drafting a new strategy that is expected to increase prioritisation of social protection and has invested recently in programmes in Ethiopia and Tanzania. Nonetheless, the bank operates a demand-led system, which means it cannot fund social protection programmes unless domestic governments elect to take up the offer. This tends to limit the benefits to middle income countries, which have the appropriate systems in place to take advantage of the schemes, while low income

countries lose out. For example, the bank's social safety nets portfolio increased by a factor of 14 following the global financial crisis, but 75 per cent of the portfolio was in Latin America with only 5 per cent in Africa (Independent Evaluation Group 2011). Conditional cash transfer schemes in Latin America have been particularly effective in reducing inequality and cutting poverty levels, as box 4.1 sets out.

Box 4.1: View from Brazil – conditional cash transfer schemes in Latin America

IPPR visited Brazil two months after Dilma Rousseff had taken over as president. Her message was one of continuity with her popular predecessor, Luiz Inácio Lula da Silva, including an early pledge to increase the *bolsa família* (family allowance) policy.

The conditional cash transfer (CCT) scheme, which was created by Lula in 2003 by merging a series of existing social welfare schemes, provides financial aid to poor Brazilian families once their children attend school and are vaccinated. It currently reaches over 12 million households, one-quarter of the population, and is worth around 22 reais (\$12) per month per child. The scheme is administered directly to female heads of households through a debit card scheme, which avoids the risk of corruption.

According to the academic institute Fundação Getúlio Vargas, the number of Brazilians with incomes below 800 reais (\$440) a month has fallen by more than 8 per cent every year since 2003. Income inequality, measured by the Gini index, fell from 0.58 to 0.54 over the same period and is now at a 30-year low. The programme has also made a contribution to nutrition levels, with 82 per cent of respondents to a survey reporting that they were eating better. Proponents hope that as well as reducing poverty, it will produce long-term dividends as the number of children receiving a decent education increases and there is a decline in the number suffering with curable diseases.

Testimony on the World Bank website explains how the programme is making a real difference to people's lives. Dinalva Pereira de Moura, a mother who receives the allowance, says: 'My children know that when we receive the money, they will have more to eat, and that makes them happier. And they don't skip school, because they know that the money depends on their going.' The programme is not, however, without its critics and concerns have been levelled at the lower success rates in urban areas where child labour is still rife. The National Conference of Bishops of Brazil, meanwhile, opposes the scheme and describes it as 'addictive'.

Mexico's *Oportunidades* (Opportunities) scheme, first introduced in 1997, was the inspiration for the Brazilian version. Like its more famous cousin, it provides cash in return for school attendance and the take-up of preventative healthcare. The scheme becomes more generous as children move through the school system and is generally higher for girls. It is worth between 105 pesos (\$10.50) and 660 pesos (\$66) per child per month. Following an expansion from rural to urban areas, the programme now covers over a quarter of the national population. The United Nations Development Programme found that *Oportunidades* was responsible for 21 per cent of the recent reductions in income inequality (Soares et al 2006). It is also associated with important child health, growth, and development outcomes.

Following the successful first wave of CCT schemes, many other countries have adopted their own similar schemes, including Turkey, Indonesia and Pakistan. Over 30 countries now have some form of CCT scheme and in 2009 the World Bank lent \$2.4 billion to help in this process. Today, the world's most generous scheme is in Argentina, where the government introduced its CCT programme in 2009. The *asignación universal por hijo* (universal allocation per child) was part of a near-tripling of social spending in real terms. The allowance now reaches 85 per cent of Argentine children and is worth up to ARG\$180 (US\$46) per child per month. Spending on the programme itself had reached 0.6 per cent of GDP by 2011, compared to 0.5 per cent of GDP in Brazil and Mexico.

A World Bank survey found that the policy directly led to 700,000 children in Argentina being pulled out of poverty (a 21.9 per cent reduction) while the number of children living in extreme poverty fell by 42.3 per cent. Inequality, measured as the ratio of income between the first and tenth decile, has fallen by 20 per cent. In a survey of 676 schools, the Ministry of Education found that over half reported an increase in student registration, with an average increase in attendance of 15 per cent.

Even New York City adopted a CCT trial from 2007 to 2010, showing that the policy can be equally applicable in developed countries. Again, the results were positive, including reductions in the number of families living in poverty and extreme poverty and increased attendance at high school level. It did, however, have a smaller than expected effect on school achievement and healthcare outcomes. Nonetheless, the trial shows that policies devised in developing countries can be applied in richer countries.

Elsewhere in the developing world, India's National Rural Employment Guarantee Scheme (NREGS), introduced in 2005, has acted as an effective minimum wage by providing a legal guarantee for 100 days of employment in every year to adult members of any rural household. In time, the scheme will cover 40 million households. There is a lack of national assessment on the scheme but some regional studies have shown how it is working.

In Himachal Pradesh, Kerala and Rajasthan, for example, NREGS is succeeding in bringing large numbers of women into paid work, many of them for the first time (Sudarshan 2011). That said, the Overseas Development Institute has found that NREGS are cumbersome and corruption-prone (Sjoblom and Farrington 2008). Officials at the World Bank in Delhi told IPPR that, although there were some examples of the cash not being used properly, it was working best where civil society was energised (Straw 2011).

India has also adopted a CCT scheme, the *Janani Suraksha Yojana*, to incentivise women to give birth in health facilities, which has resulted in some encouraging results (Lim et al 2010). Nonetheless, there is more that India could do to emulate the progress made in Latin America and China.

Given the impact that social safety nets and protection programmes can have on reducing global imbalances, poverty and inequality, it seems surprising that in the last financial year, the World Bank allocated just \$5.7 billion from a \$43 billion budget for social protection and risk management (World Bank 2011c). Far greater resources should be put towards these types of programmes, particularly in countries where there are persistent current account surpluses caused by high levels of domestic saving. In light of this interconnection, the G20 should go beyond its recognition of 'nationally determined social protection floors' and set out a globally-defined social protection floor at its meetings in Mexico in 2012.

New innovative financial instruments should also be used to enhance social safety net design and delivery including, such diaspora bonds for example, which aim to harness flows of remittances more productively.

The creation of social safety nets is a good rationale for the continuation of multilateral development programmes in countries like China and India, which now have their own external development programmes. More seed funding and loans to pump prime these systems should be forthcoming from all donors, including bilateral donors, like the UK, where total development assistance levels are being raised.

Recommendation 2

Middle-income countries which have made great strides in reducing poverty should focus on the provision of universal access to basic healthcare and more widespread adoption of conditional cash transfers, akin to Brazil's 'bolsa familia'.

The G20 should set out a globally-defined social protection floor and a pathway towards its realisation. This could include funding from new innovative financial instruments, such as diaspora bonds. Development aid, particularly from expanding bilateral programmes like the UK's, should focus on these areas.

Avoiding excessive volatility in some forms of short-term capital mobility

There are many good arguments for liberalising capital markets so as to enable the movement of capital to different parts of the global economy with greater efficiency. The allocation of productive investment on a global scale implies a certain level of transnational capital movement. The transfer of stable fixed-capital investment from developed to developing economies has played an important part in fostering their capacity and growth. Chapter 2 outlined the various risks, however, that capital mobility can pose to domestic economies where it is excessively focused on the short term, or subject to sudden reversals. Such risks include:

- longer and deeper recessions, and a greater risk of contagion
- appreciating the exchange rate and making exporting sectors less competitive
- incentivising the build-up of reserves, which create global imbalances.

Although the question of banking regulation should be viewed separately from the question of capital mobility, a sound international financial system is clearly integral to a durable and sustainable process of globalisation. Since the global financial crisis, reforms have begun to take place in banking regulation and macro-prudential regulation. A number of important principles, reflecting the causes of the recent crisis, underline these reforms, including:

- the importance of ensuring that financial institutions are appropriately capitalised, liquid and leveraged to cope with market volatility
- 'resolvability' for large financial institutions, to ensure they no longer require bailouts from the taxpayer
- macro-prudential oversight of both the formal and shadow banking systems, focusing as much on the interaction of parts of the global and national financial system as on the conduct of individual institutions
- greater transparency of financial institutions both to regulators and to markets, especially for complex products like derivatives.

What underlies all of these reforms is a developing awareness of the vulnerability of the globalised financial system to poorly understood and managed risk. The proximate cause of the banking crisis lay in institutions having perverse incentives to take unacceptable risks and being over-leveraged and too weak to cope with short-term liquidity shocks or falling asset values. The complex exposure between large market players, and the ability of assets which had little intrinsic value to move around the financial system with ease, also played a significant part in the crisis. Both of these problems require a new, more intrusive approach to supervision. They also require the implementation of the new Basel III capital, liquidity and leverage standards on a timeframe that ensures that banks are not forced to shrink their balance sheets and lending to meet the requirements while economies remain weak. Regulators should also have the power to use macro-prudential regulation that runs against the credit cycle: tightening rules to restrict asset bubbles during booms and loosening them as a stimulus when growth is slow.

Alongside a greater focus on risk management and macro-prudential supervision, we need to be more cautious towards financial innovation. There are benefits from financial product innovation but regulators should be more sceptical of excessive complexity and alert to the damage that can flow from poorly understood risk. The burden of proof should rest on innovators to demonstrate that the potential risks attached to new products are understood. While there is a tendency after the banking crisis for national regulators to focus on their own markets, it is crucial that these reforms are approached from a coordinated global perspective through the G20, the Financial Stability Board and Bank of International Settlements structures to ensure that there is minimal scope for regulatory arbitrage between financial jurisdictions.

In relation to capital market liberalisation, international organisations are now nuancing their previous aversion to the use of capital flow management in certain situations. In 2010, the IMF issued a position note which found that the use of capital controls was associated with 'avoiding some of the worst growth outcomes associated with financial fragility'. As a result, the paper sets out the IMF's view that 'if the economy is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued, and if the flows are likely to be transitory, then use of capital controls – in addition to both prudential and macroeconomic policy – is justified as part of the policy toolkit to manage inflows' (Ostry et al 2010).

The OECD (2011a) has made a similar statement, arguing that 'there may also be a role for some form of capital controls if designed in a way that minimises distortions in long-term investments and ordinary business activities, but these should preferably be subject to multilateral surveillance as in the framework created by the OECD Code of Liberalisation of Capital Movements'. Some economies have used tools such as moderate

holding requirements over the last year to help manage destabilising inflows of short-term portfolio investment. Such solutions explicitly aim to balance stability with an open approach to inward investment.

Despite this change of view on capital controls, the WTO's General Agreement on Trade in Services, as well as many bilateral trade agreements and bilateral investment treaties, include provisions relating to payments, transfers and financial services that may severely limit the application of legitimate capital controls.

A discussion on this issue took place at the last WTO ministerial conference, noting that: 'Some ministers also highlighted the need for greater coherence between the WTO and other international institutions, including the IMF.' More work is clearly needed to get this issue higher up the agenda, which speaks to a wider problem.

Capital mobility has an important role to play in a modern economy by ensuring that savings flow to the most productive investment opportunities in the world. Few argue that foreign direct investment (FDI) should be curbed or that currency manipulation should be legitimised. Nonetheless, it is clear that countries should have the ability, in certain circumstances and within a set of guiding principles, to impose controls on potentially destabilising flows of short-term portfolio investment. The recent intervention by economies such as Indonesia, which required minimum holding periods for sovereign debt to discourage speculative flows, suggest that it is possible to balance openness to foreign investment with protections against the destabilising effects of volatile short-term capital flows. The rules of multilateral organisations should be consistent with this new approach. More can also be done to ensure that capital flows are not used as a means of tax avoidance or evasion, as the next section shows.

Recommendation 3

Efforts to regulate more effectively the financial sector should continue with the critical aim of ensuring that the vulnerability of the globalised financial system to poorly understood and managed levels of risk is reduced. Basel III should be implemented on a timeframe that ensures that banks do not have to shrink their balance sheets and lending to meet the requirements while their economies remain weak. Something closer to the precautionary principle should apply to complex financial products, coordinated through the G20, FSB and BIS structures, to ensure that there is minimal scope for regulatory arbitrage between financial jurisdictions.

All multilateral organisations should ensure that legitimate and consistent principles are developed and agreed to govern potentially destabilising short-term portfolio inflows, while preserving openness to foreign direct investment.

Avoiding the race to the bottom on international taxation

As described in chapter 1 and above, transport and communication costs have fallen and restrictions on capital mobility have eased considerably in recent decades. This has benefitted global growth and prosperity, but it has also meant that multinational companies are able to take advantage of tax arbitrage by relocating their taxable profits between different jurisdictions to take advantage of different rules on the taxation of debt and equity, and through the pricing of intra-company trade (EEAG 2007). Domestic tax systems which assume that companies are only based in a single country have not kept up with these trends (Griffith et al 2008).

This creates two problems. First, greater business tax competition exacerbates the pressures on national finances and creates an unfair and counterproductive burden on personal and consumer taxpayers. Second, multinational companies are able to obtain an advantage over domestic firms by exploiting differences in taxation regimes. In the UK, for example, companies in the financial services sector face an effective average tax rate of 7.4 per cent, while domestically-based retail and construction face effective rates of 18.9 per cent and 21.2 per cent rate respectively (Devereux and Loretz 2011).

In announcing plans to cut corporation tax rates, the British chancellor of the exchequer George Osborne (2010) said:

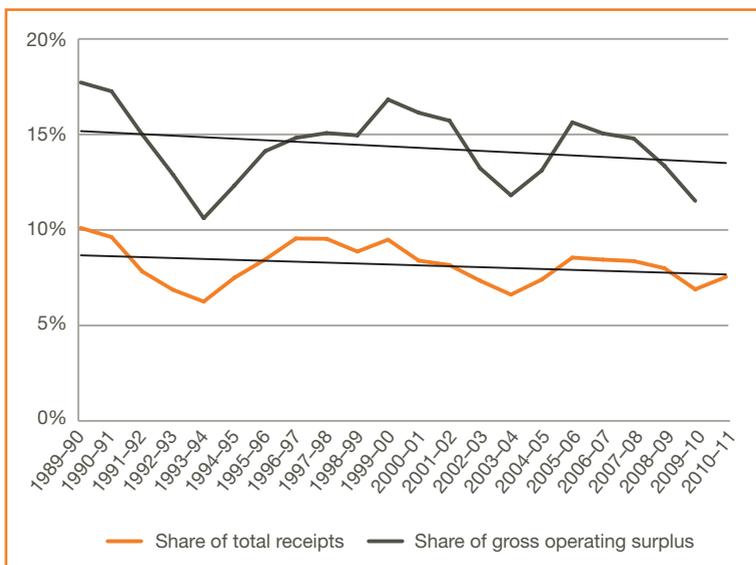
‘Corporation tax rates are compared around the world, and low rates act as adverts for the countries that introduce them. Our current rate of 28 pence is looking less and less competitive. So we will do something about it.’

The rate will now fall from 28 per cent to 23 per cent by 2014/15, at an eventual cost of £5.2 billion per annum in foregone revenues (HM Treasury 2011). Figure 4.4 (over) shows the downward trend since 1990 in corporation tax receipts as a percentage of overall receipts and of gross operating surpluses – a proxy for corporate profits. The picture is even more stark in the US, where corporate taxes paid for more than a quarter of federal outlays in the 1950s and a fifth in the 1960s, but fell to a ninth in the second half of the 1990s and to just 6 per cent by 2003 (McIntyre and Nguyen 2004).

Given that the downward trend in headline rates is speeding up, corporation tax receipts may head towards zero, with consequences for achieving a sustainable revenue mix as the burden grows on non-business sources of public revenue. Given that international competition is driving this, international cooperation on the issue is urgent and rather more important than the efforts to introduce a financial transactions tax (FTT), which has become popular in recent

years. While the latter could potentially dampen speculative finance or generate significant revenues, it requires global agreement to be effective.

Figure 4.4
Corporation tax on the decline



Source: HM Treasury, ONS Quarterly Accounts data

The European Commission's proposal for an FTT of 0.1 per cent on the exchange of shares and bonds, and 0.01 per cent on derivative contracts, estimates that it might raise €57 billion in its first year. However, the commission's own impact assessment shows that a scheme confined to the EU would decrease the volume of derivatives transactions by between 70 and 90 per cent. As financial activity were to move to other jurisdictions, it would also cut long-run growth across the EU by between 0.53 per cent and 1.76 per cent, equivalent to between €64 billion and €213 billion (European Commission 2011). Unless further studies can show that there are net benefits from an EU-only FTT, all efforts should focus on bringing the US and Asia into the discussions.

In the meantime, the European Union can make significant progress against corporation tax competition through a series of reforms. One option that has been offered is the introduction of a destination-based cash flow tax, which would eliminate the incentive to use profit shifting or intra-company transfer pricing to lower the effective tax rate (EEAG 2007). But this tax would look much like an additional value added tax and would therefore be regressive and unpopular. Instead, there are five reforms for which the UK should argue.

First, the European Union should implement the Common Consolidated Corporate Tax Base (CCCTB). Under the current tax regime,

multinationals file separate accounts for each country in which they operate; under the CCCTB, each company would compute only its EU-wide consolidated profit, on a common definition of the tax base. This profit would be allocated to member states on the basis of an apportionment formula containing factors such as shares in employment, payroll, assets and sales. Each member state would retain autonomy to tax its allocated share of profits at its own tax rate (Bettendorf et al 2011). This approach would allow countries to retain their own tax rate and pursue healthy tax competition. But within the EU, companies would have to actually move their staff and physical capital to the lower-tax regimes, rather than relying on the accounting mechanisms outlined above. In time, other jurisdictions could be encouraged to join, paving the way for an eventual global consolidated tax base.

Second, the EU and its member states should begin discussions with the International Accounting Standards Board to introduce a requirement that all multinational corporations report sales, profits and taxes paid in all jurisdictions in their audited annual reports and tax returns in what is known as country-by-country reporting. Country-by-country reporting discloses the profits that companies record in each jurisdiction in which they operate and the taxes that they pay on them. This means that they can be held accountable for what they do and do not pay (Murphy 2009). The requirement would complement the CCCTB by providing simple transparency on the activities of multinational companies in jurisdictions outside the EU.

Third, other jurisdictions should be encouraged to adopt the EU Savings Taxation Directive as a means of creating an automatic exchange of taxation information. Since 2005, the directive has ensured that paying agents either report interest income received by taxpayers resident in other EU member states or levy a withholding tax on the interest income received. In Cannes, Indian prime minister Manmohan Singh called for the G20 to take a lead on the issue 'in the spirit of our [2009] London Summit that [said] "the era of bank secrecy is over"' (*Economic Times* 2011). But the communiqué only committed to 'consider exchanging information automatically on a voluntary basis as appropriate' (G20 2011). The EU should also adopt an amendment to the savings directive which would close existing loopholes and prevent tax evasion by stopping taxpayers from channelling interest payments through trusts and intermediate tax-exempted structures.

Fourth, as the Financial Action Task Force has already recommended, the beneficial ownership of companies, trusts and foundations should be on the public record. This would prevent multinational corporations from using networks of international subsidiaries to transfer profits and reduce their tax liability. This reform would also have the added benefit of making money laundering and the handling of illicit funds more difficult (GFI 2009).

Fifth, bilateral and multilateral donors should support developing countries in building their tax collection and enforcement agencies.

Taken together, these measures will act to reduce the power of tax competition and lower the incentives on companies to execute tax arbitrage strategies.

Recommendation 4

The UK should work within the European Union to implement the Common Consolidated Corporation Tax Base in order to reduce the pressure of tax competition while retaining domestic rate setting.

The UK should work with the G20, International Accounting Standards Board and Financial Action Task Force to introduce transparency measures that will reduce the incentives for multinational companies to use profit sharing and transfer pricing to reduce their tax liabilities.

The UK should use its influence as a major aid donor to encourage other bilateral and multilateral agencies to divert more resources for tax collection and enforcement agencies.

Avoiding the downward spiral of new protectionism

Following the global financial crisis, global trade flows dropped precipitously, with real trade falling 12 per cent over the course of 2009. Despite fears that the global financial crisis would lead to a spate of protectionist policies, 2008 to 2010 saw less of a rush towards autarky¹⁵ than many had anticipated. Multilateral trade rules and global supply chains played their role in preventing a return to great depression-style protectionism (Haddad and Shepherd 2011). That said, the most recent *World Economic Situation and Prospects* report by the UN warns of increasing protectionist pressure (United Nations 2011). Indeed, the 2011 Global Trade Alert report found 194 new protectionist measures put in place since the G20 summit in Seoul in November 2010 – more than twice the number of market-opening measures that have been introduced during the same period (Evenett 2011).

Nonetheless, it is important here to distinguish between measures designed to erect uncompetitive trade barriers and those which are designed to promote domestic stability or enhance domestic growth policies. As discussed elsewhere in this report, in certain circumstances, limited forms of capital controls and intelligent industrial policies can play a useful role in domestic policy, but there are risks of abuse which need to be guarded against. Global Trade Alert has warned of a growth, since 2009, in the use of state aids to discriminate against other nations'

¹⁵ 'Autarky' is an economic term referring to closed economies which are self-sufficient and do not trade with other countries.

interests. This highlights the need for international rules on state aids which highlight when they are a legitimate tool for developing a country's economic capacity and when they are not.

Another development in recent years has been a shift in the academic debate. As chapter 2 showed, recent evidence shows that while enhancing productivity and innovation, import competition can depress wages and cause job losses. In the US, this has coincided with a decline in support for trade among the general public and in Congress. The respected Pew Global Attitudes Survey found that, of the 20 countries surveyed, support for trade and globalisation is weakest in the US. In 2002, 78 per cent said that the 'growing trade and business ties between the US and other countries' was 'good' – this fell to 53 per cent in 2008 before rising back to 67 per cent in 2011. A majority in the US (53 per cent) now see China's growing economy as a 'bad thing' for their country. The same is true in France (59 per cent), where a recent presidential candidate, Arnaud Montebourg, stood on a ticket of *démondialisation* (deglobalisation). Reflecting the changing sentiments in the US, two-thirds of Democratic House members opposed President Obama on the recent US–Korea free trade agreement, while 82 per cent opposed him on the US–Colombia agreement, his biggest split with House Democrats thus far (Tucker and Wallach 2011). In essence, trade has become a toxic issue in the US, with Democratic opinion shifting more than at any time since President Clinton's advocacy of open trade.

Alongside this increasingly lukewarm public sentiment towards globalisation in the developed world, the WTO's Doha development agenda has ground to a halt and is now effectively stalled. The fault for this lies with political leaders, who are unwilling to face down domestic vested interests and make unpopular arguments, even when these are in the long-term interests of their country. The potential strength of the WTO lies in the fact that it has successfully expanded to take in every significant economy on the planet, including all the emerging economies, and is thus a potential framework of rules with almost universal reach. The challenge is to convert this simple membership into a genuine sense of ownership, by developed, emerging and the least developed economies alike, of the rules-based global trading system and a willingness to make political compromises to allow the system to continue to advance. This will include both liberalising trade and securing the openness that already exists, as well as updating and enforcing global trade rules. Without doing so, the world trading system lacks the necessary insurance policy and safeguards against future protectionism.

Some argue that the net benefits of Doha were likely to be so small that a deal would not have actually been worthwhile (Ackerman 2005). But there are four reasons why Doha's demise should be lamented. First, it would have been the first multilateral trade agreement to contain

genuine cuts in applied tariffs from the large emerging economies. Second, multilateral agreements act as a ratchet against protectionist backsliding and would have locked in a large amount of unilateral liberalisation that has taken place since the last multilateral trade round was concluded in 1994. Third, the package for the least developed countries was substantial in relative terms, above all through the chance to compel, and render irreversible, substantial reform of the US and Europe's agricultural tariffs and farm support programmes, something that can only be achieved in multilateral negotiations.

Finally, if Doha is allowed to fail in its entirety, some large WTO members may interpret its failure as one of the WTO itself and pursue external forms of bilateral or regional trade liberalisation with renewed vigour. Such initiatives will suck out energy from multilateral efforts and, should they happen, risk weakening the WTO's cohesiveness and legitimacy, and thus its vital quasi-judicial function. A better alternative would be for small groups of interested and ambitious states to move forward within the WTO machinery with open plurilateral agreements¹⁶ in selected sectors such as services, and with a clear understanding that any other state could join these agreements in future should they wish. What matters most is that any attempt to give new traction to a liberalising agenda remains firmly integrated into the WTO system and does not detract from either its legitimacy or its scope.

In the absence of a multilateral trade liberalisation deal, the WTO should focus on how trade can be used to meet development objectives. This agenda includes tackling resource scarcity by encouraging water abundant countries to trade more water intensive goods, reducing tariffs on green technologies and services, promoting food security through a reduction in distortionary barriers and production subsidies for goods such as cereals, and examining which forms of aid for trade are most effective (te Velde 2011).

Trade reforms must also ensure a level playing field for all those competing in the global economy. This will mean intellectual property protection and enforcement provisions, open and non-discriminatory government procurement practices, and non-preferential treatment for state-owned enterprises (Ezell and Atkinson 2011) while allowing for proactive growth and industrial policies that foster structural transformation and help develop sustainable new capabilities (Rodrik 2011b).

Finally, as outlined above and in the next chapter, it is critical that both developed and developing countries acquire the capability to adopt social safety nets to ensure that their workforces are able to cope with the inevitable job losses and wage pressures that will occur in some

16 A plurilateral agreement is one in which WTO members are given the choice to agree to new rules on a voluntary basis. This is distinct from a multilateral agreement, where all WTO members are party to the agreement.

regions as a result of growing trade. In the developing world, support is required for a healthy, educated workforce enjoying social protection and respect for their rights at work. There should also be more technical support for the least developed countries and civil society organisations to participate in trade policymaking, particularly through organisations like the UN Commission on Trade and Development and the International Labour Organization (ILO)(TUC 2011). Ensuring that there is no return to the protectionist spiral of the 1930s will mean guaranteeing that trade benefits people across society.

Recommendation 5

With Doha stalled, small groups of interested and ambitious states should move forward within the WTO machinery with open plurilateral agreements in selected sectors, such as services, and with a clear understanding that any other state could join these agreements in future should they wish. Above all, the WTO should be preserved as the preeminent forum for global trade rules and negotiations on future trade liberalisation.

The WTO should increasingly focus on how trade can be a solution to development issues such as resource scarcity and food security. They should also provide more technical support to help the least developed countries and civil society organisations to participate in trade policymaking.

Avoiding the failure of nation states to agree and enforce multilateral agreements

The decade that has just passed appears to have seen the high water mark in public and government attitudes towards multilateralism. It started with the Jubilee 2000 campaign to drop the debt on poor countries, was followed by the Make Poverty History campaign of 2005, which sought to commit G7 countries to increases in development aid worth \$50 billion by 2010, and ended with the coordinated stimulus package announced at the G20 Summit.

Since that point in April 2009, multilateralism has had few successes. Subsequent G20 meetings in Toronto, Seoul and Cannes, the ongoing Doha round of WTO negotiations, and the climate talks in Copenhagen and Cancun all disappointed. Meanwhile, a number of countries – notably Italy, France and Germany – have failed to deliver on their development promises. In each instance, national considerations have trumped a global agreement.

The fastest-growing countries are also becoming increasingly assertive. Groupings of developing countries have been in place for many years, including the G77, which was founded in 1964.¹⁷ Developed countries

¹⁷ See <http://www.g77.org/>

have made attempts to include the fastest of these developing countries in decision-making processes through both the G20 and the now moribund 'Heiligendamm process', which sought to formalise a permanent dialogue between G8 countries and Brazil, China, India, Mexico and South Africa. A new grouping of BASIC countries – Brazil, South Africa, India and China – was established in November 2009 and has acted with a single voice on issues such as climate change.

Multilateral coordination will always be vulnerable to our inability to enforce agreed action. Since the legal machinery necessary to enforce global agreements is almost invariably inadequate, reporting and transparency mechanisms are usually proposed in their place. In an atmosphere of distrust, these are often weak and easily evaded or broken. Restoring cooperation in multilateralism requires three fundamental reforms that seek to strengthen the trust that is its foundation.

First, the IMF and World Bank require further reform to reflect current economic realities. Reforms to the IMF board announced in 2010 are a step in the right direction but continue to leave the world's least developed countries underrepresented. Proposals to shift the voting shares by over 6 per cent in favour of emerging market and developing countries was significantly at the expense of other developing countries. For example, as a continent, Africa saw its voting share fall from 5.9 per cent to 5.6 per cent, while the EU continues to have a 29.4 per cent share of the vote despite making up less than 26 per cent of global GDP. China, meanwhile, will have less than 4 per cent of votes despite making up around 10 per cent of global GDP. It is also an anomaly that the United States alone retains an effective veto of most decision-making.

In the World Bank, developing countries represent over 80 per cent of the world's population. They are where almost all of the bank's activities take place and, through loan repayments, are the main financial contributors. Yet middle-income countries, including global powers such as India, China and Brazil, are stuck on around one-third of World Bank votes, while low-income countries languish on just 6 per cent. High-income countries, meanwhile, will hold over 60 per cent of voting power across the World Bank Group for at least the next five years (Horton 2010).

Second, there is a need for the fastest-growing countries to take a greater leadership role commensurate with their benefit from, and growing size in and contribution to, global growth. Brazil, China or India should almost certainly provide at least one of the next leaders of the IMF, World Bank and WTO. If these institutions are to remain the forum for decisions about development and trade, they must be more attentive to the needs and heterodox approaches of developing

countries. These countries will, in turn, need help in developing the capacity to deal with the additional responsibility before assuming it.

Third, reform is needed to create a properly functioning G20. The G20 covers 80 per cent of world GDP and 60 per cent of the global population. Its unbureaucratic processes give it the potential to be effective while at the same time more universal than the G7 (though much less so than the UN) by bringing emerging market voices into these important discussions for the first time. Nonetheless, it has failed to realise its early promise.

With such complexity in negotiations and decision-making, the participants of the G20 (politicians, policymakers and technocrats) need a better institutional framework to ensure they convert discussions into agreement and action. Multilateral negotiations will always be a competition, but parties ultimately engage because they know that the outcome, while less than their ideal, will be better than had they gone it alone. With the notable exception of the Durban climate talks, most recent negotiations have tended towards the lowest common denominator rather than a more ambitious collective solution.

British prime minister David Cameron has made recommendations about the future of the organisation: chiefly, to create a small secretariat to underpin the troika of past, present and future G20 presidencies, to establish the G20 as a legal entity, and to formalise the basis on which it coordinates the work of international bodies (Cameron 2011). We would agree and suggest measures to enhance this further.

First, it has been suggested that the small secretariat should be based in a country outside the G7 – perhaps Turkey, at the crossroads of east and west, north and south (Mandelson 2011). Second, the secretariat should work with the troika to set the agenda and ensure that individual presidencies do not sidetrack the main agenda in favour of their own pet projects. We know that Chinese thinktanks are already examining how a G20 secretariat could function in practice and their ideas should form a central part of any future reform (Straw and Glennie 2011). The secretariat should use an open method of cooperation to improve its effectiveness, setting specific timetables for achieving agreed action points and using quantitative and qualitative indicators to ensure that best practice is rolled out (Meyer et al 2011).

Third, the secretariat should design a mechanism for altering the composition of the body every five years to reflect changes in the global economy (Straw et al 2009).

Fourth, the G20 should formalise its relationship with civil society through the business B20 and labour L20 structures, both of which have been constructive and useful.

Recommendation 6

The IMF and World Bank should be reformed to ensure that voting shares better reflect current global economic realities.

Over time, the fastest-growing economies should take a greater leadership role within the governance of multilateral organisations.

The G20 should be reformed to increase its effectiveness by creating a formal secretariat with specific responsibilities to help set the agenda, monitor progress against action points, consider future composition, and formalise the relationship with civil society groups.

Conclusion

Avoiding the six threats outlined in the introduction to this chapter will be critical to ensuring that the third wave of globalisation results in sustainable and broad-based rises in living standards for all. The policy tools outlined in this chapter are fundamentally rooted in the actions that national governments take collectively through multinational organisations, rather than in an idealistic, often unrealistic notion of global government.

Each recommendation seeks to take into account the complex realities of current negotiations, suggest a route ahead where an impasse has been reached or a new approach where an issue has not received sufficient attention. In some areas – such as the case for current account targets and measures to deal with corporate taxation – it will require new rules. In other areas – such as in the specific instances where sectoral industrial policy or limited controls on short-term capital flows can be a legitimate policy tool – it will require rethinking of rules and their application by multilateral institutions.

Even if these new solutions can be agreed, however, there is still a downside to globalisation that must be managed. Chapter 2 highlighted that alongside the contribution that globalisation makes to growth, innovation and productivity, it also accelerates technological change, reshaping industries and causing insecurity for individuals and volatility for economies. To live in this world, people require support to prosper. Some of this support must come from the state in the form of social protection and investment in both their individual competencies and the collective capabilities of the economy.

Countries must ensure that they are able to compete in the global economy and have the domestic latitude to promote their comparative advantages. They must ensure that their domestic workforces have the skills necessary to get jobs and that employers are properly utilising the skilled workforce that already exists. Public services must provide for a

fit, healthy and educated workforce and, increasingly, ensure that there is adequate and affordable childcare provision for those seeking to join the labour market. Finally, affordable social protection systems must be in place to protect the most vulnerable and those facing a period of transition due to ill health, unemployment or old age.

In each of these areas, no single approach should prevail. A diverse market for policy solutions is desirable and should be encouraged, so long as legitimate rules are in place to ensure that these multiple approaches to boosting the competitiveness of individuals and firms do not become a cover for protectionism or economic nationalism.

Chapter 5 takes the UK as a case study of a medium-sized developed country seeking to ensure that as many people as possible benefit from the opportunities that come with globalisation, while protecting those most vulnerable from the pressures and rapid economic changes that come with integration in the global economy.

5. MAKING A LIVING IN THE GLOBAL ECONOMY

A UK CASE STUDY

As discussed in the previous chapters, with the right policies in place, the third wave of globalisation has the potential to drive global growth, alleviate poverty and reduce inequality. These opportunities are not isolated to the developing world, but have the potential to bring significant benefit to the UK and other developed economies. They can gain as new markets grow and proliferate, and opportunities multiply for joint ventures and production that bridge business on different continents. Although there are questions about the long-run pace of global growth and the current size of the global middle class, the direction of travel is clear, with demand constantly growing for capital and consumer goods and services in developing countries.

Ensuring that the benefits of globalisation are shared as widely as possible is a collective responsibility that requires collective action. In chapter 4 we made a series of recommendations for improving both the architecture and the practices of global economic governance. Without international coordination on global imbalances, growth strategies, short-term investment, corporate taxation and trade policy, globalisation will encourage a race to the bottom in which narrow national interests trump a more mutually beneficial outcome.

Implementing these policies, however, will not be enough. Individual governments need to be active in helping to equip businesses and individuals to prosper in the global economy. If they do not take on this role, globalisation will only benefit the few, not the many. And this will fuel a public backlash and potentially a resurgence of nationalism and protectionism.

There are already signs of growing public anxiety about globalisation in many developed countries. In the UK, levels of dissatisfaction with globalisation have risen, as they have in the rest of Europe. In 2003, a Eurobarometer poll found that 60 per cent of UK respondents were in favour of globalisation, compared to just 27 per cent who were opposed (European Commission 2003). By 2010, just 30 per cent of Brits thought that globalisation was good for the British economy, compared to 34 per cent who thought it was bad (with 23 per cent saying it did not make a difference and a further 13 per cent being unsure). Voters over 40, living in the north, Midlands and Wales, and from lower socio-economic groups were particularly negative (YouGov 2010). Box 5.1 reports on our visit to the north east of England, where we encountered a range of views on the benefits and costs associated with globalisation.

Box 5.1: View from the north east of England

In July 2011, Lord Mandelson and the IPPR project team visited the north of England to learn more about the impact of globalisation on some of those parts of the UK that are often described as 'lagging'. Over the last four decades the gap in economic performance between the prosperous greater south east (and particularly London) and regions in the north east and north west of England has widened considerably. This has coincided with the intensification of trade liberalisation as well as the increased importance of the financial services sector, particularly in London, to the British economy (Viitanen and Baker 2011).

This stark story of a productive south and an underperforming north is somewhat misleading. In a series of meetings with local councillors, business owners and union representatives in Newcastle, we heard a more nuanced story about the opportunities and challenges presented by globalisation. For example, the Port of Tyne has become a dynamic regional export zone over the last 10 years, with annual turnover having risen from £20 million in 2001 to a (forecasted) £59 million in 2011. It expects to have shipped out 641,000 cars in 2011 alone, compared to 374,000 in 2009.

One of our most revealing meetings was with a group of students at the Hartlepool College of Further Education, studying for a diverse range of professional and educational qualifications, including diplomas in sport, travel and tourism, and apprenticeships in engineering, vehicle maintenance and hairdressing. As residents of an area that has seen relatively high levels of economic deprivation in recent decades, this group might be expected to have been pessimistic about their place within the global economy.

Indeed, one engineering apprentice spoke of the difficulties he had experienced in finding a job as a mechanic, and believed that this was the result of immigrants coming to live in the area and taking local jobs. While Hartlepool is not a prime destination for economic migrants, this is an issue that has been experienced in many other parts of the UK, raising legitimate questions about how to ensure that migration and integration policies allow a circulation of people and skills throughout the UK while also making sure that local areas are equipped to deal with this change and to support individuals who may lose out as a result of economic openness.

However, when asked for their opinions on whether globalisation was a positive or negative force, the overwhelming majority of young people we spoke to were outward-looking and confident about their ability to make the most of the benefits offered by globalisation. Some aimed to travel and work abroad, while others felt that an influx of foreign labour had introduced new perspectives and boosted innovation in local businesses. This suggests that with the right policies in place, all parts of the UK can share the dividends of globalisation.

This change in attitudes is partly explained by the impact of the global financial crisis. It has lowered rates of growth, increased levels of unemployment and squeezed living standards across most developed economies. However, it also reflects deeper-rooted anxieties about the economic and social impacts of globalisation, as discussed in chapter 2. These challenges will not be addressed through recourse to protectionist policies and a ‘battening down the hatches’ mentality. Globalisation has the potential to bring benefit to all, while protectionism offers the prospect of mutual disadvantage. The task for policymakers is to be more active in developing well-skilled workforces and innovative businesses alongside strengthened support for individuals and communities in responding to the negative impacts of some economic change.

The public policy challenge for developed countries

Prosperity in the decades ahead for the advanced market economies in Europe, North America and Asia will more than ever before rest on their ability to generate and apply knowledge to provide the world’s consumers with high-value-added goods and services. It will need to be a journey of perpetual movement up the value chain.

Open and competitive markets will be one of the most important spurs to achieving this. But on their own competitive markets are not sufficient to ensure sustained and broadly shared prosperity.

The first priority and the cornerstone of a successful industrial policy is the systematic development of workforce ‘human capital’. Investing in education and skills and reforming schools, colleges and universities to improve performance is essential. No individual should be let down by the provision of teaching or training in the classroom or workplace; each should have the skills and knowledge needed for productive, rewarding employment and career progression.

And for those who lose their jobs in sectors exposed to competition or downsizing of employment, active labour market policies are necessary, in order to get them back to work in new sectors. Welfare states must

be focused on supporting high levels of employment, particularly through the provision of childcare.

To enhance innovation, governments in developed countries should ensure that there is a sound science base, decent investment in basic research, a strong patent system and other incentives to encourage innovation in the private sector, and support for businesses looking to develop, demonstrate and deploy new technologies. This will include universities that actively work with the private sector to transfer technology, encourage collaboration, and foster spin-offs. Improvements to human capital must go hand-in-hand with advances in physical capital. It is critical that the national infrastructure in energy, transport and telecommunications is world-class

Ensuring that human capital, physical capital and innovations are put to productive use means providing an environment in which people are willing and able to create new businesses, smaller companies with the potential to grow quickly are able to do so, and all businesses recognise the value of skills, innovation and investment to their long-term success. These kinds of businesses need a supportive framework of company law and corporate governance, and should be able to draw on a dense ecosystem of support from investors, banks, public agencies, higher education and research institutions. It will be an economy that is both competitive and collaborative, and one that bridges any notion of a sharp divide between the public and private sectors.

Turning to the UK specifically, as a medium-sized country trying to make a living in the world, we outline some essential reforms in three key policy areas that will help realise these goals:

- a new role for industrial policy
- smarter skills policies
- strategic, active and affordable welfare policies.

Industrial policy

For the UK in particular there is a need to move firmly beyond the now-dated 1980s mindset that the best industrial policy for government is 'no policy'.

In practice, UK governments in 1980s were more pragmatic in their deeds than their words suggested. The Thatcher government pursued a very active and successful policy of reviving the UK car industry, attracting Japanese inward investment by deploying of full range of incentives and support. The UK's aerospace and aero engine industries were backed on their road to world class excellence by 'Launch Aid' payments. And the 'big bang' set of financial services deregulations were a proactive government policy to reinvigorate the City of London as a global financial centre.

New Labour, on coming to office in 1997 was on reflection too timid about the benefits of active industrial policy. Although there was longstanding policy to raise overall productivity levels – including competition policy, measures to improve access to finance and support for the science base – for too long the government shied away from systematically analysing the sectors where the UK had genuine competitive advantage and thinking through how, across the range, government could foster their development. The *New Industry, New Jobs* white paper (HM Government 2009) finally set a course for a more active, systematic and self-confident strategy. It is welcome that, after some initial hesitation, the Coalition government has not completely turned its head on this approach.

In the third wave of globalisation, markets, private business and entrepreneurs will continue to set much of the pace, but governments and public agencies are going to play roles that go far beyond the ‘neoliberal trinity’ of property rights protection, contract enforcement and sound money. Looking at the success of rapidly growing economies, it can be argued that sustained growth tends to require more than conventional macroeconomic policies. It often depends on the implementation of policies that actively promote economic diversification and shift focus from low-productivity activities (such as traditional or subsistence agriculture) to mostly tradable higher-productivity activities. In short, it requires a conscious effort to put the economy’s resources ‘into those sectors that are on the automatic escalator up’ (Rodrik 2011a).

In Europe, industrial policy has been constrained by EU competition regulations. Under the Treaty on the Functioning of the European Union, many forms of ‘state aid’ – such as loans, grants, interest relief, export credit insurance or the provision of goods and services on preferential terms – are prohibited. This approach has become increasingly problematic in recent years as a result of three key developments.

First, a greater understanding of the dangers posed by climate change have made it plain that government intervention is required at both the Europe-wide and individual member state level to stimulate investment in clean energy technologies.

Second, the financial crisis has revealed the risks of allowing the private sector to concentrate its resources in volatile non-tradable sectors (such as real estate) at the expense of more sustainable tradable sectors. Here, there has been a fairly predictable distortion between risk and reward, short-term gain and long-term growth. Third, as China and other emerging powers have expanded their role in the global economy, these nations have derived considerable competitive advantages through their use of strong, state-backed industrial policies.

This is not to propose a free-for-all for member states on state aids. But there needs to be greater flexibility around industrial policy. 'No state aids' is not necessarily the optimal policy goal: the need is to devise rules for 'good' state aids that genuinely enhance EU member states' economic capabilities. Suitably targeted interventions in the most competitive sectors and in those that facilitate the development and use of clean technologies would be particularly useful, as long as state aid is provided on equal terms to any firm in the sectors in question (Aghion et al 2011).

In concrete terms, the UK's industrial policy in the future needs to focus on sectors where Britain has or could have a comparative advantage, where global demand is most buoyant, and where market forces alone are not adequate to realise this potential. The challenge is to identify these sectors and the relevant policy levers that will leverage private resources and skills in order to develop them.

As figure 3.6 above shows, there are a series of sectors where Britain has the potential to enhance its performance and market share. The government should develop policies for each of these sectors, setting out how these sectors are performing, where market failures in the provision of research and development, finance and information exist, and what interventions – if any – the government will undertake to address these externalities.

To complement this, the vision and scope of the nascent Green Investment Bank needs to be more ambitious. First, it should become a National Investment Bank with green characteristics, rather than an institution purely focused on green investments. The energy and transport sectors are two critical areas where Britain already has some comparative advantages, but it makes little sense to restrict such an important branch of industrial policy to these sectors in isolation.

Second, this bank should be able to utilise the historically low yields on government borrowing with immediate effect. Figure 5.1 (over) shows the interest rate on 10-year government bonds. Any investments with a rate of return greater than the current yield of around 2 per cent will generate a positive net impact on the government's balance sheet. Investing in marketable services of this kind would turn the government's private finance initiative on its head by allowing the public sector to borrow and then sell or lease back the service to the private sector, rather than the other way around.

As a useful model of how state investment could become more targeted in the UK, box 5.2 shows how Germany's KfW investment bank has worked in practice.

Figure 5.1
UK 10-year
bonds (nominal
par yields)



Source: Bank of England 2011

Box 5.2: View from Germany – the Kreditanstalt für Wiederaufbau Bankengruppe

IPPR visited Germany in September 2011, as negotiations about the future of the eurozone were becoming increasingly fraught. While there, we met with politicians, policy analysts and business leaders, who gave us an insight into the features of the German economy that have enabled it to weather the financial crisis much more robustly than many of its European counterparts. The German government's proactive industrial strategy has been a key element of this, which it delivers in partnership with the KfW export bank.

The Kreditanstalt für Wiederaufbau Bankengruppe, or KfW, was established in Germany in 1948 as part of the post-war reconstruction effort. It has subsequently become Germany's largest promotional export bank, and is responsible for executing numerous government policies. Eighty per cent of its statutory capital is held by the federal government, and the rest by the 16 German federal states. KfW operates under its own act of parliament, although it also adheres to the German Banking Act on a voluntary basis where appropriate.

Domestically, the organisation has three main functions: it provides funds to small and medium-sized enterprises (SMEs), with a particular emphasis on start-ups, it promotes employment and education policies, and it finances environmental protection

schemes and domestic housing programmes. Internationally, KfW provides export and project financing and extends loans and grants within the framework of the government's international development assistance policy. KfW also acts as an intermediary in synthetic securitisations, helping to release the capital of German banks so that these are then able to provide new funds to the SME sector (Moody's Investor Service 2011).

Although the financial crisis has exposed some weaknesses within the structure of KfW – with its export and project finance arm having performed relatively poorly since 2008 – its overall impact on the German economy has been a positive one. In 2010, KfW injected €28.5 billion into the SME sector alone, and total domestic financing reached a record €64.3 billion. According to KfW figures, companies in receipt of this finance created 66,000 new jobs (in addition to the sector's existing 1.3 million), while the demand generated by this financing maintained a further 1 million jobs throughout the German economy over the course of the year (KfW Bankengruppe 2011).

The combination of long-term investment loans and working capital finance provided by KfW on favourable terms has helped the German SME sector to emerge from the financial crisis relatively unscathed and to avoid the high levels of layoffs seen in many other European countries. Other factors have clearly been important here, such as supportive German government policies on short-time working. However, KfW remains a useful model of how high levels of targeted state investment can buttress a sustainable domestic economy.

Recommendation 7

Governments should develop a limited number of strategic, sectoral industrial policies that support, preserve and encourage national comparative advantages, without introducing distortions that undermine innovation and competition.

In the UK, this would include areas like financial and business services, pharmaceuticals, aerospace, education and health services, green technology (especially wind power), hi-tech and electronic industries, and tourism.

The Green Investment Bank should be broadened to become a National Investment Bank and be able to borrow with immediate effect to create marketable services in sectors where Britain has a comparative advantage.

Smarter skills policies

Chapter 2 outlined the interaction between globalisation and technological change. By driving up productivity and creating a premium for innovation, global competition is contributing to the phenomenon known as ‘skills-biased technical change’ which increases the rewards for workers with high skills and reduces the rewards for those with low or no skills.

Developed countries have, in recent years, seen a polarisation of their labour markets, with growth increasingly focused on high-skilled jobs at the top of the labour market and low-skilled, primarily service sector jobs at the bottom. Medium-skilled, vocational jobs – for example in the manufacturing sectors in the US and UK – have been particularly hard hit, as both productivity improvements and global restructuring reduce employment at this level. This phenomenon has also contributed to the stagnation of median wages highlighted in figure 3.4.

Governments have responsibilities in three areas relating to education and skills in a global economy. First, they need to ensure that the overall skills level of the working population is as high as possible to allow them to compete. This means increasing the flow of educated people coming out of school, technical colleges and universities, and also helping workers already in the labour market to increase their skills level through encouraging lifelong learning. Second, governments need to ensure that the skills already existing in the economy are being properly utilised by businesses, and that those in lower-skilled sectors have ‘good’ jobs with opportunities for progression and development. Third, governments need to have an approach to immigration which ensures that short-term skills shortages in particular sectors can be filled by migrant workers. A wide range of evidence points to the economic benefits of migration, both for overall GDP and GDP per head, and also in terms of less easily quantifiable benefits, such as increased flexibility and innovation.

Fostering skills

In the UK, successive governments have prioritised the development of a highly-skilled economy. After Labour entered government in 1997, targets were introduced to improve the national skills base in relation to other countries, and unprecedented public investment in education and adult skills provision followed.

These efforts have borne fruit. In 1975, half of all working-age men in the UK had no formal qualifications. By 2009 this figure had fallen to just 12 per cent (Machin 2003, UKCES 2011). Between 2002 and 2009 alone, the proportion of working-age adults without a level 2 qualification¹⁸ (equivalent to five GCSEs at grade A to C) fell from 35 to 28 per cent (UKCES 2011) due to the rising qualification levels of new labour market entrants. However, the UK still lags behind some of its

18 According to the classifications of the National Qualifications Framework, or NQF.

competitors when it comes to qualification levels, particularly at the lower and intermediate levels. Just under a third of the UK workforce is not qualified to level 3 (equivalent to A-levels). Although in line with the OECD and EU19 average, this is substantially higher than in the Scandinavian countries, Germany, Japan and the US. The UK does better on higher education, with a third of the working-age population holding a degree, but lags some way behind Canada, Japan and the US.

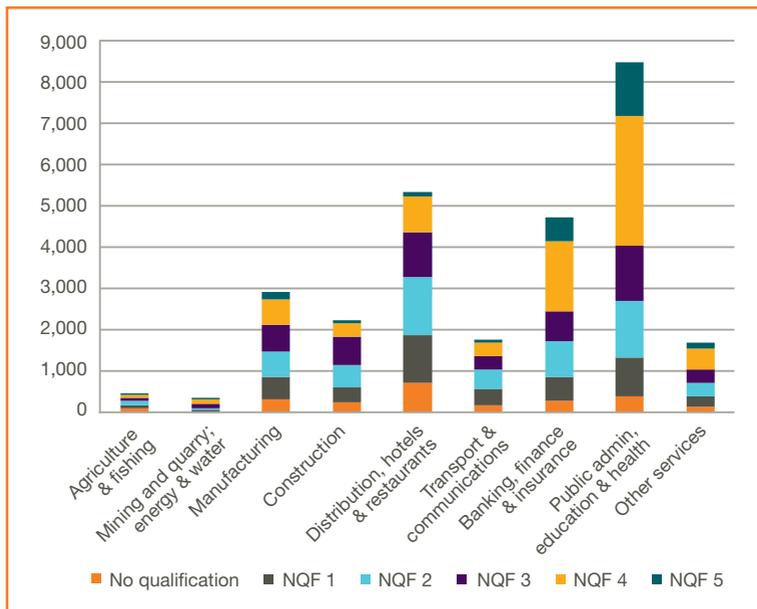
Creating a well-skilled workforce that is able to compete and thrive in the global economy is not and should not be the responsibility of government alone. It is appropriate that the government should oversee the process of deciding where the UK needs to develop new sources of comparative advantage. But studies of skills systems in Europe show that they are most effective when employers, together with unions or other channels for employee representation and government support (such as sector skills councils), have ownership of skills policy and delivery (see Lanning and Lawton 2012 forthcoming). Skills systems that rely too heavily on state targets and delivery agencies on the one hand, or individual initiative on the other, fail to develop robust local or sectoral institutional frameworks to which businesses make long-term commitments and in which high-quality training can be secured. The tripartite, coordinated skills training systems of Germany and other continental countries have long track records of providing the high-level apprenticeships and technical skills that underpin advanced business competitiveness. These are the areas in which the UK is comparatively weak.

Utilising skills and ensuring good jobs

Creating new forms of long-term employer engagement in skills policy and delivery in the UK would also enable improvements in how skills are utilised by employers. The demand side of skills policy is as important as the supply side – since workers who acquire new skills need to be able to put them to use in the workplace in order to achieve productivity gains, and employers must align higher skills levels with business strategies that enable them to move up the value chain. Too often in the UK, individuals who have gained level 2 qualifications, in particular, have found that their new skills are not put to use and so they do not see the wage increases or career progression that should flow from higher productivity.

Ensuring that skills are utilised and that there are ‘good’ jobs at different skills levels – in lower as well as higher tiers of the labour market – is important for ensuring that those with lower skills do not see globalisation as something that benefits only those with a degree. Figure 5.2 (over) shows the distribution of qualifications held within the key sectors in the UK economy, by NQF level. Qualifications are an imperfect proxy for skills (since they do not take account of other ‘softer’ skills that may be associated with particular jobs or professions) but they do give a sense of how different sectors compare in terms of the individuals they employ.

Figure 5.2
Qualification
levels by sector
(‘000s of jobs)



Source: UKCES 2009

Note: NQF1 is equivalent to a foundational diploma or GCSEs graded D–G; NQF2 is equivalent to GCSEs graded A*–C; NQF3 is equivalent to A-levels or the international baccalaureate; NQF4 is equivalent to bachelor degrees; NQF5 is equivalent to postgraduate qualifications. For further explanation see Ofqual 2010.

These figures show that there are unskilled and lower-skilled jobs even in sectors traditionally thought of as being skewed towards high-skilled individuals, including many where the UK has a strong comparative advantage, such as the banking, finance and insurance or public administration, health and education sectors. These jobs are frequently low-paid, offering little or no training of substance and few opportunities for staff to develop or utilise their skills (Lanning and Lawton 2012 forthcoming).

It is therefore increasingly important, alongside policies to build a ‘high-skilled’ society through the acquisition of educational and professional qualifications, to focus on creating a ‘well-skilled’ society, in which every sector, at all levels, contains ‘good’ jobs that make the most of people’s skills and that offer opportunities for development and progression.

Reforming skills policy in this direction involves a set of evolutionary reforms aimed at raising business performance, job quality and the quality of training provision at both the sectoral and local levels. ‘Soft’ support will be a part of this, based on deals with business centred on public funding for training and business improvement in return for commitment to developing competitive strategies that support continuous workforce development and the utilisation of skills and

professional experience. In some cases, where workplace standards raise considerable concerns for citizens' wellbeing, regulations such as occupational licencing may be required.

Migration and skills

Finally, migration policy has an important role to play in helping an economy to compete in the global economy. In the UK, the advantages of immigration are being lost in the current political debate, which is overwhelmingly focused on driving down overall levels of net migration to the UK. This is perversely leading the government to clamp down hardest on entry routes for some of the most economically valuable migrants, especially skilled workers and overseas students from outside the EU.

The government should, instead, go *with* the grain of migration patterns, which are becoming increasingly temporary. Temporary migration increases the benefit to both countries, as returning workers take skills and capital back home, while maintaining strong links with Britain. Shorter-staying migrants tend to use fewer public services and send more money home in remittances, which contributes far more to the developing world than either aid or foreign investment. While it is tempting to talk tough on immigration, this is one of many areas where carrots are better than sticks. For example, the government could divert a share of national insurance contributions for each migrant to act as an incentive to return home. Such an approach would be fairer for those who come here, work hard, and play by the rules. It would also be more realistic, and better for our economy.¹⁹

Recommendation 8

The aim of national skills strategies should be to create well-skilled and adaptive workforces, capable of responding quickly to changes in the global economy, and properly utilised by employers.

In the UK, efforts should continue to improve education and skills provision in the UK but greater priority should be placed on ensuring that skills policy utilises the existing skills of the domestic workforce. The expertise of local employers, educational institutions, training providers, researchers and other key experts should be better used to ensure that this takes place.

Migration policies should support the development of a better-skilled workforce through promoting more circular forms of migration, rather than closing down avenues for highly-skilled migrants to work and study in the UK.

¹⁹ For more on the trend towards temporary migration and its policy implications, see Cavanagh 2011.

An active welfare state

While creating many new opportunities for British companies and workers, globalisation can also cause jobs losses and downward pressure on wages. Ensuring that those who find themselves out of work, as a result of globalisation or other factors, is a fundamental responsibility of a modern welfare state. As chapter 4 outlined, many developing countries are creating their own social protections to help their citizens in times of need, such as when they lose their job. As well as providing temporary relief, these measures will also raise domestic consumption, as citizens feel more able to spend disposable income rather than saving for potential difficult circumstances in the future.

In most developed countries, welfare states have been in place since at least the 1940s, but while universal coverage ‘from cradle to grave’ has long been a cherished principle, the consensus underlying this principle has frayed badly in recent years. There is now a strong sense that the welfare system rewards people who do not work while failing to give adequate support to those who do. To ensure that the benefits system does not provide perverse incentives to stay out of the labour market, successive governments have increased the conditionalities attached to the provision of welfare, so that those who can work are required to seek and take available employment. However, less has been done to address the concern that the welfare system does not give real protection to those who need it at particular crunch points in life, such as when they lose their job or face higher costs to keep working, such as when they start a family.

This issue became particularly acute in the UK following the financial crisis, which led to a rapid increase in unemployment to levels not seen since the 1990s. Many who lost their jobs as a result of the recession came into contact with the benefits system – often for the first time in their working life – and found themselves entitled to relatively small amounts from a welfare state they had been paying regular contributions into, sometimes for many years. The sense of unfairness created by this situation was exacerbated by the fact that people who had not worked for some time were entitled to the same level of support.

Welfare reform is therefore vital if individuals are to get the support they need to deal with the risks that globalisation can bring – principally when they lose their jobs or need to change career – and that public commitment to welfare spending is retained. In broad terms, this means that the welfare state should do fewer, bigger things, focusing on what really matters to individuals and their families in the globalised world of the 21st century, rather than historic patterns of welfare provision.

In conditions of fiscal constraint, there are no easy options for welfare reform. Tough choices must be made between different services, benefits and programmes. But policymakers who seek to combine

economic openness with social justice should be guided by the core principle that welfare reforms focus on maintaining high levels of employment, since this is the key plank underpinning the long-term affordability of the welfare state. This should be achieved principally through active labour market policies, lifelong learning opportunities and affordable childcare.

For those who can return to work quickly, one way to solve the problem of low unemployment benefits would be to introduce a national salary insurance scheme (see Cooke 2011 and Purnell 2011 for a discussion of how this would work in practice). This system would provide people with higher levels of benefits than they are currently entitled to if they lose their job, but would also require this support to be repaid when they return to employment. A national salary insurance of this kind 'would offer much greater security to people when it is really needed, without imposing significant new net costs on the state. It would achieve this by reinvigorating the contributory principle, as well as harnessing the attractive features of the income-contingent loans system used to provide support to students' (Cooke 2011).

In addition to a national salary insurance scheme, there is a strong case for ensuring that anyone facing long-term unemployment (of more than 12 months in duration) is guaranteed a job. In these circumstances, the third sector and local government can act as 'employers of last resort' by providing jobs of social value with a requirement for jobseekers to take up work or lose their benefits (see Wray 2011 for a US proposal along these lines). Steps must also be taken to ensure that working people take home a decent income, through pressure to expand the living wage (especially in large, high-turnover companies exposed to the global economy).

Recommendation 9

Welfare systems should provide fewer but clearer and more substantive social protections that can meaningfully support workers and help them to thrive in a globalised economy, while also giving them a much stronger safety net in times of hardship, such as job loss caused by global competition.

In the UK, the government should introduce a national salary insurance scheme designed to provide individuals with higher levels of support if they lose their job, but requiring this support to be repaid when they return to employment.

This should sit within a broader suite of measures to decisively reorient the welfare state to deal with the key risks that individuals face, including income loss and unemployment.

Conclusion

As a relatively highly-skilled medium-sized economy with a comparative advantage in a number of high-value sectors, the UK has the potential to benefit significantly from deep integration with the global economy. In sectors such as financial and business services, pharmaceuticals, aerospace, education and health services, green technology, hi-tech and electronic industries and tourism, increasing global demand can help create jobs and opportunities in the UK.

But openness to trade alone will not deliver broadly-based growth and prosperity for Britain or its citizens. An active role for the state is necessary to ensure that Britain is taking advantage of its comparative advantages and making investments to boost future productivity. A reformed skills policy is essential to ensure that British citizens are able to compete in the global economy while also ensuring that British businesses properly utilise existing skills in the workforce. Modern welfare policies can ensure that those who lose out as a result of the negative consequences from globalisation are helped back into work.

This chapter has suggested a number of reforms that will help the UK specifically to achieve these goals. In tandem with the recommendations for reforms at the international level described in chapter 4, these will put the UK in the best possible position to reap the benefits and mitigate the risks associated with the third wave of globalisation.

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