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Global Governance of International Competitiveness Spillovers

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Abstract

Reducing public sector deficits and high debt burdens in part will require an increase in net exports – which is only possible if the countries concerned are able to produce goods and services that are 'competitive' on world markets. Policies aimed at enhancing competitiveness may be offset by actions taken in other countries and can generate negative international pecuniary spillovers. This paper discusses different approaches towards dealing with (perceived) cross-border externalities. In many cases there will be a significant degree of uncertainty as what the net effects of policies are, taking into account the overall impact of policy measures that have a bearing on firm-level competitiveness. A case is for greater cooperation to enhance the transparency of applied policies; assess their impacts and establish mechanisms to consult and exchange information.

Keywords

International economic policy; multilateral cooperation; spillovers; competitiveness; economic integration

JEL Classification: F13

Introduction[*]

Competitiveness concerns are front and center in the economic sections of newspapers around the world. Improving competitiveness is a key objective for policymakers in Europe but is equally central in policy debates in the United States (Porter and Rivkin, 2012). Many high-income countries confront an urgent need to reduce public sector deficits and pay down high debt burdens that increased rapidly following the 2008 financial crisis. In part this will require an increase in net exports – which is only possible if the countries concerned are able to produce goods and services that are 'competitive' on world markets. The extent to which this can be realized will depend primarily on economic policy reforms by the countries concerned. A complicating factor is that such measures will be (are) pursued by many countries, so that whatever a government seeks to do to improve the competitiveness of firms based in its territory may be offset to a greater or lesser extent by actions that are taken in other countries. Moreover, the policies that governments pursue may generate negative international pecuniary spillovers. The effect of economic policies and regulatory measures implemented by a given jurisdiction on the firms located in other jurisdictions has long been the focus of debate and controversy. Actual or perceived spillover effects may motivate reactive (retaliatory) policies and become the focus of efforts to negotiate agreed rules of the game.

An influential strand of the economic theory of trade agreements is premised on the notion that the motivation for governments to negotiate trade agreements is to internalize the externalities that are created by the unilateral use of trade-related policies (i.e., terms of trade effects). The set of such policies is large, and extends well beyond the traditional focus of trade negotiators on tariffs and quotas that are applied at the border. While economists view trade agreements and international cooperation as driven by terms of trade externalities and/or political economy factors (trade agreements as commitment mechanisms), politicians, business people and civil society more generally often tend to frame concerns regarding the effects of policy measures taken by foreign countries in terms of the impact on the competitiveness of national industry. Abstracting from the current economic challenges confronting countries with unsustainable debt burdens and government budget deficits, competitiveness is a key focus of policy debates the world over, reflecting the recognition that in open societies the survival and growth of firms – and thus the creation of employment opportunities for the workforce – depends on their ability to increase their productivity. Many policies may affect the competitiveness of firms, either directly, or more frequently, indirectly.

"Competitiveness concerns" have been a staple feature of efforts to cooperate on economic policies, especially in the context of trade agreements and formal economic integration efforts. Indeed, one driver of such agreements has been to "level the playing field" for firms located in the participating countries. A recurring conundrum has been what policies to include; what should remain sovereign and what should become subject to common disciplines. During the period leading to the creation of the EEC, Jelle Zijlstra, the Dutch Minister of Economic Affairs, argued that tariff removal also required "common policies on taxes, wages, prices and employment policy" (Milward, 1992, p. 188) in order for firms to have a level playing field. Similarly, the Belgian coal mining industry argued in the late 1940s that a common market could only be accepted if German wage and social security costs were raised to Belgian levels. French officials persistently demanded policy harmonization in the social area—equal pay for both sexes, a uniform working week—as a precondition for trade liberalization (French standards in this area were higher than in other countries) (Hoekman and Kostecki, 2009).

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The European Union is the most far-reaching economic integration initiative extant involving sovereign states. Many policy areas that are excluded from shallower trade agreements are covered. Notwithstanding the depth of the European integration effort, however, there are very large differences in the competitiveness of the firms and industries located in different EU member states. The same is true for countries that are not parties to integration agreements – and in practice, notwithstanding the large number of PTAs that are in force, much global trade takes place between countries that do not have PTAs. Bilateral trade between the EU, US, Japan and China does not occur under the auspices of PTAs as none of the four entities have a PTA with each other. These stylized facts suggest that there exists substantial scope for countries to pursue greater cooperation ('deep integration'), but the example of the EU and the Euro zone illustrates that moving down this track – even if it proves to be feasible – will not necessarily remove or address competitiveness concerns.

Different approaches can be envisaged in dealing with (perceived) cross-border negative pecuniary spillovers created by policies in addition to reactive domestic policies. International law is one option. Others include "soft law" forms of bilateral or multilateral cooperation and delegation to independent entities that are given a transparency and analysis mandate—e.g., tasked with assessing whether and how large any negative spillovers are. In many cases there will be a significant degree of uncertainty as what the *net* effects of policies are, taking into account the *overall* impact of the relevant policy measures that have a bearing on firm-level competitiveness. A precondition for agreement on binding international rules is a shared recognition that the negative spillovers associated with a policy (set of policies) are significant and that a specific set of disciplines will result in greater efficiency (lower costs). At present there is no such recognition when it comes to important policy areas that generate negative competitiveness spillovers. An implication is that countries need to work towards putting in place the preconditions for stronger forms of international cooperation—by improving the transparency of applied policies; supporting independent analysis of the effects of policies; and establishing mechanisms through which governments can consult and exchange information.

1. Competitiveness and its determinants

The term "competitiveness" is widely used and many definitions have been suggested. Economists tend to take the view that competitiveness is a notion that applies at the level of an enterprise, whereas many commentators and pundits apply the concept to territories – cities, provinces, regions, and nations. Krugman (1994) has argued forcefully that the concept should not be applied to nations. Countries do not compete, firms do, and a focus on competitiveness at the national level can very easily result in an incorrect and perverse zero-sum view of international exchange (De Grauwe, 2010). Firms compete in global markets, with some firms winning (expanding their profits and growing) at the expense of other firms that lose market share, are forced to contract and may go bankrupt. At the firm level there are winners and losers, but for countries as a whole the competitive process is welfare-enhancing. That said, it is important for policy-makers to take a nation-level perspective of competitiveness because locational factors help shape firm-level competitiveness (positively or negatively) by determining the availability and cost of production inputs and operating and transactions costs. Competitiveness is the result of firms exploiting the sources of comparative advantage that prevail in a given location, many of which are endogenous in the sense of being the result of economic policies and institutions that have been put in place over time.

Analysts often equate a country's competitiveness with the real exchange rate (and changes in the real exchange rate over time), usually defined as the relative price of a basket of goods in two countries (consumer price index) or relative unit labor costs (Boltho, 1996). Another frequently used indicator is the (trend in) market (export) shares for a country (e.g., Del Gatto et al. 2012). Neither of these variables is necessarily informative about the determinants of either the level or changes of the indicators used, which is of course the key question for policy. Many factors can affect relative unit labor costs and the evolution of market share. The most broadly accepted definition of aggregate national competitiveness is total factor productivity (Porter, 1990). Delgado et al. (2012) define what

they term foundational competitiveness as the expected level of output per working-age individual (i.e., potential workers as opposed to those actually employed) given the overall quality of a country as a place to do business. The rate of increase in productivity determines the rates of return on investment, which in the aggregate determines economic growth rates in the longer run – the ability to generate greater output from any given supply of inputs. In such a longer-run perspective, competitiveness will be a function of the ability of firms to allocate and deploy resources to the most productive, highest valued activities. This in turn will depend on the feasibility and cost of re-allocating and re-deploying resources, with more productive firms expanding and others contracting or exiting. There is growing evidence that productivity differences *within* national industries is a major factor in determining cross-country productivity differences (Syverson, 2011; Altomonte, Aquilante and Ottaviano, 2012) and that the performance of services sectors plays an important role in this (Francois and Hoekman, 2010) . An implication is that competitiveness will be a function of the efficiency of product, labor and capital markets, as well as macroeconomic policies and the availability and quality of public goods provided by governments (infrastructure, security of property rights, etc.).

In a recent extensive empirical analysis and survey of the literature, Delgado et al. (2012) highlight three interrelated drivers of national competitiveness: (i) "social infrastructure" and political institutions, (ii) macroeconomic policy, and (iii) the microeconomic environment (including the business climate broadly defined to encompass factor markets, product market contestability, trade openness, physical infrastructure and the sophistication of company operations and strategy). All three are found to be significant drivers of competitiveness, but the last is argued to be most important in that it has the greatest impact on firm-level productivity. The other two broad drivers are economy-wide in their impact—affecting all firms or broad groups of firms similarly. The business/microeconomic environment in contrast may have very differentiated impacts by influencing the ability of entrepreneurs to start new activities and the ease of expanding and contracting economic operations. Moreover, the relevant variables can be influenced by numerous actors, including municipal or regional governments, as opposed to primarily being determined by the central government.

The approach taken by Porter and co-authors is very broad, spanning a large number of the relevant variables that affect competitiveness. Efforts to determine what matters from a more narrow trade perspective tend to take institutional and macroeconomic framework conditions as given and focus on policy areas that can be changed in the short run. The World Bank for example has developed a trade competitiveness policy toolkit that centers on three broad areas: economic policies that affect overall incentives; factors affecting operating costs; and policies that may be used to address national market failures (Figure 1).

Figure 1: Three pillars of trade competitiveness

Source: Reis and Farole (2012).

In operationalizing this framework the focus is on (i) the incentive framework for trade: anti-export biases created by trade and tax policy; the regulatory environment/investment climate confronting firms; and external market access conditions; (ii) factor inputs and trade costs: labor markets, skills, and the sophistication of management, accessibility and cost of production inputs, capital equipment, utilities, finance, and business services, as well as trade logistics and transport services; and (iii) proactive trade promotion policies: the capacity, incentives, and institutions that impact on innovation processes, standards and certification systems, and export and investment promotion mechanisms, including special customs regimes and economic zones, clusters and sector-specific support (industrial policy) (see Reis and Farole, 2012). Note that this more narrow focus on the determinants of *trade* competitiveness still spans a large number of policy areas, illustrating the challenge of identifying let alone agreeing on an international framework to "govern" the use of policies that impact on competitiveness.

2. Competitiveness drivers and international spillovers

The empirical literature on competitiveness and its determinants is informative as it helps to identify policies that impact on competitiveness. At the same time a problem from an international law or rule-making perspective is that almost anything can matter for competitiveness. The problem is to determine what types of policies create the greatest negative pecuniary spillovers and where there is scope for international coordination to improve outcomes for all participating countries. The empirical literature suggests that the microeconomic environment is key(Altomonte, Aquilante and Ottaviano, 2012; Delgado et al, 2012), whereas the center of attention in policy debates on competitiveness spillovers is often on macroeconomic variables such as monetary policy, intervention in the foreign exchange market, or allegations that countries target recurring current account surpluses that in turn result in large global imbalances. Macroeconomic policies will shift incentives for the whole distribution of firms located in a country as opposed to targeting or affecting the growth of the most productive and innovative firms. Macroeconomic policy can have major impacts on export performance and economic growth and development in low-income countries with distorted domestic markets, but the literature on competitiveness suggests that good macroeconomic policy is a

necessary, not a sufficient condition for competitiveness. What matters more (most) from an overall productivity growth perspective is the *micro*economic incentive framework.

Macroeconomic policies may generate negative spillovers if a country is large enough to affect world prices/interest rates. The export-driven growth strategy pursued by China with great success is often claimed to be a case in point, with critics arguing that China has pursued a policy mix that targets an undervalued exchange rate, subsidizing its exports to the detriment of employment in other countries (Bergsten and Gagnon, 2012). Exchange rates have often been the source of economic tension between trading partners. Countries that are running large current account deficits – that import much more than they export – frequently claim that surplus countries are "unfairly" manipulating the exchange rate so as to give their exporters a competitive advantage – increasing the domestic prices of imports and reducing the foreign currency denominated export prices. In the 1980s such claims were frequently made against Japan and the Asian "tigers"; in the 2000s it was the turn of China to bear the brunt of such complaints.

A depreciation of the exchange rate can be equivalent to a combination of raising import tariffs for all traded goods and providing local firms with an across-the-board export subsidy. Governments have long been concerned with the possibility that a trading partner might pursue policies to engineer a depreciation of the exchange rate so as to undo trade liberalization commitments negotiated in trade agreements. Such concerns have become particularly prominent in recent years as a result of the build-up of large current account surpluses and foreign exchange reserves by a number of countries, especially China. Perceptions that exchange rates are manipulated can generate pressures for protection by businesses that confront competition on both their home and export markets. More generally large swings in exchange rates can also have major impacts on debt service levels of countries that have borrowed in the affected currencies, giving rise to fiscal pressures. The rise in the US dollar in the 1980s was a factor in the debt crisis of that time and affected both debt restructuring and the required increase in net exports by borrowers.

Whether major negative spillover effects are associated with specific policies is an empirical matter. In cases where there are negative pecuniary spillovers, a key issue is to disentangle intent from effects. To continue with the case of deliberate undervaluation of the exchange rate, this can be one element of a policy aimed at stimulating economic growth by increasing the profitability of the tradable sector in contexts where firms confront a bad investment climate and high operating costs as a result of domestic distortions (Rodrik, 2008). If there are also positive externalities associated with expanding exports of manufactures, measures such as currency depreciation may be welfare-improving for the country concerned as well as the world as a whole (Eden and Nguyen, 2012). Freund and Pierola (2008) find that significant increases in manufactured exports that are sustained for at least 7 years (what they call export surges) in many developing countries were often preceded by a real devaluation of the exchange rate. This generates not just an expansion in existing exports but entry into new export products and new markets. The latter are important, accounting for 25 percent of export growth during the surge in developing countries. They argue that maintaining a competitive currency leads firms to expand the product and market space for exports, inducing a large reorientation of the tradable sector.[1]

The cost and quality of numerous services inputs will affect the competitiveness of firms, as services are important elements of production and transactions costs. The costs of services may be increased as a result of limited competition that allows prices to reflect significant markups over costs. Actions to reduce these excess costs and improve quality will enhance the competitiveness of firms located in the markets concerned, with an aggregate effect that is akin to a depreciation of the real exchange rate. If it is difficult to address the various distortions in an economy that give rise to excess

[1] Disentangling the two can be very difficult in practice, in that the objective of a policy may be to offset an externality, but the level of the instrument used is such that it goes beyond what is needed to do so.

costs for firms, it may be more straightforward to seek to depreciate the exchange rate as a way of offsetting (some of) the excess operating costs. There are many market failures that can have a negative effect on competitiveness of firms. A common example is credit constraints for small and medium sized firms—e.g., absence of financing for investment in new technology or new business lines—that prevent upgrading and the production of higher value-added products. While policy interventions should be targeted at the source of market failures, in the interim 'compensating measures' such as maintaining an undervalued exchange rate may help firms to exploit their competitive advantages.

Maintaining a competitive real exchange rate is important for economic growth, but the national welfare case for targeting the exchange rate is premised on tradable sectors suffering disproportionately from market failures. Whether this is true is an empirical matter. The extent to which undervaluation will "work" in expanding net exports will depend on many factors, including the behavior of nominal wages (if these increase, the competitive impact will be undone), the ability of the monetary authorities to control inflationary effects (which can generate macroeconomic instability with associated costs that far outweigh what will be the temporary advantages given to exportables), the extent to which firms rely on imported inputs (in an increasingly supply chain driven world, a tax on imports is a direct tax on exports that embody the imports—so that the competiveness effects of a depreciation will be offset the higher is the degree of integration into global value chains and/or the import dependence of firms); the degree to which exporters hedge against foreign exchange risk; and the currency in which they invoice their products. All these factors matter for the effectiveness of the policy for the country pursuing it, and thus for any assessment of the extent to which there are negative spillovers for other countries.

Deliberate policy intervention that aims at lowering the exchange rate can generate negative international competitiveness spillovers for competing exporting firms, but this is not the case for policies and institutions that incentivize firms to improve productivity performance. As mentioned, there is a large set of policies and institutions that have a bearing on productivity growth (competitiveness). Countries that put in place an appropriate enabling microeconomic environment – such as an innovation regime that encourages investment in human capital and R&D; a financial system that provides firms with access to start-up equity capital and funding for expansion; actions to enhance competition on services markets so as to reduce the cost of services inputs and increase quality; corporate governance mechanisms that reward performance; an open trade and investment regime – will presumably experience higher productivity growth rates and generate more competitive firms that grow market share internationally. However, this does not constitute a negative spillover. The same is true for more fundamental determinants of national competitiveness that will take longer to change such as public health and educational attainment, or for factors that cannot be changed – such as location and natural endowments.

Much can be learned from successful countries concerning what types of policies and institutions matter, but the fact that some countries do better than others is not a justification for the latter to argue that the actions put in place by the former are to their detriment. To the contrary – higher productivity performance and growth in successful nations creates greater economic opportunities for all countries, as long as markets are open. Less dynamic countries that are not able to put in place an incentive framework that supports competitiveness may have lower growth and GDP per capita, but that is the result of their own implicit or explicit choices. This is not to deny that policies that target specific industries or firms can generate negative international spillovers. However, the policies and institutional factors identified in the literature as drivers of competitiveness are not sector- or product-specific but focus on activities that are "general inputs" into productivity growth. Common examples would be designing the tax regime so as to generate incentives for R&D investments and actions to ensure (greater) availability of finance and venture capital, as well as measures to ensure that markets are contestable so as to facilitate expansion by dynamic firms into new activities and to grow.

3. Some implications for international cooperation

Generally applicable regulation and other government policies that affect relative prices for firms will affect competitiveness. But for there to be a case for seeking to agree on international rules there need to be spillovers—terms of trade externalities—or coordination failures that result in prisoner's dilemma type inefficient outcomes. There also needs to be clarity on the policies that generate the externalities – it is not enough to point to outcomes such as current account surpluses or large bilateral trade imbalances as these can be the result of many factors of a structural nature as well as policies. As discussed below, this is a major problem when it comes to thinking about what rules might be appropriate and what remedy to apply in cases where such rules are found to be violated. Thus, international cooperation may be difficult to achieve. Even if specific policies can be identified, coordination or harmonization may not enhance national economic welfare, especially if specific outcomes (e.g., current account balances) reflect aggregate savings and investment behavior and/or differences across countries in social preferences, demographics, and so forth.

In many of the policy areas that are the focus of attention in "competitiveness" policy debates, differences in policies — e.g., with respect to labor standards, social security or similar forms of regulation—may not affect the ability of firms to compete on world markets. If firms in "high labor standards" countries can ensure that the incidence of the implicit tax is borne by workers—that is, that the work force pays for the resulting benefits through lower wages—labor costs may be unaffected (Ehrenberg, 1994). Moreover, insofar as the cost-raising effects of worker's rights cannot be fully shifted to workers, the resulting increase in product prices (due to higher costs) will put pressure on the exchange rate (because foreign demand for exports falls as prices increase, all other things equal). The resulting depreciation will lower the standard of living by raising the cost of imports. While the whole economy thus bears the burden of the higher standards, the exchange rate adjustment allows firms to continue to compete on world markets. As long as the labor standards or other social regulation in force reflect the desires of citizens, the costs of implementation simply reflect the trade-off between monetary and non-monetary wealth that society has made.[2]

What matters for rule-making is not just whether there are clear (agreed) policy-specific externalities and coordination failures but also whether an agreement can be enforced. The dispute settlement system of the GATT/WTO has been a major factor motivating suggestions that the WTO should be expanded to include more disciplines on policies that (are claimed to) impact on competitiveness. Thus the ability of dispute settlement to deal effectively with conflicts is another criterion to factor in when considering binding international rules in an area (Maskus, 2002).[3]

The WTO and regional trade agreements tend to focus on discrimination at the level of a product or a sector. Even where there are rules that discipline the use of general policies – such as the ban on export subsidies or quotas – the application of such policies is generally specific to a product or a sector. Much of the debate on competitiveness revolves around policies that are general in the sense that they affect production costs or relative prices – such as the (real) exchange rate – or affect the dynamics and potential growth performance of an economy as a whole. As noted, the literature suggests the key driver of competitiveness in the longer-term is the microeconomic incentive framework – the investment climate/business environment broadly defined. If this is messed up, there is a good case in the short run for targeting the (real) exchange rate to offset the associated disincentives. This is not a longer-term solution of course – there is a need to address the various distortions/disincentives directly, which needs to be pursued in parallel (and will of course in turn be reflected in the evolution of the real exchange rate). Whether the concern is a product-specific policy

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2 These issues were analyzed in depth by scholars in the 1990s—see, e.g., Bhagwati and Hudec (1996) and Lawrence et al. (1996).

3 There are different dimensions to this but a key one is that trade remedies (import protection) need to be effective in dealing with the effects of the policies that are deemed to violate a WTO commitment.

or more general economic policies that impact on the real exchange rate, the key for international cooperation is that there is a terms of trade externality or coordination failure. The solution to the former may be binding international rules, while the latter type of problem may be more effectively addressed through other forms of cooperation.

What follows discusses several policy areas that seem particularly germane from a competitiveness perspective: macroeconomic policies that have an impact on trade, and microeconomic policies that promote/support the allocation of resources to dynamic/innovative firms.

Macroeconomic policies

Misaligned exchange rates ("currency manipulation") can have negative spillovers and thus international cooperation could in principle be globally welfare improving. Defining what types of specific international disciplines would result in such improvements is extremely difficult however, in part because it may not be clear whether there is in fact a significant negative spillover, and if there is, what the appropriate remedy is. As has been discussed in depth in the literature on this subject there may be very good reasons why exchange rates diverge from "equilibrium" levels for long periods of time that have nothing to do with a desire to circumvent market access commitments. Nor is undervaluation necessarily a reflection of deliberate attempts to engage in beggar-thy-neighbor, mercantilist behavior aimed at generating large trade surpluses. It is important to recognize that current account balances reflect the difference between aggregate savings and investment in a country, and that these variables are driven by many factors – demographics, the financial system, social preferences, investment opportunities, the pension regime, etc. Seeking rules on maximum allowable global current account surpluses over a given period of time or on the extent to which the real exchange rate can deviate from its "equilibrium rate" over a given period would constitute significant intrusion into economic policy in that it implies a need to commit to a willingness to intervene to change savings and investment rates and second guess WTO Members social policies and preferences. It would also imply a major shift away from the approach that has been pursued to date in international trade cooperation by targeting outcomes as opposed to agreeing to disciplines on specific policies that generate spillovers.

Given that the IMF cannot force governments to adjust exchange rates – it can only advise – there have been suggestions that the WTO members should agree to stronger rules in this area that can be enforced through dispute settlement. At the moment, the WTO does not provide this possibility, other than through GATT Article XV. This calls for WTO members to cooperate and consult with the IMF on matters relating to foreign exchange reserves, the balance of payments and exchange rate issues. It states that the CONTRACTING PARTIES and the IMF "may pursue a coordinated policy with regard to exchange questions" and that contracting parties "shall not, by exchange action, frustrate the intent of the provisions of the GATT." The existence of the IMF helps understand why the GATT/WTO disciplines are not very specific: it is left to the IMF to address exchange rate misalignments.

Mattoo and Subramanian (2009) argue that if there is a clear finding of undervaluation and this is clearly due to government action, this should be regarded as fully equivalent to a violation of import tariff bindings and the ban on export subsidies. They recognize that undervaluation can result from a number of factors, including fiscal and monetary policies, policies related to capital flows, taxes and subsidies, and intervention in foreign exchange markets, but argue there is a clear hierarchy of policy actions in terms of proximate causation. Prolonged one-way intervention in foreign exchange markets by the central bank or by government and quasi-government agencies, redenomination of domestic debt into foreign currency, and extensive forward market operations are policy actions that can clearly be identified as causes of undervaluation. In such cases, they propose that countries bring cases to the WTO, with the IMF – as is already the case when members invoke the GATT balance of payments articles – being tasked to assess whether the member's exchange rate is misaligned and whether this is a consequence of government action. Thorstensen et al. (2011) and Lima-Campos and Gil (2012) have

argued that WTO Members should launch countervailing duty investigations against currency manipulators, defined as countries with sustained exchange rate levels that are greatly depreciated as compared to the levels that applied when tariff concessions were negotiated.[4] Gagnon (2012) argues that that WTO rules should be reformed to facilitate the use of import tariffs on the exports of countries found to be currency manipulators.

There are compelling arguments why efforts to go down the path of invoking the WTO's contingent protection or dispute settlement mechanisms are likely to do much more harm than good in terms of sustaining multilateral cooperation or addressing the underlying source of the externality. One reason is that it is necessary to consider the overall current account and not bilateral trade balances. One deficit country taking trade action against a surplus country may not do much to affect the balance of overall imports and exports of the two countries concerned. Moreover, as a result of the rapid rise in vertical specialization and intra-industry trade, much of a surplus country's exports may embody imports sourced from the deficit country – so that an import surcharge by the latter may also negatively affect its exports. The level of the real exchange rate is not a policy instrument on which a government can make specific commitments. It is endogenous, and will reflect a mix of fiscal and monetary policies. Whether a government is engaging in deliberate undervaluation is inherently a subjective exercise, not least because there are different methodologies and approaches to determining the "equilibrium" real exchange rate, which may generate quite different benchmarks (Eden and Nguyen, 2012). Even if the assessment is left to the IMF—as required by GATT Article XV—it will be very difficult to objectively assess in a specific disputed case whether there is currency manipulation, and if so, to what extent a country is undercutting its trade policy commitments to liberalize access to its markets and/or is subsidizing its exports. There are many other objectives that may underpin an active monetary and exchange rate management policy that have nothing to do with seeking to circumvent trade policy commitments (Staiger and Sykes 2010).

Current account surplus countries have historically never been willing to subject themselves to binding international disciplines. At the end of the day policies that result in large current account surpluses are costly to the countries pursuing such behavior as they imply suppressing domestic consumption. Over time there will be endogenous pressures limiting the magnitude of sustained imbalances and pushing towards adjustment of the underlying policies – as has been occurring in the case of China. Equally important is to recognize that from a competitiveness perspective, countries running large, sustained current account deficits that reflect an excess of consumption over income need to put their own house in order—by focusing on improving both the macro- and microeconomic environment that determines productivity performance. Improving product market regulation (reducing barriers to competition in services sectors, including network industries); permitting foreign ownership; lowering trade barriers; labor market reform to enhance labor mobility; eliminating fiscal distortions (e.g., non-renewable energy subsidies); improving educational quality and outcomes, R&D and innovation incentives and the quality of infrastructure; controlling the cost of healthcare; etc.

That said, whatever one's views, doing more to clarify, analyze and discuss what the effects are of prevailing policies would help to identify the extent of negative spillovers and possible actions that could be taken to enhance competitiveness in deficit/low productivity countries. The same is true with respect to the possible spillover effects on capital flows of the monetary policies that are pursued by large countries—e.g., the current debates about the impact on the rest of world of monetary easing by the US and the EU, which some countries argue generates capital inflows and thus puts pressure on their exchange rates/competitiveness. As argued by Irwin (2011) there is a clear case for the IMF and the WTO to work out how they can help defuse current and future disputes over exchange rate/monetary policy and, more specifically, whether agreement can be obtained on specific "rules of

[4] One problem in pursuing this suggestion is that the WTO requires subsidies to involve a financial contribution by the government and be product-specific in order to be actionable. An undervalued exchange rate will affect all exports and is not specific.

the game." Gagnon (2012), Irwin (2011), Mattoo and Subramanian (2009) and many in the policy community in the United States and Europe take the view that trade retaliation should be on the table as a remedy if these rules are violated. This is arguably seriously misconceived as it can easily lead to the unraveling of the open multilateral system of trade and the predictability of the policy environment in which traders operate. Trade policy should not be seen as an appropriate tool to address monetary policy related conflicts. If countries can agree to stronger rules, given that much of the concern relates to the effects of the induced capital flows, taking action to tax capital inflows (raise the cost of buying domestic bonds or other financial instruments) is a more appropriate remedy, one that is currently unconstrained under the WTO and that can be implemented unilaterally by governments as an instrument to manage the impacts of capital flows.[5]

Spillovers from microeconomic policies affecting competitiveness

As noted earlier, much of what matters for longer-run competitiveness should not generate negative spillovers and thus does not give rise to a need for international disciplines. Potential exceptions are industrial policy type sector-specific interventions. This is of course is a well known issue area for international rule-making, as reflected in WTO disciplines on the use of export subsidies and trade policies that can be used to offset tariff reduction commitments such as local content requirements. The 2008 financial crisis gave rise to a significant increase in the use of subsidies of different types, some of which were aimed at stimulating demand – e.g., "cash for clunkers" programs to stimulate demand for automobiles – while others involved support for specific sectors (e.g., governments taking direct equity stakes in financial services and car companies) (see the Global Trade Alert website). Clearly such policy interventions affected competition on the relevant markets concerned. Looking forward there may be more recourse to subsidy-type policies as traditional border trade policies (tariffs, quotas) have become much less effective in supporting domestic economic activity as a result of global production fragmentation and the organization of production in international value chains. Rather than restrict access to markets – which raises the costs of imports that increasingly are direct inputs into export production – governments may respond to pressures to create/safeguard jobs at home by providing subsidies to local economic activity, whether *de jure* or *de facto*.

The WTO Agreement on Subsidies and Countervailing Measures (SCM) prohibits export subsidies and establishes conditions under which domestic subsidies that cause adverse effects for other WTO Members can be challenged or countervailed. The WTO does not restrict the ability of governments to use subsidies or to allocate subsidies to domestic producers only—Art. III:8 GATT explicitly excludes subsidies from the national treatment rule. To be actionable subsidies must be *specific*, entail a *cost* to government and create a *benefit* for firms. Adverse effects are defined in trade terms: the subsidies create adverse trade effects for other WTO members. The SCM agreement does not specify any types of specific subsidies that are permitted and thus are not actionable.[6] The problem that arises is that subsidies may be an appropriate instrument to address market failures – along lines of the case for an undervalued exchange rate to offset domestic distortions – but may give rise to international competitiveness spillovers. At the moment the focus of WTO rules is only on the latter; it is irrelevant as far as the WTO is concerned what the subsidy aims to achieve. In general, as is well known, a subsidy can be an efficient instrument to offset some types of market failures. If a subsidy offsets/corrects market failures in principle it cannot be held to create a negative spillover on foreign

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5 Restrictions on capital flows can play a useful role in coping with surges of capital inflows and the associated spillovers (asset bubbles; potential financial instability) that are in part the result of monetary policies in large trading partners (see e.g., Magud and Reinhardt, 2006; Ostry et al. 2010; and Canuto and Cavallari, 2012). Of course, this is not a panacea: one country's success in using capital controls will increase the difficulty for other nations doing the same (Committee on International Economic Policy and Reform, 2011), pointing to the need for greater communication between authorities and justification of the measures taken (Canuto et al, 2012).

6 A provision that did so or some specific subsidies was time-bound and lapsed in 2001.

interests and or raise a competitiveness issue. The problem is that the WTO ignores what a subsidy is aimed to achieve—the focus is only on trade effects. If a country has made tariff commitments and subsequently decides to use a policy instrument such as a specific subsidy it may have an adverse trade effect on trading partners and thus be actionable even if the sole objective is to correct a domestic distortion.[7]

The WTO makes allowances for countries to invoke a general exceptions provision (Article XX GATT) to use otherwise prohibited trade policies as long as these do not discriminate between domestic and foreign goods and are necessary to achieve a regulatory objective (e.g., protect health and safety; conserve non-renewable natural resources), but this provision does not (cannot) apply to non-prohibited subsidies (as these are not disciplined by the SCM agreement, which only lays out when domestic subsidies are actionable) and cannot be used to justify specific subsidies because of the non-discrimination requirement (Mavroidis, 2012). Moreover, an exception will not insulate a country against countervailing actions (Howse, 2010). As a result, governments may be pressed to take unilateral action against imports produced by firms that are deemed to have benefited from subsidies whatever the rationale or effect of the subsidies beyond trade. Thus, "competitiveness concerns" may conflict with the objective of addressing market failures and give rise to pressures for countervailing action by other countries.

A key policy issue is whether and what types of specific subsidies motivated on the basis of market failures, should be permitted. For example, should free allowances made under emission trading schemes be actionable? Feed-in tariff programs that pay renewable energy producers a premium for green energy generation? Given the rapid increase in green tax/subsidy-related trade disputes and countermeasures (antidumping and countervail cases for solar panels; feed-in tariffs; the EU decision to extend the ETS to all airlines landing in its territory) international agreement on what constitutes 'acceptable' targeted policies that are beneficial for the environment (address market failures) and should be non-actionable would help reduce the scope for globally welfare-reducing actions taken under the banner of competitiveness (Henschke, 2012). The same is true of other subsidy policies that can be justified as aiming to offset specific market failures. A case in point is the treatment of special economic zones (SEZs) and the scope for SEZs to fall foul of the ban on export subsidization. Just as deliberate targeting of a competitive exchange rate may be a short term instrument to offset the effects of a bad investment climate, SEZs can be effective instruments to insulate firms from an unsupportive business environment that impedes investment in tradable industries.

4. Improving global governance

A common theme of the literature on competitiveness is to identify a set of policies that can be pursued by governments to enhance the long term productivity performance of the economy. A feature of virtually all the literature is that the focus is on countries. While there is much cross-country comparison and analysis of policy indicators and outcomes, there is however mostly little attention given to the potential for negative pecuniary spillovers, let alone empirical estimates of how large spillover effects are. One reason for this is that what drives competitiveness is mostly determined by national governments and polities—what other countries do certainly may have impacts on competition on global markets but in many, if not most, countries it is the national investment climate broadly defined that is the main determinant of the ability of national firms to compete effectively on world markets. The exceptions are the literatures on "industrial policy" (targeted intervention that impacts on production incentives for specific industries or economic activities) and on "global imbalances" (the strand that focuses on "export mercantilism", i.e., deliberate exchange rate undervaluation aimed at sustaining large current account surpluses.

[7] One result is that the rules may distort what governments are willing to commit to in the WTO. See Bagwell and Staiger (2006) for an analysis of the incentive effects of existing WTO rules on subsidies.

In both these areas matters are not by any means clear-cut when it comes to the global welfare effects of specific policies and the magnitude (or even sign) of negative spillovers. As discussed above, there is a serious tension between concerns about the competition effects of industrial policies and the need for intervention to address market failures. One can (and should) question whether policies do in fact address such failures but this is not to deny that policy intervention can improve allocative (and dynamic) efficiency. As argued above, there is a clear case for revisiting the current WTO rules in the area of subsidies. On the macroeconomic sources of potential spillovers, there are numerous possible rationales for countries to have current account surpluses – including self-insurance against exogenous shocks and "sudden credit stops"; financial repression implemented as part of an economic development strategy; regulation of product and factor markets that reduces competition and raises costs of entry and operations, thereby lowering investment; limited financial market development and weak governance that generates excessive corporate savings; or weak social protection (safety nets; health insurance; pension systems) that induces high precautionary savings by households.

The underlying drivers of large current account imbalances are likely to impede long-run growth and thus are unlikely to be sustained in the long run. Rebalancing must involve changes in economic structure. The associated "competitiveness agenda" overlaps to a significant extent with the need for "structural reforms" to increase competition in services sectors (health; financial services (pension systems), professional and business services, transport and logistics, as well as product and labour market regulation. Developing countries face significant difficulties in designing such reforms, in part because of concerns about the realization of regulatory objectives. There are multiple players with different objectives within governments that have a role in setting regulation. Moreover, efficient provision of services often involves a cluster of activities that cuts across multiple regulatory agencies, making it more difficult to determine what is needed to improve competitiveness.

These are areas where it will be difficult to agree to binding rules on the substance of regulation through negotiations, even in cases where there are negative spillovers/terms of trade effects. A problem for international cooperation is that frequently policies and their effects are not transparent – not enough is known about extant policies and their impacts. More systematic collection of information on relevant policies and objective analysis of their effects on competitiveness and any spillovers is a pre-condition for any effort to arrive at a common understanding of any specific situation. This is in part being done by organizations like the OECD and the World Bank, but it arguably needs to become much more central to the work of the WTO. Bolstering voluntary mechanisms that are open to all countries that focus on the identification of beneficial structural reforms, including in services sectors, from a national self-interest perspective could help prepare ground for possible enforceable agreements on specific policies once there is a common understanding that this would benefit all participating countries.

Hoekman and Mattoo (2010) suggest the formation of "knowledge platforms" that would act as vehicles through which countries can assess/analyse the impacts of current policy regimes and identify beneficial reforms and the investments needed to implement them. Such platforms would connect stakeholders to different sources of expertise – local, regional, global; facilitate knowledge exchange; build on existing networks of regulators and industry associations; and connect with both the donor community for support for implementation of reforms in developing countries and the business community – which has a direct stake in pro-competitive reforms and needs to play an active role in monitoring progress in implementing reforms and holding governments accountable for results. While undoubtedly a complex, resource-intensive, time-consuming exercise, shifting the focus of international more in this direction is arguably a necessary condition for "ownership" and political support for putting in place policies that will enhance competitiveness.

The incorporation of such forms of cooperation is sometimes found in PTAs. Often this takes the form of provisions to provide technical and other forms of assistance, and the establishment of mechanisms for the exchange of information, interactions between business

associations/investors/civil society groups, and non-economic forms of cooperation (e.g., student or cultural exchanges). PTAs often also create a variety of official bodies that are tasked with implementation of the agreement in specific areas and that can act as mechanisms through which the regulators and other officials from the participating countries establish working relationships. One lesson from successful North-South PTAs is that the prospects for the agreements to enhance the welfare of developing country signatories are improved if the focus extends beyond market access (i.e., terms-of-trade externalities) and government-to-government interaction. Including complementary measures that aim at improving the domestic regulatory environment; bolstering related institutions; the provision of technical and financial assistance; and active engagement by the private sector in surveillance and enforcement of commitments is equally if not more important.

5. Concluding remarks

Although the rapid increase in global integration and production-sharing (international supply chains) means that trade policy is likely to feature much less prominently in the toolbox of governments in the future than it has in the past, other instruments such as monetary, fiscal or industrial (sector) policies continue to have an important role to play. These are appropriate instruments for governments to use in the pursuit of growth and development goals, but they can have beggar-thy-neighbor features and thus generate international tensions. Addressing such conflicts – which in part will be the consequence of successful pursuit of export-led growth and thus be difficult to disentangle from more general competitive pressures – in a cooperative manner is important both to prevent recourse to unilateral trade 'retaliation' by trading partners and to allow those countries that are most in need of effective pro-active policies to use them without fear of negative reactions from the rest of the world.

For there to be a rationale for countries to negotiate internationally binding rules on specific policies, they need to generate terms of trade spillovers. This also applies to policies that impact on the competiveness of firms in a country: the question is to what extent such policies generate negative pecuniary spillovers. The literature on the determinants of competitiveness suggests that policies and institutions that support the emergence of productive firms and boost overall total factor productivity do not generate negative spillovers. What this suggests from a global governance perspective is that mechanisms are needed that generate greater transparency and facilitate learning about what works and what matters for competitiveness. This is the focus of work by many organizations, including the IMF, the OECD, and the World Bank. It is not however a focal point for the WTO. Thus, one conclusion suggested by the discussion in this paper is that the WTO membership – the primary international organization where competitiveness concerns will arise and can be addressed – consider doing more to promote such exchanges.

Deep integration based on internationally agreed, binding norms that are applied on a nondiscriminatory basis to all traders may enhance global welfare. But, the need for deeper integration on most issues that impact on competitiveness is arguably limited. Frequently, shallow integration will be a more powerful instrument – i.e., competition between regulatory regimes that reflect national circumstances. In areas such as social regulation and macroeconomic policies it will be very difficult to achieve deep integration (coordination or harmonization of policy). A necessary condition is a common understanding of how regulation/policy affects competitiveness. This can be pursued via creation of processes through which governments and domestic stakeholders can identify the effects of policies and alternatives that are likely to enhance competitiveness. Entry barriers such as non-recognition of professional certification and qualifications and conformity assessment regimes that imply redundant costs for foreign suppliers are examples of regulatory areas where domestic reform can do much to reduce to foster greater competitiveness. Binding international law that spells out the substance of the relevant regulatory requirements is not likely to be feasible or desirable, however. A focus on agreement on good regulatory principles (process- and transparency related) and creation of mechanisms through which firms can interact with governments to identify market-segmenting

impacts of prevailing policies and less-trade restricting alternatives is likely to be a more productive path.

The same applies to macroeconomic and monetary policies, where a first step should also be more open discussion and specific analysis of the spillover effects of policies. Seeking to agree on binding rules seems very unlikely to be feasible—it is difficult to imagine large countries ever agreeing to be subject to binding legal disciplines outside of the framework of a monetary union (and even then the Eurozone illustrates that the degree of integration that is required is very far-reaching). Deficit nations are ultimately subject to market discipline, while surplus countries confront "only" political market discipline—insofar as large, sustained surpluses that are the result of deliberate policies, governments will be subject to political pressure from their citizens if the costs in terms of consumption and investment returns forgone become too high. It is important in this connection to recognize that the recent period that has given rise to macroeconomic policy-induced competitiveness concerns has been rather unique in that it is associated with China's re-integration into the global economy. This has been very beneficial to China as well as the world as a whole, but the rapidity and magnitude of the resulting shifts in trade shares and relative incomes has been unprecedented, giving rise to major adjustment costs for other countries. However, it has also created great opportunities as the effective size of the world economy has increased substantially. The policy challenges of leveraging this opportunity into sustained higher growth are primarily domestic—putting in place a supportive business environment and investment climate that generates high quality jobs for citizens.

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