A joint initiative of Ludwig-Maximilians-Universität and the Ifo Institute for Economic Research

CESifo Forum

Autumn 2003

Volume 4, No. 3

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CESifo Forum ISSN 1615-245X
A quarterly journal on European issues
Publisher and distributor: Ifo Institute for Economic Research e.V.
Poschingerstr. 5, D-81679 Munich, Germany
Telephone ++49 89 9224-0, Telefax ++49 89 9224-1461, e-mail ifo@ifo.de
Annual subscription rate: €50.00
Editor: Heidemarie C. Sherman, Ph.D., e-mail sherman@ifo.de
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CESifo Forum

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The Doha Development Agenda

Market Access and Domestic Support Measures

Lionel Fontagné*

Cancun has been a disaster and the developing countries, notwithstanding the emergence of the G90 and G22, could be at the end of the day badly hit by this collapse of the multilateral trade negotiations. The Round launched in Doha (November 2001) was after all aiming at opening markets in order to foster growth and alleviate poverty in the developing world.

Before Cancun, public opinion was focusing on the interpretation of the *TRIPs* agreement, concerning the enforcement of intellectual property rights for medicines. The possibility to take measures (compulsory licenses, production of generic drugs) to protect health in case of diseases such as AIDS had been reaffirmed in Doha, and the translation of this position in terms of specific policies independently from the outcome of Cancun has been a major achievement in economic terms (Bell et al., 2003) and from a moral point of view. But there are a series of other key issues incorporated in this agenda on which progress has been delayed as a follow up of Cancun.

First, implementation-related issues have been raised by the unbalanced deal concluded in Marrakech. The developing world considers that developed economies have not fulfilled their commitments concerning the pace of liberalisation in labour intensive industries (notably regarding the implementation of the Agreement on Textiles and Clothing – ATC), whereas their own commitments (especially concerning intellectual property) are disproportionate. The next item is agriculture. The famous ambiguous formulation regarding "reductions of, with a view to phasing out, all forms of export subsidies" is only part of the story. Market access as well as distorting domestic policies are key issues. Then come the negotiations on services, on market access for non-agricultural products, and on the sensitive Singapore subjects. Interestingly, this Agenda ends by taking into consideration specific needs of the Least Developed Countries (LDCs). First, the objective of duty-free, quota-free market access for products originating from LDCs is endorsed by the declaration; second the importance of provisions regarding Special and Differential Treatment (SDT) for LDCs is reaffirmed.

Such an Agenda raises a lot of concerns, and the Cancun disaster might after all be the outcome of a lack of commitment of unconvinced stakeholders.

The Doha Agenda: complex inter-relationships

First, the relationship between market access and development, or more generally between growth and openness, is far from clear. The literature demonstrates that opening an economy is only a prerequisite of growth: capital accumulation, education, institutions are needed. Hence, liberalising imports in the South, or conceding free access to the markets in the North, is only a building block in a wider development policy.

Second, it is even less clear whether the various objectives contemplated in the DDA are mutually compatible. If market access is favourable to growth in the LDCs, then liberalising imports in the North on a multilateral basis will erode the margin of preference conceded to LDCs and will reduce their access to these markets. If less distorting farm support in the North increases world prices of food products, LDCs that are net importers of food will be adversely affected through negative terms-of-trade effects. In total, this agenda is an intricate menu of objectives and means that could lead to deceptive or undesired outcomes.

Against this background, this article aims at focusing on objectives and possible outcomes of the

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negotiations concerning market access and domestic support for agriculture and manufacturing.

Markets remain protected

Improving market access is still an "unfinished business" (WTO, 2002). Despite low average levels of protection, agriculture and labour intensive industries carry a much higher level of protection than the average. The dispersion of tariffs within sectors can be very large too, due to tariff peaks on certain tariff lines. Distortions induced by such variance in tariffs are sizeable: a uniform duty equal to the mean tariff would be welfare-improving and less easy to capture by vested interests. Hence, both international trade theory and political economy point to an extraordinary loss of resources potentially associated with the intricate system of protection exporters face, notwithstanding administration costs of the various regimes or compliance of rules. On top of this, a variety of instruments are used to protect markets that make the measurement of protection levels more complex: how to tackle this complexity will be a key issue of the current Round.

Negotiators have to deal with measurement problems

There is no unified measure of protection

The (simple) average of bound tariffs[1] for industrial products in the Quad is 5.2 percent for Canada, 4.1 percent for the EU, 3.9 percent for the US and 3.5 percent for Japan (in 2000). In agriculture, the simple average of bound rates is more difficult to estimate: there are notably a series of instruments that must be converted into ad valorem equivalents. The tentative estimation by the OECD leads to 19.5 percent tariff for the EU, 11.7 percent for Japan, 5.5 percent for the US and 4.6 percent for Canada. The World Bank gets much higher results, respectively 20 percent, 29.7 percent, 9.0 percent and 8.8 percent.

Developing countries are even more protective of their markets. The (simple) average of bound tariffs for industrial products is, for instance, 17.6 percent for Cameroon and 31 percent for Argentina.[2] The estimated simple average of tariffs in agriculture is 88.3 percent for Colombia and 124.3 percent for India, according to the OECD. The World Bank finds respectively 105.6 percent and 101 percent for the latter two countries.

MAcMaps, the new database on trade barriers recently developed by the ITC (UNCTAD-WTO) in collaboration with the CEPII (Bouët et al, 2001), points out a similarity of production levels between the EU and the US, on the basis of weighted averages (all products), namely 3.9 percent for the EU and 4.3 percent for the US in 2001. In contrast, Canada (6.7 percent) and Japan (10.7 percent) are much more protected.

A variety of instruments of protection are mobilised

The reason why such differences occur in the results is a rather technical matter, which could merit considerable development. To put it simply, at least four main elements have to be taken into account. First there is a difference between bound and applied (MFN[3]) tariffs. Second a series of preferential agreements have conceded preferential tariffs, below MFN levels. Third, not all tariffs are defined in ad valorem terms: in particular, numerous duties are defined in dollars (per unit, per ton, etc.) and tariff quotas are opened to exporters (lower tariff inside the quota). Lastly, the procedure chosen to average (and aggregate) tariffs tabulated at the detailed level matters (Bouët et al, 2003; Martin et al, 2003). All these elements raise challenging issues for negotiators. Hence the renewal of interest for the measurement of preferential access, meaning that tariff data must be compiled at the bilateral level, for each importer. At the same time, the calculation of ad valorem equivalents of specific tariffs emerges as a strategic issue for the negotiators that will have to chose reference unit values.[4] Lastly, the calculation of averages matters too, in as far as the formula chosen to lower tariffs takes into account the average initial level of protection.

LDCs are specialised in products severely affected by current protection schemes

According to the WTO, there are 10.5 percent of Canadian tariff lines with applied MFN duties

[1] Bound tariffs refers to the upper limit for applied tariffs, on which the importing country has made a commitment.
[2] These figures refer to bound rates at the end of the implementation period, which is 2005 for developing countries instead of 2000.
[3] Most Favoured Nation: the tariff that is conceded to any member of the WTO.
[4] The Girard proposal, for instance, devotes a full appendix to such calculation methods.

above 15 percent, the threshold corresponding to the international definition of tariff peaks for industrial products. The ratio is 1.7 percent for the EU, 4.3 percent for the US and 3.3 percent for Japan respectively.

Given the concentration of such peaks in sugar, tobacco, cereals, fruit and vegetables, and fish products, as well as in footwear and clothing, LDCs are potentially[5] severely affected. Hoekman et al. (2001) record more than 1,000 HS6 positions affected by tariff peaks in the Quad, concentrated in agriculture and in labour intensive manufactures of interest to developing countries. But the most potentially affected exporters are LDCs. Their share of potentially affected exports is much larger than the developing world average: 15 percent as opposed to 8 percent on the US market, 30 percent to 12 percent on the Canadian one.

In addition to tariffs, quotas have been steadily maintained under the ATC. Even if the calendar of trade liberalisation (meaning quota dismantling, since tariffs remain) has been respected, the actual amount of liberalised imports has been limited, importers having selected less sensitive products in the early phases of liberalisation.

This lack of market access might be one explanation of the poor performance of LDCs in world trade over the past three decades. While the share of developing economies as a whole in world exports rose from one quarter to one third, the share of LDCs declined from 1.9 percent to 0.5 percent (IMF-WB, 2001).

Recent initiatives conceding free access to LDCs, such as the Everything But Arms[6] European initiative, the African Growth and Opportunity Act implemented by the United States, or the Japanese "99 percent initiative", provide a targeted solution to this problem. For instance, an assessment of benefits for Sub-Saharan Africa (SSA) of fully and unrestricted access to the Quad countries has indicated this could lead to a 14 percent increase in their exports, associated with a 1 percent increase in GDP (Ianchovichina et al. 2001). This is a sizeable gain in comparison to the outcome of a complete round (see below).

[5] Preferential schemes partially limit the negative impact of such tariff peaks on LDCs exports, but tariffs remained relatively high before the implementation of the AGOA and EBA initiatives.
[6] This initiative offers zero tariff and zero quota access to all exports emanating from LDCs, with the exception of weapons. Calendars are phasing out protection for sugar, bananas and rice.

Zero tariffs and zero quotas do not mean free access however. Measures at the border, based on environmental or technical considerations, are imposing requirements to be matched by exporters.

SPS and TBT adversely affect LDCs exports

The attempt of public policies to tackle biological and informational risks that are specific to international trade is lawful. The introduction of allogenic species, predators and diseases through international trade has been ascertained, whereas the opportunistic behaviour by exporters (in presence of information asymmetries and moral hazard) raises issues related to the quality/innocuousness of products.

The challenge is to implement "measures" at the border without raising barriers to trade. Accordingly, WTO Members must notify these measures. On the basis of such notifications, less than one quarter of the product categories identified at the HS6 level of the nomenclature are traded free of any barrier. Conversely the remaining products, accounting for 88 percent of world merchandise trade, do face at least one SPS or TBT justified on environmental grounds in one market, and 13 percent of world trade is effectively affected by such measures (Fontagné et al., 2001). Food products, such as meat, fish, and other animal products, plants, bulbs and cut flowers, which are products of interest to developing country exporters, are the most concerned. And while the share of LDC exports consisting of products potentially affected by such measures is below the world average, the share of directly affected exports (40 percent) is much higher than the average. In response to this exposure of the LDCs to such measures[7], the World Bank has launched its "Africa Trade Standards Project" aiming at "Bridging the Standards Divide".

Sanitary measures (SPS) and technical barriers (TBT) affect the majority of world trade

Internal support and export subsidies distort world agricultural markets

A key achievement of the Uruguay Round has been to extend multilateral discipline to domestic

[7] For instance, the European standard on aflatoxin has been estimated by the Bank to cost African exporters over $670 million per year in lost agricultural exports (Otsuki et al., 2000).

support in the farming sector, as well as to export subsidies. Domestic support related measures have been classified according to the associated level of market distortions. The so-called "boxes" characterise what is prohibited, allowed, or to be phased out. Even if the amount of domestic support granted to farmers has hardly decreased in the OECD in the second half of the 1990s, a slight reduction in the market distortions is observed.[8] All in all, agriculture has been reincorporated into the arena of multilateral negotiations, without imposing rules that are too tight: further reductions and commitments will be more sensitive (Tangermann, 2001).

The US$ 300 billion spent by the industrialised countries on farm support are often compared to the amount of their aid to development (which represents only a sixth of this sum). The associated increase in agricultural output in the North, combined with reduced imports by rich countries, are estimated to flatten world prices at the expense of developing countries (Watkins, 2003). Even though some cases, such as the US$ 3.6 billion subsidy granted to US cotton producers in 2001 – which led to accusations of US dumping[9] – fit well in this analytical scheme, how developing countries are actually affected remains an open question.

Formulas simplify the negotiations

The DDA should address preferential access or risk missing the target

There are numerous proposals, more or less ambitious, more or less cautious, on the table. In particular, the (revised) Harbinson proposal for agriculture, and the Girard proposal on modalities for negotiations on non-agricultural products are key propositions.[10] A glance at these proposals convincingly shows that making progress in the negotiations in the multilateral arena will necessitate the adoption of simple schemes of trade liberalisation. It will also impose the need for progress in the agricultural part of the Agenda. But if the DDA is to reach its target, benefiting the least advanced economies, pragmatism will be required.

The rationale for a formula approach to market access

Concerning market access for products, there are 146 members negotiating on thousands of products. Under such circumstances, any means for simplifying negotiations will be preferred by negotiators. This is why a "formula approach", consisting in the systematic compression of tariffs based on a simple arithmetic formula, could be chosen.

Of course the number of formulas that can be implemented is only bounded by the limits of the negotiators' imagination. The reference is the so-called Swiss formula in which the target tariff, t_1 depends non-linearly on the initial tariff t_0 and a coefficient b:

$$t_1 = \frac{bt_0}{b + t_0},$$

where b is a coefficient corresponding to the upper limit of desired tariffs after the cut. Flexibility, needed to make such approach acceptable by all interested parties will lead to a slight departure from this crude arithmetic (Francois and Martin, 2003). However, any such formula, like the one contained in the Girard proposal[11], will raise all the issues referred to above: calculation of ad valorem equivalents, aggregation procedures to calculate averages, and last but not least massive preference erosion.

Differentiated impacts on developing countries

A formula approach apparently fits well the objectives of the DDA: by strongly reducing tariff peaks, it offers better access to LDC exports in labour intensive and agricultural goods; it largely opens other developing countries' markets that remain currently highly protected and thus stimulates South-South trade; it allows a different b coefficient for developed and developing economies to be adopted, respecting the spirit of the SDT; lastly it allows a different coefficient for trade in manufactures and food products to be used, in order to match obvious political economy constraints.

This means, however, killing too many birds with one stone. The two latter supposed advantages contradict the objective of making agricultural mar-

[8] The ratio of producer support for the OECD was 31 percent in 2000–2002 (compared to 36 percent in 1986–88). The coefficient of nominal protection was 31 percent in 2002 (compared to 57 percent in 1986–88). Of course there is a huge dispersion of coefficients across OECD member countries and across commodities: rice, sugar and milk remain the three most protected categories of products (OECD, 2003).
[9] See IATP (2003).
[10] Detailing the content of these proposals goes beyond this article. See the USDA, USTR, DG_trade and WTO web sites for details.

[11] This proposal multiplies b by the average of the base rates.

kets more open, or of enhancing South-South trade. But the key issue here is the erosion of preferences, and here a break-down of developing economies into sub-groups is necessary.

It has been stressed above that tariff peaks potentially affect exports of LDCs which are nevertheless conceded preferential market access (ACP countries, the GSP scheme, AGOA, EBA, etc.). Hence, any (non-linear) formula approach will have two effects: first to eradicate the remaining peaks faced by LDCs exporters, and second to erode the margin of preference they had been conceded. The net effect can be negative. As far as their own market liberalisation is concerned, LDCs could be allowed to limit their own commitments, which will have an ambiguous effect on welfare too.

The remaining developing countries are in a different situation: they are not covered by recent initiatives in favour of poor countries, and they do not benefit from such preferential access, in particular for agricultural products. These countries should therefore strongly lobby in favour of a formula approach eradicating tariffs. However, in some cases this would put diversified and protected manufacturing industries at risk, and would more generally cut government revenue.

Formula approaches raise the risk of preference erosion

The expected impact of any deal concluding the round can hardly be assessed using a partial equilibrium framework: interactions between goods and factor markets, between sectors, between countries, make it necessary to rely on a general equilibrium approach. Results drawn by multi-country computable equilibrium (CGE) models have been at the centre of the debate surrounding the Uruguay round.[12]

As a follow up, methods have been considerably improved and have led to a rather consensual view[13] concerning the benefits of trade liberalisation for developing countries. The larger benefits accrue from countries' own trade liberalisation and increase with the square of the level of protection; static gains to be expected are modest in relative terms (as a percent of GDP), and concentrated in the agricultural sector; dynamic gains are much more associated with liberalisation of the manufacturing sector, in which economies of scale are prevalent. All in all, developed countries will record the largest absolute gains by liberalising their own agriculture, while developing countries will obtain large relative gains by opening their own economies and being conceded better market access for industrial products. Lastly, as a group, developing countries will extract limited gain from agricultural liberalisation in the Quad, since net food importers will be adversely affected by the rise in world prices of food products (Anderson et al., 2000).

Different impacts with different formulas

In addition to these traditional results, recent developments have emphasised the impact of the choice of formulas, namely linear versus Swiss formulas. Fontagné et al. (2003) focus on market access and contemplate a menu of scenarios in which developing countries are conceded SDT. Bilateral tariffs at the product level[14], derived from MAcMaps, are cut according to a linear formula (where tariff peaks[15] can be included or excluded from the liberalisation), versus a truncated Swiss formula[16] (applied to all tariffs). Coefficients of reduction are those suggested by previous rounds[17], and the SDT offered to developing countries is a lower coefficient of linear reduction and a larger b coefficient in the Swiss formula. Results reported in the Table highlight that benefits of increased market access at the world level are much higher with a Swiss formula and, in contrast, rather limited if one adopts a linear formula excluding peaks. Considering the Swiss formula combined with the SDT, the largest benefits accrue to Japan, where agriculture is highly protected. This is also why EU gains are much larger than US ones.[18] Lastly, ACP countries record very limited gains, in particular in comparison to developing Asia which has in the past been conceded less preferences by industrialised importers.

A formula approach will, however, lead to a sizeable erosion of preferences conceded to the poor-

[12] Goldin et al. (1993) and Francois et al (1993) are the key references for ex ante World Bank, OECD and GATT estimates. See Francois (2000) for a survey of the ex post literature.
[13] This view is however challenged by Whalley (2000), who points out inconsistencies in the results obtained by the various models.

[14] HS6 level.
[15] Tariff peaks are defined in this exercise as those superior to 15 percent in manufacturing, energy and raw materials, and those above 85 percent in agriculture and agrofood.
[16] In a truncated Swiss formula, the reduction is linear up to the threshold defined as a tariff peak, and non-linear thereafter.
[17] 35 percent for the linear formula and a Swiss formula, and a coefficient b equal to 28 (manufactures) or 58 (food).
[18] The same explanation pertains to the occurrence of more limited benefits to developing countries, when such special treatment is offered.

Long-run percentage welfare change

% Welfare	Linear formula	Linear formula excluding peaks	Swiss formula	Swiss formula + Special & Differential Treatment
EU-25	0.38	0.14	0.55	0.47
USA	0.18	0.09	0.24	0.12
Japan	0.86	0.29	1.45	1.29
Cairns	0.30	0.14	0.35	0.39
Developing Asia	0.80	0.28	1.07	0.91
ACP countries	0.43	0.26	0.41	0.29
Other countries	0.55	0.20	0.79	0.70
World	0.42	0.16	0.61	0.51

Source: Fontagné et al. (2002).

est developing countries so far, with the aim of favouring exports of small and insufficiently diversified economies. The more specialised the exporters, the larger the benefits extracted in the past from preferential access schemes and the stronger the adverse effects of market opening they will have to cope with.

Even tariff peaks favour LDC exporters to some extent: in 1999, ACP countries benefited from a preference for peak tariff products on the European market, reaching 28 percentage points, as compared with only 6 points for all products (Hoekman et al., 2002).

Cutting agricultural support in the developed countries leads to a welfare loss of the developing countries

This is why a formula approach will put the benefits of past policies at risk. A limited number of products is affected by such issues (less than 15 percent of HS6 categories), and an even more limited number of importers having conceded sizeable preferences: among OECD countries, the EU15 is the most prominent concerned importer (Fontagné & Mimouni, 2002).

While free access for peak products limited to LDCs would lead to an 11 percent increase in their total exports, the extension of such free access to other developing countries would halve such benefit; and a further reduction of the MFN duty to 5 percent would result in such benefits to disappear for LDCs (Hoekman et al, 2002). SSA exports, initially boosted by free access conceded by Quad countries' initiatives (AGOA, etc.), would be slightly reduced if liberalisation by other developing markets compensated for the erosion of preferences on industrialised markets. But welfare gains would then be reduced, due to a deterioration in the terms-of-trade associated with a shift from high-priced industrialised markets to low-priced developing ones (Ianchovichina et al., 2001).

Puzzling impacts of a liberalisation in agriculture

A CGE framework can also be used to examine the decomposition of benefits among the various items of the DDA agenda. On the basis of a scenario for a linear reduction in tariffs of 50 percent for industrial and food products, in border measures for services, in export subsidies, and in domestic support[19], Francois et al (2003) find that liberalisation at the border in agriculture (27 percent of world gains) leads to larger gains than market access for non-agricultural products (respectively 16 percent). This is even less the case for services (11 percent). But the striking result is that the reduction in domestic support only secures 4 percent of the total gains[20], naturally accruing to countries reducing this distortion, namely the industrialised ones. Hence, contrary to a simplistic analysis of the associated distortions, there is not so much to be gained in this area, and the expected benefits to developing countries should be considered cautiously.

This confirms previous partial equilibrium estimates, which indicate that developing countries as a group would suffer a welfare loss in case of a 50 percent reduction in domestic support for agriculture in the developed countries (Hoekman et al, 2002).

In total, tariff reduction matters much more, for the developing world, than do the domestic policies in OECD countries. How can such puzzling effects be understood? In addition to issues referred to above (preferential access, tariff peaks in agriculture, domestic support), initial trade patterns and the associated terms-of-trade effects matter, in the face of any substantial increase in world agricultural prices consecutive to reduced distortions in world agricultural markets (FAPRI, 2002).

The (revised) Harbinson proposal, combining a progressive reduction of tariffs[21], if not a Swiss formula, with a SDT (lower reduction in tariffs) and a reduction in domestic support and export subsidies, offers a stylised framework to address such issues (Bouët

[19] The scenario also includes a reduction in trade costs, corresponding to a trade facilitation.
[20] The remaining elements are trade facilitation (34 percent) and the interaction term (8 percent).
[21] Tariffs above 90 percent would be reduced by 60 percent.

et al, 2003). Reductions in domestic support alone would induce a limited welfare gain at the world level, resulting in a welfare gain for the EU and Japan, and a loss elsewhere, in particular for the ACP countries. In contrast, a reduction in border protection alone would lead to larger gains at the world level, shared among all country groups, with the exception of the former Soviet Union. Lastly, the combination of all elements of the Harbinson proposal would mainly benefit the Cairns group, the EU and its periphery, Japan and South Korea, but would harm ACP countries, China, the former Soviet Union, and the rest of the world.

Conclusion

Considering the wide agenda drawn up in Doha, market access (compared to domestic support) remains a key item of the negotiations in order to reach the development target of the DDA (Hertel et al., 2002). Given the complexity of the negotiations and the number of parties involved, a formula approach is to be preferred. Any non-linear formula strongly eroding tariff peaks will boost welfare gains at the world level. However, the road to hell being paved with good intentions, this will be at the expense of preferences conceded to LDCs. This is why the erosion of preferences resulting from the round should be carefully assessed in order to avoid putting the benefits of past policies and recent initiatives such as EBA and AGOA at risk. Acting in favour of development is not such an easy task given the highly differentiated situation of developing countries.

There are limits to the arguments raised in this article. Preferential access is generally associated with the enforcement of rules of origin for exported products, hampering LDCs to take full advantage of the preferences they have been conceded (Brenton, 2002). Second, trade preferences without MFN access for the products of interest to other developing countries will not benefit the majority of the world's poor, since most of the world's poor live outside LDCs (Hoekman, 2003). Third, multilateral trade liberalisation, through its combined impacts on prices and incomes, does not systematically alleviate poverty in non-LDC developing countries (Hertel, Preckel et al., 2002).

Last but not least, raising fears about preference erosion does not provide an alternative to the Agenda: reasoning in terms of country vulnerability is certainly more appropriate than favouring a second-best situation. Vulnerable countries should, for instance, be conceded no or very simple rules of origin, should receive assistance necessary to match SPS and TBTs. The scheduled phasing out of their preferential access should be compensated by commitments in terms of development aid, in order to build institutions or infrastructures making it possible to reap the benefits of a less distorted world market. Lastly, they should be secured free access not only to developed countries, but also to other developing economies.

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The failure of the WTO Ministerial Meeting in Cancun: Implications for Future Research

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On September 14th 2003, the meeting of WTO Ministers in Cancun ended without reaching a consensus. According to press reports and subsequent statements by those present at that meeting, the apparent and proximate cause of the Ministerial's collapse was a failure to agree on launching formal negotiations on the so-called Singapore Issues.[1] Others, however, have put forward alternative explanations for the meeting's failure, including poor chairmanship of the Ministerial meeting by Mexico's Foreign Minister, Mr. Luis Ernesto Derbez; a failure to agree on the modalities for negotiations on agricultural trade barriers, export subsidies, and domestic support policies; the inability of many WTO members to negotiate or discuss many issues simultaneously during and before the Cancun Ministerial Conference[2]; and a perception that some national representatives in Cancun were not prepared to go beyond pre-determined demands of others and showed little propensity to "negotiate seriously" with other delegations.

The purpose of this essay is not to dissect precisely why the Cancun Ministerial is said to have failed. Nor is the goal here to offer predictions about the World Trade Organisation's (WTO's) future, although some of the factors discussed here must surely be relevant. Instead, the objective of this short essay is to identify some questions that in my view ought to receive more attention from the scholarly community. This is not to say that the questions identified here are necessarily novel or to suggest that there are not thoughtful perspectives on them in the existing legal, economic, historical, and political science literatures on the evolution of the world trading system. Rather it is that I doubt we have adequately answered some of these questions and that revisiting them may be a worthwhile endeavour – especially as, after the Cancun Ministerial, many feel that the world trading system is at a "cross roads." This affords an excellent opportunity for scholars – some of whom may not have focused on policy-oriented matters before – to contribute to the debate over the future course of – what is no less than – an important element in the governance of international economic relations. If this essay persuades a few more scholars to enter this debate then my efforts will not have been in vain.

There are questions that ought to receive more attention by the scholarly community

Some other preliminary remarks are in order. First, it is important to note that the failure to reach consensus at the Cancun Ministerial does not mean that previously-agreed commitments by WTO members are no longer binding. (Of course, the degree to which WTO members feel compelled to adhere to those commitments is another matter.) Therefore, the expiry of the so-called "peace clause" on disputes on agricultural subsidies will still go ahead. So will the formal ending of the Multifibre Arrangement on January 1st 2005. Second, the failure to reach consensus at Cancun

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[1] The Singapore Issues are currently taken to include four matters relating to international commerce namely, the relationship between trade and investment policy, the interaction between trade and competition policies, transparency in government procurement practices, and trade facilitation practices (such as more efficient customs procedures). It is worth pointing out that some WTO members, including the European Union and its Member States, took the view before the Cancun Ministerial meeting that an agreement to launch the Singapore Issues had been taken at the Doha Ministerial Conference in 2001, and that at the Cancun meeting WTO members would determine the modalities for those negotiations. Other WTO members – notably from Africa – had argued that no such decision was taken at the Doha Ministerial Conference and that the Singapore Issues should be addressed *after* (not at) the Cancun Ministerial.

[2] This argument is often put differently; that the negotiating agenda for the Doha Development Round is "overloaded" and beyond the capacity of many developing countries to effectively negotiate.

will not result in the shutting down of the WTO's relatively small secretariat in Geneva; nor will it see the end of dispute settlement cases between WTO members. Moreover, ongoing negotiations among WTO members are technically supposed to continue, although the enthusiasm to complete them may well have diminished.[3] The third point to bear in mind is that WTO Ministerial meetings have failed before. According to some observers, of the nine meetings of Ministers from members of the General Agreement on Tariffs and Trade (GATT) and the WTO, four have been branded "failures." Inevitably, some old hands have claimed that "we have been here before." In short, failure to agree is neither uncommon nor will it formally undermine the legal and organisational foundations of the world trading system.

One could, of course, end this essay on such a sanguine note, retreat back into the ivory tower and wait for the next successful WTO Ministerial meeting. (After all, if the old hands are right, then there is over a fifty percent chance that the next Ministerial meeting – which must be held in the next two years – will be successful and so revive the Doha Round of multilateral trade negotiations!) Unfortunately, there are at least two reasons not be so sanguine. The first is that while waiting for the next successful WTO Ministerial meeting (or other initiative to re-launch this round) market outcomes will continue to be distorted by discriminatory trade barriers and the like. If the World Bank's estimates of hundreds of billions of dollars of gains from the successful completion of the Doha Round are to be believed, then the sooner these welfare-reducing barriers are eliminated the better. The second reason is that past experience with ministerial meetings on trade matters may provide a misleading guide to as to the likely success of future WTO Ministerial meetings. Specifically, in the view of many, the Cancun Ministerial differed from its predecessors in the three following respects: by seeing the active participation of many more developing countries (and perhaps, more importantly, of the engagement of seemingly robust groupings of developing countries); a greater focus on "behind the border" measures (which, some say, include the Singapore Issues); and the need to complement the traditional goal of enhancing market access with that of promoting development (whatever that may mean.) Indeed, it is an open question as to whether the current system of reciprocal negotiations in trade rounds is suitable in a world trading system which has enlarged along the above dimensions.

Should the Singapore Issues be taken off the agenda?

What next? A streamlined agenda for the Doha Round?

One response to this open question has been to call for a reduction in the number of subjects that are on the negotiating table in the Doha Round. The principal target is typically the Singapore Issues and, since the collapse of the Cancun Ministerial meeting, calls for their removal have intensified (see, for example, Hoekman 2003). Without in any way denying the importance of the policies associated with the Singapore Issues for economic developments, those supporting the removal of these topics from WTO trade negotiations make two arguments. The first is that the Singapore Issues are not related – or not sufficiently related – to the market-access core of the world trading system, and therefore do not adhere to the tried-and-tested formula of improving economic welfare through trade negotiations that result in reciprocal reductions to impediments to international commerce.[4] And, second, that negotiating and implementing any WTO agreement on the Singapore Issues would be both too complex and too expensive.

Taken separately or together, I have not been persuaded that these two arguments settle the matter. With respect to the first argument above, one might pose a few questions. Are we sure that the efficiency of a nation's customs procedures has little bearing on the extent to which foreign firms can make good on a nation's market access commit-

[3] Indeed, to the extent that the failure to reach consensus on the modalities for a number of negotiations in Cancun constrains the ability to make cross-issue trade-offs, then concluding the on-going negotiations may have been made more difficult. Another knock-on effect of the loss of negotiating momentum in the aftermath of the Cancun Ministerial is that WTO members are less likely to refrain from bringing dispute settlement cases if they fear less will be lost in current and future negotiations with "defendant nations."

[4] I note in passing that some recent estimates of the effects of liberalising certain elements of the traditional market access agenda are surprisingly small, casting the issue of the relative benefits of pursuing some elements of the traditional agenda and the Singapore Issues in a rather different light than is usually represented. Take, for example, the IMF's and World Bank's joint study on market access that was published in 2002 (see International Monetary Fund and World Bank 2002). This study estimated the total increase in non-OECD countries' welfare from liberalisation of OECD countries' agricultural policies at US$8.7 billion. Interestingly, the same study found that the total welfare cost for non-OECD countries of other non-OECD countries' agricultural policies was US$21.7 billion, more than twice the amount of harm done by OECD countries. In the light of these numbers, and others, I suspect that future historians of the Doha Round will question why so much prominence was put on agricultural trade reform by developing countries in the run up to, and at, the Cancun Ministerial Conference.

ments? Indeed, doesn't the long history of negotiating rules on customs procedures and the like in the world trading system suggest that the link between trade facilitation and market access has been well established? If the current discussions on the transparency in government procurement did not in fact have a market-access component to them, then how can one explain the numerous remarks made by leading developing countries that current proposals for further international rules in this regard will have consequences for foreign access to their state procurement markets? Nor am I persuaded that securing improvements in market access will necessarily translate into welfare gains unless states take steps to prevent the formation of international cartels and other anti-competitive practices. Moreover I find it difficult to argue that, on the one hand, improving market access for products is essential to the Doha Round while simultaneously contending that improvements to another mode of entering foreign markets – through foreign investments – is unnecessary. Indeed, the latter attitude is a little hard to square with the considerable effort expended on negotiating the General Agreement on Trade in Services during the Uruguay Round. In sum, the view that the Singapore Issues would have little or no bearing on market access seems particularly hard to sustain.[5]

In fact, much of the commentary from academic writers and officials from the international financial institutions on the appropriate scope of the Doha Round is influenced by a few papers that purport to examine the experience of developing countries in implementing the Agreement on the Trade-related Aspects of Intellectual Property Rights and the Agreement on the Application of Sanitary and Phytosanitary Measures, known as the TRIPS and SPS agreements respectively.[6] Even if one is convinced that the latter research is credible, it is quite a different matter to assume that the effects of signing WTO agreements on the Singapore Issues would be the same. Sometimes reasoning by analogy is convincing, sometimes it is not. I would suggest that a better approach is to conduct separate empirical analyses of the economic consequences of the proposed multilateral provisions on the Singapore Issues. In my view here is a substantial opportunity to advance our knowledge, but to be persuasive a change in research strategy will be needed. It is not enough for trade economists merely to apply first principles to the analysis of some "trade and X" issue (X could be any of the Singapore Issues or indeed any issue that might fall within the remit of the WTO.) Instead, scholarship should at a minimum require a thorough understanding of the proposals advanced at the WTO and of the policy field in question.[7] Hopefully this would see the era of trade economists moonlighting as competition policy experts, trade facilitation experts, and the like.

There is a much deeper question raised by the debates over the Singapore Issues: What areas of policy have characteristics such that they can and should be subject to binding international commitments at the WTO? I do not pretend that this is a novel question, as the debates over "shallow" and "deep" integration in the early 1990s can attest. Rather, in my view, this question has yet to be answered satisfactorily. Are the only legitimate prerequisites for including a policy instrument in the WTO that there be some discernable impact on market access and that there be some impediment to domestic reform that prevents the optimal policy being chosen unilaterally? (These two characteristics of tariffs and quotas are said to account for the success of reciprocal bargaining on border measures in successive GATT and WTO rounds.) Or are there other characteristics of a policy that make it suitable for inclusion in the WTO? Presumably, the latter question would say something about the potential desirable trajectory for the WTO and its relationship to other international organisations and agreements that impinge on economic policy matters. Alternatively put, tackling this latter question would help in thinking through whether the WTO should become a more important forum for international economic governance, as has been suggested by some European scholars and policymakers. Just as economists have

Which policy areas should be subject to international commitments at the WTO?

[5] This is all the more so once one appreciates that substitution between discriminatory trade policies is possible. For instance, if a reader thinks that the phasing out of the MFA (which is essentially a system of quotas) in the West will trigger a large number of antidumping and safeguards cases against developing countries, then it would seem that only in the most limited sense can the removal of the MFA actually be thought to have improved market access. Given the discretion available to governments in implementing their unfair and fair trade laws, how can one have any confidence that lowering a discriminatory trade barrier must improve market access? Once one accepts that the consequences for market access of the liberalisation of traditional border barriers can be meagre or nil, then how can one be sure that their liberalisation has a greater effect on market access than some of the initiatives associated with the Singapore Issues?

[6] Finger and Schuler (2000) is perhaps the best known of the very small number of papers of this genre. Hoekman (2003) and Finger (2002) both cite this paper in the manner described in the above paragraph.

[7] Hopefully the chapters in Evenett and SECO (2003) demonstrate some desire to practice what I preach. No doubt subsequent research will remedy the deficiencies and omissions from this volume!

long worried about the boundaries of the firm, what are the boundaries of the WTO?

I do not propose to answer this question in its entirety in this short essay, however I would like to develop some ideas that might take the discussion forward. The starting point of my argument is the long-recognised idea that a case for international collective action can also be constructed when the effects of a state's policy decisions (including decisions not to take action) "spill over" national borders and affect the welfare of inhabitants or economic entities in another jurisdiction. One type of decision that creates such spillovers are the numerous recent prosecutions by the European Commission and by the United States' Department of Justice of international cartels. These decisions are likely to have had positive knock-on effects outside Europe and the United States, where other nations' purchasers are likely to have benefited from the break-up of these international conspiracies. Another example of cross-border spillovers created by national policy choices is in environmental policy (see the analysis in Bhagwati and Srinivasan 1996, section 4.5).

Collective action must satisfy five criteria

But is demonstrating the existence of spillovers enough to warrant the inclusion of a policy instrument in the WTO? Arguably not. It seems to be that whatever collective action is proposed it must also satisfy the following five criteria, listed in no particular order of importance:

- There must be a discernable positive welfare impact to undertaking the collective action,
- At least one domestic constituency in each of the major trading partners must support the negotiation of the initiative at the WTO,
- Reasons must be advanced as to why the proposed multilateral obligations must be binding (ie., as to why hortatory language expressing best intentions is insufficient),
- The obligations must be codified precisely, their implementation observable, and where the collective action at issue permits some discretion for national policymaking, the latter must be relatively transparent,
- The obligations created must be amenable to enforcement through the WTO's dispute settlement understanding.

It would be useful to assess whether each of the policies proposed for inclusion in the Doha Development Round meet these five criteria and whether the cross-border spillovers associated with those issues are of sufficient magnitude to warrant negotiating an international initiative. The fact that few, if any, such comprehensive assessments have been conducted to date may be because many skills are probably needed to undertake them (including economic, empirical, legal, and political science analyses). Perhaps this is an area where some serious inter-disciplinary research could be initiated.

Capacity constraints and multilateral trade negotiations

One often-mentioned and quite distinct objection to broadening the scope of the multilateral trading system is that it places additional demands on the negotiating capacities of developing country members of the WTO. Furthermore, it is also argued that the "newer" subjects for discussion at the WTO are "complex" and "highly technical."[8] My own view is that the latter argument is very unconvincing and the former one is doubtful but is, in principle, potentially subject to empirical investigation. If the complexity of a trade issue alone determined whether it should be included in multilateral trade negotiations, then arguably the last subjects to be discussed in the WTO would be agriculture and anti-dumping. Indeed, on these grounds much of the cherished non-manufacturing market access agenda would be ruled out! Having written a Ph.D. thesis on the U.S. antidumping law and its implementation, I am at a complete loss to understand how following the details of antidumping negotiations is less complex than assessing the proposed multilateral rules on competition policy. Moreover, given that many developing countries have enacted and implemented both antidumping laws and competition laws in the last fifteen years, one cannot argue that they necessarily have more domestic capacity on antidumping to draw upon. The complexity argument is a red herring.

The argument that developing countries simply do not have the talented personnel to negotiate and implement multilateral provisions requires careful assessment. Scarcity of talent at a point in time certainly argues for identifying the most beneficial negotiating priorities; again reinforcing the need

[8] Comments like this can be found in the recent editions of the World Bank's Global Economic Prospects report.

for careful (often country-by-country and not broad brush) studies of the consequences of different types of multilateral provisions. I know of no theorem or body of empirical work that demonstrates that the identified trade liberalisation priorities would be the same for each developing country. (Incidentally, taking the argument a step further, if scarcity of talent is a particular problem for a developing country, it is not clear that the overall policy priorities are trade-related; they could in fact be domestic policy initiatives.) Moreover, even if two trade-related negotiating priorities are expected to have approximately the same potential benefits for a given country, the amount of time needed to prepare for negotiations, to engage in negotiations, and to implement any provisions that are agreed may differ. Exploring these matters carefully would require substantial data collection, empirical analysis, and a precise knowledge of what it takes to prepare for and implement multilateral trade accords; all of which should be undertaken before sweeping statements are made about the implications of capacity constraints for developing countries' negotiating strategies. Indeed, on the basis of the considerations laid out above, I am doubtful that any generic claims about the implications for the scope of the Doha Round, or for developing countries' interests in that Round, that are based on personnel constraints can withstand careful scrutiny.

With respect to the scarcity of trade negotiators, the more significant challenge is probably how to expand their numbers in developing countries over the near to longer term and how to retain such talent. Given the pressing nature of this challenge, it is perhaps a little discouraging that the last "mini-census" of negotiating talent in Geneva was completed five years ago.[9] (Another such "mini-census" is underway.)[10] Moreover, we know little about how much trade-negotiating talent (if any) resides in national capitals. Without this type of information, undertaking a needs assessment is very difficult. Furthermore, it would be useful to understand the pros and cons of developing countries pooling negotiating expertise in regional or other groupings. (While on the subject of regional groupings another interesting, yet unexplored, question is the extent to which preferential trade negotiations "crowd out" or "crowd in" the capacity available to negotiate multilateral trade agreements.[11]) Many of these observations could be developed empirically as well as evaluating the capacity building implications of entering into different types of trade negotiations. Such a research programme might go a long way to add flesh to the bones of the capacity building question. Again, I suspect that the claims made currently in this regard are far ahead of the data necessary to support them.

The so-called development focus of the Doha Round. Where is the pay off to this political correctness?

Given the failure of the Cancun Ministerial Conference, I feel it is incumbent on analysts of the world trading system, and of the international institutions more generally, to pose another potentially controversial question: What have been the consequences of putting development considerations at the centre of the Doha Round and, therefore, at the heart of the current operation of the multilateral trading system?[12] Just as it is perfectly acceptable to question whether the so-called Singapore Issues have "overburdened" the new round, so it is legitimate to ask whether the new developmental focus of the WTO has unnecessarily complicated the completion of the Doha Round and whether it contributed to the collapse of the Cancun Ministerial Conference? A related but distinct question is whether the new development mandate for the WTO is consistent with its long-standing role as an institution where agreements on certain trade-related matters are negotiated and where compliance with those agreements is monitored and assessed? If not, then it strikes me that some serious thought is needed as to the purpose of the WTO.

Has the development focus of the Doha Round contributed to the failure of the Cancun Ministerial?

Given the partisan – and quite honestly vicious – nature of the trade and development debate in the

[9] See Michalopoulos (1998).
[10] One of my students is completing a masters thesis on this subject, hopefully developing and extending the measures reported in Michalopoulos (1998).

[11] The following vignette crystallised this issue for me. Recently the Caribbean nations negotiated the revised Treaty of Chaguaramas, part of which contains provisions for the creation of a "common market" in that region. One of the chapters of this treaty was on competition law and policy, and many of the provisions in that chapter were similar to those being discussed in the WTO's Working Group on the Interaction of Trade and Competition Policy. One wonders if the experience acquired in negotiating this regional trade agreement left the Caribbean nations in a better position to participate in the debate over the benefits of multilateral rules on competition policy? Trinidad and Tobago definitely played their part in these multilateral discussions.
[12] It is widely accepted that the Doha Ministerial Declaration marked the official acceptance of a greater focus on development considerations in the deliberations of the World Trade Organization. Having said that, I know of no clear and precise statement of what in practical terms is meant by this enhanced commitment to development. There is a sense among some observers and trade negotiators that the developmental focus in the Doha Ministerial Declaration means "all things to all men."

public arena, I should hasten to add that the question being asked here is not whether economic and other forms of development are desirable. I would hope that all well-intentioned readers could conceive of an analyst being firmly pro-development yet at the same time being not wholly convinced of the WTO's new development mandate (in large part because it is not clear what is meant by the latter!)

One response to the questions posed above is to argue that the development mandate agreed on at the Doha Ministerial Conference is unimportant window dressing that does not affect the substance of the WTO's activities, or the status of its previous agreements. It seems to this (potentially misinformed) observer that few trade negotiators from developing countries would see the matter in this way. Moreover, even if the so-called development mandate is merely talk, it has added a degree of smoke and mirrors to negotiations in Geneva and elsewhere that one can see little obvious benefit from. In contrast, it is quite likely that the development mandate has raised the expectations of some trade officials from developing countries, emboldening them to make new and perhaps more ambitious proposals – some of which call into question the very status of previously agreed trade accords. Overall, I am not sure that all this window dressing or this WTO-equivalent of political correctness has been cost-free.

Adding the development mandate raises a number of unanswered questions

Another response might be to argue that by encouraging the opening of markets the WTO (and its predecessor the GATT) have, by and large, promoted economic development; therefore, adding a formal development mandate to an institution which has been promoting it all along may not be problematic. While I tend to agree with the first claim made, I am doubtful of the conclusion. There are a number of objections to this argument, especially when one appreciates that there is no explicit statement that the new development mandate for the WTO refers only to traditional economic variables such as exports, employment, or the growth of national income. Others are therefore perfectly within their rights to interpret the new mandate as meaning that other dimensions of development (for example, the environment) are important and should receive due attention in trade negotiations. And so I contend that the questions posed at the beginning of this section are important and cannot be dismissed out of hand.

In considering the consequences of adopting a greater development focus at the WTO, I wonder if the matter can be broken down into the following questions.[13] First, what do we mean by a greater developmental focus or developmental mandate?[14] Is the intention that the WTO's activities should be directed towards certain agreed outcomes that will benefit (in some, perhaps observable, way) developing countries? Or is the intention that the agenda and decision-making processes of the WTO should better reflect the interests of developing countries?[15] Second, to what extent does the development mandate (whatever that may be!) replace or augment the existing principal institutional objective of the WTO, which is to facilitate the negotiation and implementation of trade-related agreements between sovereign states? Thirdly, does the development mandate only relate to the WTO's activities after the Doha Ministerial Conference? If not, then to what extent can previous WTO and GATT agreements be reinterpreted, scrapped, or rewritten in light of the new development focus? Fourth, in what ways (if at all) will the adjudication of disputes between WTO members change as a result of greater sensitivity to developmental concerns? Fifth, in what ways (if at all) will the accession of new members to the WTO be influenced by the new development mandate?

I do not want to give the impression that no thinking has gone into these – and similar – questions. For example, Hoekman, Michalopoulos, and Winters (2003) have made some suggestions for intelligently implementing special and differential treatment for developing countries. In addition, Cottier and Takenoshita (2003) have considered the implications of moving away from a consensus-based decision-making rule at the WTO. Finally, Abbott (2003) offers an interesting treatment of some of the issues raised above. Yet, I know of no systematic treatment of the implications of adopting a greater focus on development considerations at the WTO – and worse still, precious little evidence that much thought went into these matters before the Doha Ministerial Declaration was adopted.

More constructively, I wonder if there are any lessons from the experiences of other international

[13] This is almost certainly a non-exhaustive list of the questions that might be asked.
[14] For the sake of clarity, I use the expressions enhanced development focus and development mandate synonymously.
[15] To use management speak, is the intention to alter the metrics or processes of the WTO?

organisations that have changed their mandates in significant ways, in particular to adopt new or different objectives or to give greater weight to the interests of a subset of its members. Of particular interest in this regard may be *certain elements* of the recent experience at the World Bank and the IMF.[16] First, towards the end of the 1990s the IMF briefly gave more attention to poverty alleviation and related matters and then soon ended this initiative. It would be useful to learn, what lessons were learned and are transferable to the WTO, and whether any principles for the allocation of responsibilities across international institutions could be deduced. Second, to what extent has the shift away from a primary focus on the economic consequences of development towards other objectives been successfully accomplished at the World Bank? Did this shift introduce new trade-offs between objectives and, if so, how where they resolved? Again, what lessons are there for the WTO? In addition, given the existence of the World Bank, the regional development banks, and the United Nations Development Programme and the United Nations Conference on Trade and Development, one ought to ask whether the WTO is taking on new development-related obligations that might be better accomplished elsewhere?

In concluding this short essay I hope that I have provoked readers into thinking about what are the appropriate boundaries for the WTO and what role scholarly research, informed by discussions with policymakers and other interested parties, can play in addressing some of the more systemic factors that probably underlay the failure of the WTO Ministerial Conference in Cancun. If, as I suspect, we have not appreciated fully the consequences of adopting a greater focus on development-related concerns in the WTO – including the implications for what topics should be on the negotiating table in the Doha Round – then I fear the slide towards unilateral and preferential trade measures will continue, undermining the principle of non-discrimination that has served the world so well since the Second World War.

[16] This is not to suggest that these two institutions have the same functions or resources as the WTO.

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US Trade Strategy and European Interests

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Since the start of the Bush administration, the U.S. has sought to advance a strategy called competitive liberalisation. And, in fact, the U.S. is trying to promote free trade on multiple fronts: globally through the WTO, regionally primarily through the Free Trade Area of the Americas which involves 34 countries of the western hemisphere, and then bilaterally through agreements with individual countries in other regions.

By moving on multiple fronts the U.S. hopes to accomplish a number of objectives. First, since the U.S. produces about 25 percent of the world's GDP, depending on exchange rates, the Administration believes that in this way it can add to US leverage for openness. In effect, the U.S. wants to be aggressive on opening markets in a number of areas and if one party or another decides not to move or to slow down, we say we are ready to go when you are, but if you are not ready to go, we shall go with others who are ready. This is important, in my view, in part also for the domestic audience, in that we want to keep free trade on the front burner.

The U.S. is moving on multiple fronts

Free trade may be described by the bicycle-theory: if you don´t keep it moving forward, just like a bicycle, the gravitational pull will topple it. So we want to keep moving forward. It is obviously a way to help businesses, exporters, importers, consumers and the workers that have their jobs because of trade. We can also use these agreements to try to break new ground and set higher standards. For example, in two free trade agreements we completed with Singapore and Chile, we have been able to advance the state of the art in topics like digital intellectual property rights or some of the services topics. We are even trying to have a co-operative arrangement on environmental labour objectives. And we can also use these mechanisms to create stronger partnerships with the WTO because the countries that we work with become good coalition partners in advancing free trade in other contexts. So far we feel we have been able to make progress both generally and specifically. Generally we have been able to regain momentum for trade in the U.S. and also globally and in doing so, we have tried to take the sometimes technical subject of trade and connect it to other objectives – to growth, to development, and also importantly, after September 11, to a larger security agenda. And let me be very clear on this: I certainly would not suggest that terrorism is caused by poverty. If you look at the demographic backgrounds of the terrorists, you would have a hard time making that case, and indeed it would be an insult to hundreds of millions of poor people around the world who don´t take out their difficulties on blowing up buildings. But there is no doubt that – as you look around the world to a place like Indonesia – one recognises that societies that fragment, that become less cohesive, where people lose their sense of hope and opportunity, become fertile grounds for people who have agendas of destroying as opposed to creating. In this context trade and openness and democracy can become part of the larger campaign against terrorism.

US bilateral efforts

President Bush put in a lot of political capital trying to regain our overall trade negotiating authority that we call "trade promotion authority", and that some of you might have known as "fast track". There were three failed efforts in the 1990s to extend this authority. It took a major effort to move forward, and many people may be unaware of the fact that the Trade Act of 2002 which did that also included about $20 billion of preferential trade for the developing world analogous to what Europe had done with the „Everything but arms" initiative.

Working closely with EU Commissioner Lamy we were able to launch the WTO negotiations in Doha

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Presentation given at the Munich Economic Summit, May 2003.

reversing the failure of Seattle. Here I want to give particular credit to Commissioner Lamy, because when I took office in 2001, most of my trade minister colleagues suggested we should not even try because the cost of failure would be too high for the WTO. Pascal Lamy was one of the people most committed to the idea that we should make an effort and together we worked very hard to accomplish this.

We also brought China and Taiwan into the WTO, something that I think will have great historical importance. Some of the developments in China, although they move with fits and starts, have been very important to the international economy. We now move the Free Trade Area of the Americas negotiations forward. We completed the Singapore and Chile free trade agreements and we have launched a series of new free trade agreements. One is with the Central America Free Trade Agreement which includes the five countries of Central America, another with the five countries of the Southern African Customs Union, and one with Morocco, which would be our second agreement with an Arab-Muslim country. We launched one with Australia and also an initiative called the Enterprise for ASEAN Initiative, which is to build on the Singapore Free Trade Agreement, and we are considering the possibility of additional free trade agreements with other ASEAN countries.

US global initiatives

Today I want to focus primarily on our global initiatives in the WTO. As I mentioned, we launched the Doha Development Agenda in Qatar in November 2001. EU-US leadership was fundamental to moving this forward. We now have 146 participants – Macedonia joined us recently – and the primary focus now is on what we have to accomplish to have a successful meeting of ministers in Cancun in September of this year, because we have a target date of completion of January 2005. This of course is ambitious, for if you remember, the Uruguay-Round was begun in 1986 and was not completed until 1994. We have a much tighter timeframe, but I do believe it is possible to accomplish this.

We believe the Doha Agenda is a once-in-a-generation opportunity to really move the global trading system forward. It takes a number of years to negotiate these agreements and then of course the implementation phase covers another ten to fifteen years. After we launched this agenda, the United States set forth some very bold proposals in the industrial and consumer good sectors and the agricultural sector, and we are also very committed to services.

There are three pillars of what the trade officials call the market access agenda. First, in agriculture we have three key elements. One is to eliminate export subsidies, which the IMF and others have identified as the most egregious form of interference in world agricultural trade and which is also clearly something that has a very deleterious effect on developing countries. The proposal is to cut average world farm tariffs from 60 to 15 percent according to a formula that would do this. In the case of the United States, it would cut our average agricultural tariff from 12 percent to 5 percent and the formula would have a cap that would limit the highest tariff in agriculture to 25 percent.

There are three pillars of the market access agenda

When you consider that, for example, in Japan the rice tariff ranges between 500 and 1000 percent, or that our sugar tariffs are about at 100 percent, this would have a very significant effect in the area called trade distorting domestic supports. These are not export subsidies but they are subsidies internal to a country that distort production and thereby affect markets. We had a proposal that would cut $100 billion out of that, cut our support in half and also bring down the European subsidies much closer to ours.

Secondly, in the consumer and industrial goods area we were even bolder because this is the area that was first protected under the GAP in 1947 and we argued that after some 50 years it was time to finally eliminate the tariffs in the industrial sector. On the way to do that we recommended that all tariffs at 5 percent or below would be eliminated within the first five years which would be of benefit to both developed and developing countries. When we examined the benefit of this measure on trade between the European Union, the United States and Japan, we discovered that it would cover about three quarters of the trade in industrial and consumer goods. For many of the businesses in the United States, and I believe this is true in Europe as well, many of these tariffs are almost at a nuisance level. They require paper work, they require time and effort and so we wanted to clear them out

since many developing countries' tariffs are not quite so low. We also thought that this would show a commitment by the developed countries to opening our markets to the developing world.

And then we also would cut, by the end of the first five years, tariffs down to 8 percent on their way to zero. We also proposed a series of what trade officials call sectoral zero-for-zero initiatives. This means that if a critical mass of countries were to agree to eliminate their tariff in a given sector, just as countries did in the information and technology area in the 1990s, we would eliminate our tariffs in that sector, hence it's zero tariff for zero tariff, and we would like to try to do this for products of both developed and developing countries. I will come back to explain where I think this could be particularly important for German and European businesses.

The third proposal addresses the services area which was not covered by trade negotiations until the Uruguay Round but has some extremely important elements. For economic development it is very hard for countries to really get off the ground if they don't have the infrastructure, telecommunications, financial services, construction and engineering services. Another fact that many people are unaware of is that services now account for the major part of both developing and developed countries' GDP. In the United States services are about 66 percent of our GDP and about 80 percent of our jobs. The numbers I saw most recently for Germany were a little over 60 percent and the World Bank's numbers for developing countries were about 54 percent. This is obviously an area where there is a huge potential for expanding markets.

Cutting industrial tariffs would create thousands of jobs in Germany alone

World Bank studies have shown that global free trade in industrial goods and agriculture could boost developing countries' annual incomes by $540 billion, lifting some 300 million people out of poverty, i.e. more than the population of the United States. Nearly two thirds of these benefits would go to the developing world not only because their ability to export to the developed world but also because of the existing barriers among each other. About 70 percent of the tariffs that the developing counties pay are to other developing countries. So this is a tremendous possibility of expanding developing countries' trade. In the services area where less work has been done, the World Bank has shown that you could actually get a $900 billion annual income boost from removing the barriers.

European interests

Now let me move more particularly to the European benefits. Some of the statistics I am pointing to here come from work done at the University of Michigan. The statistics refer to a combination of the EU and the EFTA countries. Free trade in goods would boost the economy of Europe by some $200 billion a year and in services by some $300 billion a year.

Just taking up the second point, the German Economics Ministry pointed to some analysis from 1999 that showed that by cutting industrial tariffs by just 50 percent as opposed to total elimination you could create some 55,000 jobs in Germany and boost Germany's GDP by €11.5 billion a year.

I mentioned earlier the possibility of zero-for-zero negotiations. Some of the areas that we are trying to focus on right now with the European Commission are aircraft, pharmaceuticals, computers, medical equipment, electrical equipment, office and industrial machinery and also autos and auto parts. Our numbers show that this would make about a third, maybe a little bit more, of Germany's exports tariff-free. The effect of these numbers may be seen in reference to autos. India's auto tariffs are about 105 percent, the EU's about 10 percent and ours about 2.5 percent.

To be successful in this effort – and this is one of the items we are working on – we will clearly have to give different phasing and special differential treatment to the developing world. Nevertheless, as I mentioned, it also will benefit developing world trade, because we do not want to repeat a type of neo-colonialism, where trade just flows form the developing to the developed countries. There is tremendous potential for trade among the developing countries themselves, and we were pleased that when we came out with our goods proposal UNICE (Union of Industrial and Employers' Confederations of Europe) was very supportive as was the BDI (German Federation of Industry).

So where are we today? Earlier this week I attended a meeting of the OECD countries in Paris. A

number of developing countries were invited there as well. Preparing for this meeting over the past few weeks I have been working closely with EU Commissioner Pascal Lamy to try to see if we could get some renewed momentum going at Cancun. We both felt that, for all the good work being done by our ambassadors to the WTO in Geneva, it is vital to draw ministers into this process. But if you try to get ministers from some 146 countries you must get very focused on the agenda. So we came up with a list of about six items – it could vary, it is not trying to leave anything in or out. And these were six categories, including goods, agriculture, services, and development issues, the so-called Singapore issues, like trade facilitation, transparency in government procurement, topics the European Union has also been promoting. I think these have good support, whereas some dealing with investment and competition policy are going to be little tougher.

But we also were quite specific in coming forward with four specific ideas to draw closer in the goods area. And let me tell you the logic here. We knew that the agricultural discussions were stuck. The goods discussions are very important for the world economy as part of the market access agenda, and the US and the European positions were not all that different, although ours were a little bit more aggressive. So we identified four key points of agreement to a) show that the United States and the European Commission are working together, b) add a sense of hope and opportunity for the other countries, a sense of movement, and c) try to shape the agenda going on in Geneva, because during the month of May the chairman of this negotiating group will be developing a framework.

First, we came together on the idea of having one harmonising formula to reduce tariffs along the lines that we suggested. We did not come to an agreement about the exact cap or method. Second, besides the idea that we should have a formula, there is the idea that we should eliminate tariffs below a certain level – we have not yet agreed on a number, we are at 5 percent, the EU is more around 2 percent, but they may be able to come up a little bit. Third is the notion of sectoral zero-for-zero negotiations that I mentioned, and then, fourth, a component for special and differential treatment.

This can set the stage but what was also very clear coming out of the OECD meeting in Paris, is that there will have to be movement on agriculture. And this is not just a demand of the United States. Brazil was very adamant on this, Egypt was very adamant on it, Indonesia from Southeast Asia was very strong about this, Morocco, speaking on behalf of the African group, and of course Australia, New Zealand and Canada. It is fortunate that there is a process going on now to consider reforms of the EU's Common Agricultural Policy (CAP). To their credit, Commissioners Fischler and Lamy have put forward a proposal on behalf of the Commission. That does not solve everybody's problems, but it would have two benefits: it is obviously driven by European concepts for internal reform and it also has the possibility of giving the Commission additional flexibility in these negotiations. Commissioner Fischler is pushing for a decision on this by June.

One of the reasons why I was in Berlin and in Paris, where I had discussions with the finance ministers and also with members of the business community, was to emphasise the importance of this development. I have been trying to set the stage by showing that for the European business community and others there are benefits from the good's area and by showing other countries in the world that the United States and the EU are moving together. But the ultimate reality is that it will come down very significantly to the reform of the Common Agricultural Policy.

Four ideas that would draw the U.S. and Europe closer on goods

Let me just mention what I could consider to be some of the German interests in the reform of the CAP. First, this has been driven first and foremost by the recognition of many European countries of the need to reform the Common Agricultural Policy for European reasons. Obviously the European Union is in the process of enlargement. Therefore the question is: how easy will it be to restructure the CAP when you have 25 as opposed to 15 countries, especially when many of the ten new members have agricultural sectors with their own sensitivities.

But in addition, particularly from a German perspective, there is a desire to try to focus agricultural policy and consider world concerns, environmental concerns.

The nature of the CAP reform that Franz Fischler has put together is designed to do this by so-called de-coupled payments. Without getting too techni-

cal, the agricultural area is a little different than the goods area. The rules permit subsidies but they have to be de-linked from production, hence the word de-coupling, and if they are they are put in a category called the green box, meaning they are permitted subsidies.

Thus, some of the proposals that Fischler has put forward, and that the United States started to put forward in 1996, say that if you want to pursue world or environmental objectives, you can pay your farmers. It is up to you or for us to decide whether that is a good use of money or not, but if you want to do it, you can do it, just don't distort production by encouraging farmers to produce more than they otherwise would. Because if you increase prices and as a result get a surplus of production, then you want export subsidies in order that people buy it.

Thus there are reasons why this is being driven by the EU's internal interest. But there is a second benefit which is that CAP reform would give a very important shot in the arm to these trade negotiations. And again, it does not do as much in the area of market access, but frankly I think it would be a very important step.

CAP reform is essential for successful trade negotiations and the EU's internal interest

Additional benefits are that this is one of the best ways that Europe and the rest of us can help developing countries. And I know there is a sincere interest in that, particularly in Germany, and also in other quarters in Europe, because many of these developing countries really depend on their agricultural exports to increase their income. It could be a boost to the fragile world economy.

It would obviously be a great benefit if the Cancun meeting were successful and we could build confidence, over time reduce those barriers and reap the benefits that I mentioned in the goods and services trade. In my view this comes at a particularly important time for Germany, given the efforts on structural reform. It is easier to deal with changes on the domestic side when you have a growing international economy and more jobs through exports. Indeed, whether it be Germany or Latin America or others, it is easier to undertake structural reforms if you have overall global growth. It is a good opportunity also, because the proposals are not being put forward by Brazil or Australia or the United States but by the European Commission. Thus, given German sensitivities about operating in a European framework, the opportunity presents itself and is also an opportunity to strengthen a key multilateral institution, the WTO.

And finally, at a time when people are writing stories about how the United States and Europe can find areas of co-operation, here is one that is definitely in everybody's economic interest and also supports a multilateral institution.

Many people have said the United States is not committed to multilateralism, but it is hard to look at these proposals and say the U.S. is not. Now the question is whether Europe is committed to multilateralism.

An appeal to European businessmen

It is vital to get European business engaged with the Doha agenda. I already pointed out some of the benefits, but here are some examples. Kodak, a US company, pays $250 million in tariffs around the world. To the question of how to reduce that number our answer was that Kodak would have to learn about agriculture, because to be able to go at the overall industrial tariffs we are going to have to deal with the agricultural issue.

It is increasingly important that companies take the responsibility to try to build support in their communities, with their employees, with their shareholders. There is no shortage of people out there that either want to sound anti-globalisation themes or talk about protectionism. This is certainly true in the United States. Industries that are struggling to keep up, that are afraid of competition, are extremely well organised in Congress. However, one of my challenges is trying to get some of the industries whose business models are totally based on the assumption of openness to act on that. For example, in trying to get the trade act through we could not get the votes of the two Congresswomen from Silicon Valley. Now someone has to explain to me how the hi-tech community can survive without global openness. Its businesses have to make it clear to their members of Congress how important this issue is.

About four weeks ago I was in Los Angeles trying to help organise an entertainment coalition for free trade because increasingly, particularly in these bilateral agreements, we are dealing with

some fascinating issues of the digital world and protection. The Motion Picture Association helped put together this coalition because half the revenues of the entertainment industry depend on overseas sales. Well, I think there needs to be a similar effort in Europe.

Let me give you another example. One of the farm co-operatives in the United States put on their biweekly payslips the amount of sales they have overseas so the employees could see the importance of overseas trade for their own livelihood. This is not just a government task. There are many opportunities to build coalitions with US or other businesses in areas of common interest. We talked about the services industry and the goods industry. I mentioned another topic under the Singapore agenda, trade facilitation.

In so many quarters of the world the added cost of simply doing business, whether because of inefficient custom systems or other arrangements, can overwhelm what one does in the tariff area. To be more specific, we have been working with Egypt (with some of our aid money) to help them build their customs system. Right now it does not matter what their tariffs are because the customs official at the border can decide to double the price or increase it to some arbitrary degree. If you double the price it certainly wipes out any benefit of a tariff cut because you have just increased the base to which the tariff applies.

The final point that I want to leave you with is that this truly is a moment where it is going to be absolutely vital to have EU member states recognise the broad benefits of CAP reform and the criticality not only for Europe but for the global trade negotiations. I know that this is not just a German responsibility. There is strong support from Scandinavian countries, from Britain. But it will come down very heavily to what Germany does. I left the OECD meeting with a slight additional sense of optimism. We don't have to solve everything by the Cancun meeting – we just have to move the agenda forward to the next stage.

The Risk of Deflation in Germany and the Monetary Policy of the ECB

Georg Erber*

Since the spring of the current year a discussion has begun among economists on the world-wide danger of deflation. A study recently published by an IMF task force has put concerns in this regard, particularly with respect to Germany, back on the economic policy agenda. What would need to be done in Germany in order to better deal with this danger?

Danger of deflation in Germany?

Germany is on the borderline of deflationary. This is the conclusion reached in a study recently published by the IMF with the express approval of the IMF's chief economist, Kenneth Rogoff. For the federal government, the Chancellor, and the Minister of Finance, Mr Eichel, have publicly disputed this, as have the President of the Bundesbank, Mr Welteke as well as the Chairman of the Council of Economic Experts, Prof. Wiegard. This suggests that those responsible in Germany see no need for the ECB to take measures to counter a deflationary development.

Deflation refers to a general decline in the level of consumer prices, as measured in the EU by the harmonised index of consumer prices (HICP). In analogy to the definition of a recession, a decline of the price index over at least two consecutive quarters is the official benchmark for the occurrence of deflation.

There are different sources of deflation. On the one hand deflation my result from a general improvement in efficiency on the supply side, with increases in productivity leading to price reductions. On the other hand, it can be the result of a weakness of demand. This may lead to wide-spread price wars associated with a large margin of underutilised production capacity, and may even include ruinous competition. In such a case, one speaks of a demand-side deflationary process (IMF 2003, p. 9ff.).

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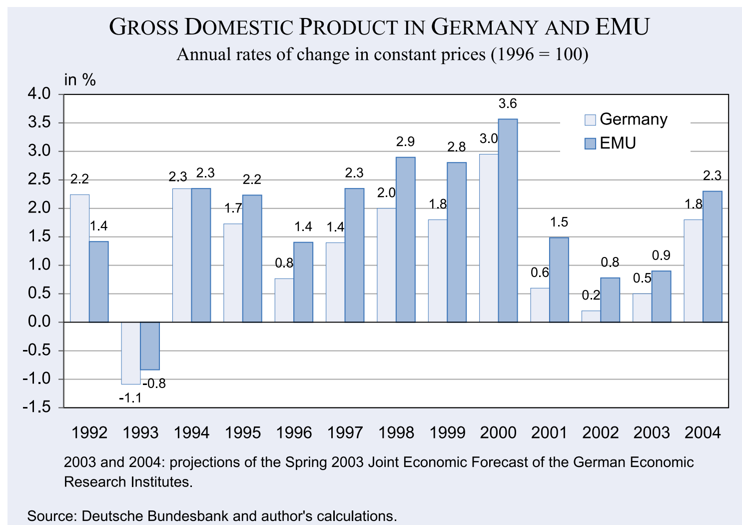
Whilst supply-side deflation was a longer lasting phenomenon in the 19th century during the era of industrialisation, in the world economic crisis of 1929 to 1933, deflation represented the effects of a weakness in demand which spread rapidly throughout the world. The concerns of the IMF economists focus at present on the danger of a demand-side deflation. Germany is only one of numerous countries that are at risk. However, deflation in a country like Japan or Germany, which are the second and third largest economies after the United States, represents a much greater threat than deflation in a smaller country; in addition, in assessing the danger one must take into account Germany's position as the largest economy within the EU.

The ECB possesses the instruments of monetary policy needed to combat deflation. The ECB has just recently redefined its monetary policy guidelines in order to better take into account the deflationary danger in EMU (ECB 2003). Instead of setting a policy goal of an inflation rate under two percent, the goal is now defined as an inflation rate of about two percent. In addition, with a view towards avoiding deflation, the ECB has set a lower limit of one percent inflation as a further monetary policy benchmark. These corrections in the ECB's monetary policy goals are, however, not sufficient to put a timely end to the present deflationary danger in Germany. Owing to inaccuracies in measuring inflation, as a rule a rate of inflation of one half percent is already considered to be the critical value at which deflation may appear.

Leading economists have characterised the new monetary policy orientation proposed by the Executive Board of the ECB as misleading (De Grauwe 2003). In particular, there is no clear commitment by the ECB to combat quickly a potential deflationary risk in individual member countries of EMU, like, for instance, Germany. The reason for this, it is argued, is that the ECB's decisions must be geared to the average of all member countries. Gearing decisions to specific countries would contradict the spirit of EMU. Thus the present attitude of the ECB means that only in the case of a deflationary risk facing the entire EMU could the ECB take monetary policy measures to counter the danger.

Adam S. Posen (2003) of the Institute for Institutional Economics in Washington arrives at conclusions that are very similar to those of the IMF.

Figure 1



GROSS DOMESTIC PRODUCT IN GERMANY AND EMU

Annual rates of change in constant prices (1996 = 100)

Source: Deutsche Bundesbank and author's calculations.

He sees Germany threatened by the Japanese illness: prolonged economic stagnation threatening to give rise to a demand-side deflation. The causes are twofold: first, in Germany, as in Japan, there is a crisis in the financial markets; and second there has been weak growth during the last three years (cf. Fig. 1). In Germany this growth weakness resulted in an unmistakeable and unexpected contraction in retail sales of 4 percent in the first quarter of 2003, and in an unforeseeable decline in gross domestic product of 0.2 percent. Whether these developments mainly reflect short-term effects of the Iraq war is a subject of controversy. For some time now, Germany has been the laggard with respect to economic growth in the EU, and the latest figures indicate a poor growth outlook for the entire EU.

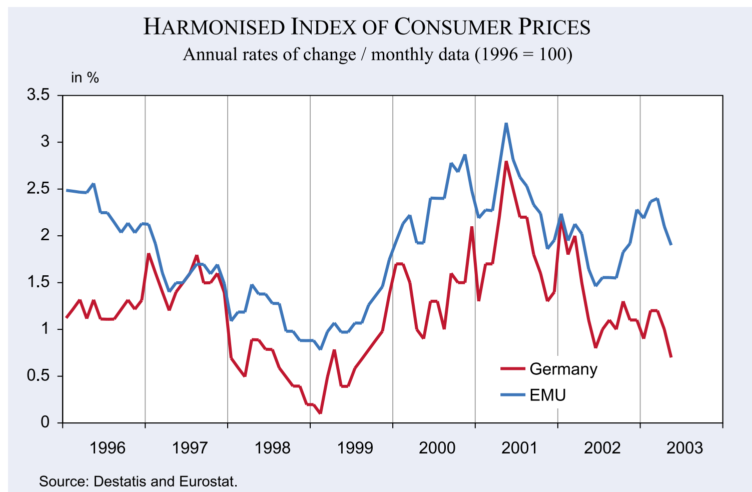
Britain's National Institute of Economic and Social Research, which also does research for the ECB and for the Ecofin Council, has carried out simulations which point to a current deflationary danger for Germany, which will be accentuated if the sharp revaluation of the euro continues.

In this context it is not only the sharp revaluation of the euro vis-à-vis the US dollar that deserves attention, but also vis-à-vis other world currencies such as the Japanese yen. The value of the euro has risen against the Chinese renminbi and against the currencies of other Asian threshold countries owing to the past export orientation of these countries towards the U.S. and Japan and in conformance with a new exchange rate policy. This means that the international price competitiveness of the euro area and especially of Germany is weakened. This is all the more threatening as in the past the euro zone's economic growth was essentially determined by exports. Two-thirds of the euro area's 0.8 percent economic growth rate in 2002 was accounted for by the surplus of exports to non-EU countries. The looming record deficit of $500 billion in this year's US trade balance may limit the willingness of the U.S. to assume the role of engine of growth for the world economy. A devaluation of the dollar helps to reduce the deficit, but at the same time it exerts a deflationary effect on those countries experiencing a revaluation of their currencies. In the U.S., too, anxiety concerning the possibility of deflation has made itself felt, especially since the "new economy" bubble has burst; the deflationary risk on the other side of the Atlantic is, however, less acute than in Germany. In the U.S., the interest rates are at an historic low, with the federal funds rate at 1 percent; in Japan, the Japanese Central Bank, with its policy of interest rates at virtually zero, has lost almost room for manoeuvre for monetary policy. Under these circumstances, devaluation of one's own currency in order to stimulate the domestic economy turns out to be a beggar-my-neighbour policy.

In Germany, the boundary conditions imposed by the world economy together with the domestic structural and fiscal crises add up to a growing demand-side deflationary danger. Although wages and salaries are increasing in nominal terms, private households are presently raising their savings ratio so that a perceptible downturn in private consumption is being observed. Available supply is not matched by adequate domestic demand, since both private investment and public expenditures are in decline or virtually stagnant. Furthermore, the German financial markets are in an unstable condition unlike anything experienced in the history of the Federal Republic. There is no scope for a rigorous expansionary fiscal policy, like that currently being followed in the U.S.; in contrast, Germany is currently trying to reduce the high budget deficit which, though otherwise appropriate, is not the answer to the challenges faced by fiscal policy.

Imperfections of the European Monetary Union

Figure 2



Source: Destatis and Eurostat.

When the Maastricht Treaty on forming a European Monetary Union was being negotiated, there was considerable controversy about the necessary preconditions for a country's membership in EMU. According to the theory of optimal currency areas, a currency area can only function efficiently, when there is a sufficient degree of convergence between the geographically defined economic units that use the common currency. The fathers of EMU had the same kind of hopes that prevailed when the German currency union was formed at the beginning of the 1990s: that a sufficiently rapid convergence between the member countries would emerge. However, in the run-up to 1998, and even thereafter, this has not been attained. One important reason for this is the still great disparity in per capita incomes in the EMU countries leading to a more rapid alignment of per capita income, not only through the common EMU financial market, but also through the price level in the individual countries. Experience indicates that this results in differences between the rates of inflation in countries with a high per capita income such as Germany, and in those with a low level of per capita income, such as Ireland, Greece or Portugal. In the complex processes involved in a reduction of the disparity of living standards in a situation in which the price levels are also disparate, it is entirely possible that there will be differences in the rate of inflation between the different EMU countries.

Another influence working against a rapid convergence of the inflation rate in individual countries is the Balassa-Samuelson effect (Rogoff 1996; Erber 2002). As a consequence of the political nature of the selection process for EMU members, the union will continue to be an imperfect currency union for some time.

Because the convergence of inflation rates of EMU member countries can be expected to continue to be inadequate, Germany will tend to remain at the lower end of the range of inflation rates within EMU, owing to the Balassa-Samuelson effect. Two years ago, Hans-Werner Sinn (2003, Sinn and Reutter 2000) showed that Germany must keep its inflation rate permanently at a level of about one percent if the EU is to have an inflation rate of two percent. This means that in a situation in which the other member countries are experiencing very low levels of price increases or even stagnation as a consequence of a general weakness in growth, the restrictions imposed on Germany do not give sufficient room for manoeuvre so as to keep Germany's rate of inflation above zero. From a German point of view, the ECB's hesitant measures to ease monetary policy since 2000 have regularly come too late to help stabilise cyclical developments or to stop in a timely fashion the incipient downward movement.

The rate of inflation in Germany, as measured by the value of HICP in May 2003 as compared to the same month of the previous year, amounts to 0.7 percent. For EMU as a whole, the corresponding figure is 1.9 percent. The difference between EMU's inflation rate and that of Germany is thus even larger than one would have expected based on long-term trends. As early as 1999, Germany was confronted by a deflationary development as a result of the effects on world-wide growth of the crises in Russia and in Asia. The rate of economic growth was, however, still 1.8 percent. In addition, Germany's financial markets were in better shape. At the same time, a devaluation of the euro vis-à-vis the dollar began which stimulated German exports.

Crisis of financial markets in Germany

After the speculative "new economy" bubble burst in the spring of 2000, the crisis in the commercial banking sector became perceptibly more acute. The large amounts of bad loans and the big losses

suffered by holders of stocks and other assets made a recapitalisation of Germany's commercial banking sector more difficult.

The capital markets have since experienced sustained losses in the value of financial assets. A dramatic fall in stock prices, falling profit expectations and falling bond rates have all contributed to this destruction of financial assets. In Germany, as in Japan, and unlike the United States and Great Britain, real estate has not offered an alternative investment opportunity with an attractive yield. (IMF 2003, p. 53, fig. 12b).

Since banks and insurance companies hold a portion of their equity capital in stocks and in real estate, they as well as other private and institutional investors have been severely affected by these developments. Large downward valuation adjustments of portfolios do, however, pose problems for banks' lending activities, since the required equity ratio may not be met or may not permit lending activity in the accustomed magnitude.

Commercial banks' liquidity bottlenecks and increasing risk premiums on loans have brought about a situation in which credit is in effect rationed in Germany and this has paralysed many sectors of the German economy. The credit contraction began in the second half of 2001 and grew stronger throughout 2002. This contraction is particularly marked in the case of the big banks. Supporting actions, like the proposal of a "Bad bank", are to avoid a credit crunch at Germany's big banks; related actions, such as the true-sale initiative with the participation of the Bank for Reconstruction and Development, are designed to strengthen the liquidity situation of Germany's commercial banking sector. At the moment it is impossible to say whether these measures will take effect quickly and will serve to alleviate the credit shortage. Only the future lending behaviour of banks vis-à-vis firms and individuals will give an answer to this question. The banks' higher lending risks are leading to markedly higher interest rates for business borrowers; the losses that banks have already suffered in their lending transactions aggravate this tendency. Moreover, many commercial banks have cut back the lines of credit they extend to their business and private clients, thus creating a liquidity risk for these customers. A good part of the insolvencies registered in the past year, which reached record levels for the post-war period, were due to such credit restrictions.

Large institutional investors in the money and bond markets, like life insurance companies and pension funds, are suffering from the sustained weakness in the prices of stocks and real estate; the very low level of nominal interest rates prevailing in the OECD countries is an additional burden, and financial emaciation threatens if these markets do not turn around soon.

If a deflation, even though mild at first, were to coincide with these processes, it could very easily lead to a cumulative debt-deflation spiral.

From deflation to depression

As early as 1933 Irving Fisher (1933) analysed this process in a study of the world economic crisis; he identified inappropriate restrictive and procyclical monetary and fiscal policies in the United States and in a number of European countries as a central cause. In their comprehensive study of US monetary history, Milton Friedman and Anna Schwartz (1963) later confirmed Fisher's analysis.

G. Akerlof (1996), who recently was awarded the Nobel prize, using a model with a modified Phillips curve, has documented the dramatic effect of deflation on growth and employment when nominal wages are rigid and, at the same time, a rapid downward adjustment of wages would be necessary for macroeconomic reasons. Such an adjustment, however, is made impossible owing to social-psychological patterns of behaviour. Compared to a traditional Phillips curve model, Akerlof's explanatory approach was able to model excellently the unfolding of the Great Depression of 1929–33.

In such circumstances, what starts out as a mild deflation can turn into a runaway deflation process as a result of the slowdown in economic activity and in employment which the deflation triggers, unless expansionary and co-ordinated monetary and fiscal policies counter the deflationary tendencies. This process gains momentum when a general deflation is accompanied by wage deflation. If firms are making losses and respond to this by cutting the wages and salaries of their employees, and if this occurs on a sufficiently broad front through-

out the economy, then a price-wage-deflation spiral will be the result.

During the Great Depression, the general level of prices in the U.S. declined by 30 percent within three years. Initially, such deflationary tendencies are unexpected, but if they persist and begin to influence economic agents' expectations, then such a process can, under certain conditions, end up as a depression embracing the entire economy. In a depression the economic agents are confronted by a dynamic disequilibrium that causes most of them to abandon hope of any improvement of the economic situation. Instead of a cyclical development, a lasting confidence crisis arises, in which doubts become stronger as to whether adaption to the downward trend can overcome the recessive tendencies.

Breaking out of such a depression caused by persistently pessimistic expectations requires great efforts and gives rise to considerable costs because of the liquidity trap that neutralises interest rate policy as described by Keynes. Japan provides a warning example of just such a desperate situation, which has continued since the beginning of the 1990s.

Monetary policy consequences for the ECB

The ECB should under all circumstances strive to prevent such a development in any member country. Owing to the great weight of the German economy in the euro area, the effects of a deflation in Germany would soon spread to other member countries of EMU. The closer the integration is between Germany and a particular country, the greater the danger of contagion. It may be difficult at the moment to quantify reliably the probability of such a process arising, but given the high welfare losses which the entire economy would suffer if it did arise, the ECB and the German government would be well advised to do everything in their power to preclude this danger.

There is, at present, no risk of a sudden acceleration of inflation either in the individual member states of EMU, or in EMU as a whole. Therefore, the ECB ought to pursue an expansionary monetary policy as a precautionary measure in order to eliminate the current danger of deflation in Germany. Many observers are sharing the impression that the important economic policy makers, i.e. the decision makers in the ECB, the German government and the Bundesbank, deny this danger or consider it negligible, and that they are prepared to stick to this attitude until it is too late. Instead of pursuing a pre-emptive anti-deflationary policy – as the IMF expressly recommends – they have assumed a wait-and-see attitude, and seem prepared to persist in this until it is very late, or perhaps until it is too late.

The decision of the ECB to abandon the money supply as a leading indicator of future inflationary or deflationary potential in EMU countries doesn't solve the problem of identifying an indicator that would enable it to conduct a foresighted monetary policy. Only within EMU has the money supply proven to be an inappropriate indicator.

The warnings issued by the IMF and by Alan Greenspan should not fall on deaf ears in Europe's central bank.

Setting a price stability goal defined as a corridor for an allowed rate of inflation of between 1.5 and 3.5 percent as an officially proclaimed policy goal could serve, together with other expansionary monetary measures of the ECB, to reduce permanently the danger of deflation for Germany as a member country. This could be done without damaging the credibility of the ECB with respect to its ability to ensure price stability in EMU as a whole.

Furthermore, high volatility of the major exchange rates should be prevented by international co-ordination of exchange rate policy, under the overall control of the IMF, in order to avoid another burden for the world economy. Within the framework of Ecofin in the EU the German government can make an important contribution to this. One must wait and see whether such an agreement was prepared at the last summit meeting of heads of government in Evian or the conference of the Institute for International Finance in Berlin. For some time now a broad discussion has been going on in the U.S. concerning the consequences for monetary policy of an economic environment with low rates of inflation.

Economic policy options for the German government

The measures discussed above would give Germany and the German government a respite which could be used to carry out expeditiously the struc-

tural reforms in the labour market and the social security systems which are unavoidable and which alone are capable of ensuring a lasting and self-sustaining economic upturn in Germany.

The German government ought to appoint a task force charged with monitoring deflation; it should examine the available information with a view towards evaluating the risks for Germany and towards formulating policy options for acting in close cooperation with the ECB.

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Corporate Disclosure in a Global Age: Next Steps

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It was only a short time ago, after the Asian financial crisis of 1997–98, that the American system of corporate disclosure – the combination of Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), the professionalism of auditors, and the rules and practices of corporate governance that are designed to ensure the timely dissemination of relevant and accurate corporate financial information – was championed as a model for the rest of the world.

How much has changed since then. A series of major corporate accounting scandals involving many former and current household names – Enron, Worldcom, Bristol-Myers-Squibb, and AOL/Time Warner, among others – rocked investors' confidence not only in the quality of financial information published by these companies, but by corporations generally. The flight from stocks helped drive their prices down by roughly 25 percent through the first half of 2002 (when uncertainties over the possibility of a war with Iraq became the more dominant force affecting stock prices).

Perhaps just as surprising as the scandals themselves, however, was the remarkably swift reaction by both the public and private sectors to address the flaws in the corporate disclosure and governance systems that the scandals revealed. Congress enacted and President Bush signed into law the Sarbanes-Oxley Act, which among other things, created a new body to oversee the auditing profession; made it difficult for auditing firms to engage in non-audit activities; and added a raft of new, tougher criminal penalties for financial wrongdoing. Less noticed, but equally important, were reforms by the major U.S. stock exchanges, the New York Stock Exchange in particular, which adopted new listing requirements: that a majority of the members of corporate boards be independent and that the hiring and firing of auditors be vested in audit committees of boards rather than in management.

The body charged with setting accounting standards in the United States, the Financial Accounting Standards Board (FASB), also reacted: by proposing a change in the rules governing the consolidation of the kind of "special purpose entities" (SPEs) that Enron abused and, more importantly, by promising to revisit the controversial issue of whether the cost of stock options at the time they are granted should be included as an expense rather than merely reported in footnotes in corporate financial statements. Although accounting for stock options was not directly implicated in any of the corporate scandals, many observers believe that excessive grants of options to corporate executives emboldened a number to "cook the books" in an effort to bolster their companies' stock price (so that they could exercise their options at high prices before they fell). If U.S. GAAP had required companies to report the grant of these options as an expense – as would have been the case had not Congress, at the behest of the business community, prevented the FASB from requiring in the 1990s – it is plausible that options would not have been so liberally granted to corporate officials, thus mitigating somewhat the incentives that led some to misreport their earnings.

Notwithstanding the various reforms – as well as the efforts under way in the private sector to improve disclosure – there is, at this writing, much skepticism about how effective all of the changes will prove to be. In part, the concern centers on the rocky start of the new audit oversight board, and the failure of the former Chairman of the Securities and Exchange Commission, Harvey Pitt, to inform other Commissioners and the White House of a potential conflict of interest involving the individual initially chosen to be the board's first chairman, former FBI and CIA Director William Webster (who has since resigned his post). The episode apparently was the last straw that led to Pitt's resignation the day of the mid-term elections. Furthermore, many wonder whether the SEC, despite the budget increase of roughly 20 percent it received in fiscal year 2003, nonetheless has sufficient resources to carry out its mandate effectively: to write rules implementing Sarbanes-Oxley, to investigate corporate financial reports, and to bring and successfully conclude all of the enforce-

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ment actions against offending companies that may be necessary.[1]

The guess here is that the reforms adopted by the Congress and the exchanges will prove more successful than the skeptics fear, but less effective than the optimists would wish. Those who concentrate on just the legal reforms overlook the fact that much in the business and political environment has changed as a result of the corporate accounting scandals. At the same, other elements of the system have not changed: notably, stock options still are not required to be expensed, while the media continue to report oddities in the earnings figures of major American companies. The widely derided practice of "earnings management" – brought to public attention by former SEC Chairman Arthur Levitt – apparently seems to persist, at least among some companies.[2]

As a result, issues relating to corporate disclosure and governance are not likely to disappear from the American political agenda, especially if the economy stays weak and stock market performance remains disappointing through the 2004 Presidential elections. Likewise, corporate disclosure should continue to be of interest in Europe, where international accounting standards promulgated by the International Accounting Standards Board are set to take effect in 2005, although EU members may endorse or reject individual international standards. Elsewhere around the world, disclosure issues may also remain salient, if for no other reason than countries that were lectured to by the United States will continue to watch with some interest as America struggles to deal with its own disclosure problems.

If corporate disclosure remains of interest, what further should be done about it? This paper attempts to provide one answer by drawing attention to a conundrum that existed well before the U.S. corporate accounting scandals of 2002, and that has since received more attention in the wake of those scandals: the disjunction between the globalization of equities markets and the continued existence of national accounting and corporate disclosure standards. On the surface, the movement toward a single global capital market – although it is still not complete, but well under way – would seem to call for a single set of accounting standards so that investors in all countries will be able more easily to compare the earnings of companies headquartered in different nations. Easier comparisons, in turn, should facilitate the allocation of capital across national borders – to those companies that most deserve it, and away from those companies that don't. Furthermore, greater transparency in financial statements, which a single set of accounting standards should make possible, in principle should lower the overall cost of capital for all companies in the capital markets by increasing investor confidence in the information available to make investment decisions. There also seems to investor demand for a single world standard, although disagreement about which one. In a survey conducted by McKinsey and reported in the summer of 2002, 90 percent of large institutional investors worldwide want companies to report their results under a single world standard, although European and American investors have very different preferences: 78 percent of the Europeans favored the international accounting standards set by the IASB, while 76 percent of the Americans preferred U.S. GAAP.[3]

At this writing, two of the main accounting standards setters in the world – FASB and the IASB – in fact are working to harmonize the differences in their standards to achieve these very goals. The IASB's proposed rule on expensing of stock options, on which the FASB also has sought comment, should provide the first major test of whether the standards-setters can realize their more ambitious objective of harmonizing all of the other standards.

I take in this paper a contrarian and skeptical view of both the likelihood that the world in fact will soon see a single set of accounting standards, and just as important, whether that is a desirable outcome. Instead, I lay out an alternative vision, one involving a competition in standards, which I believe is likely to be more flexible in the face of change and even more investor-friendly than a single set of standards overseen by a single body. I also discuss the critical issue of enforcement: even if somehow the reporting standards themselves are

[1] During the summer of 2002, both the Senate and House voted to authorize a 60 percent increase in the agency's budget, but in the end actually appropriated a 20 percent increase (after the Bush Administration signaled it preferred the lower figure).

[2] Since leaving his chairmanship, Levitt has since set forth his views about earnings management, and many other subjects, in his popularly acclaimed *Take on the Street: What Wall Street and Corporate America Don't Want You to Know and What You Can Do to Fight Back, Random House Inc., 2002.*

[3] See *McKinsey Global Investor Opinion Survey on Corporate Governance,* July 2002, www.mckinsey.com/govemance.

harmonized, if the systems for assuring their enforcement produce different outcomes in different countries, then investors still will not be able have confidence that reported figures for different companies can be easily compared. Bringing greater consistency to enforcement of standards across countries is a critical, very difficult and easily overlooked, challenge that should be addressed regardless of what one believes about the merits of harmonizing reporting standards.

The globalization of the equities markets

But first it is useful to review exactly how "globalized" equities markets are or have become. If globalization is measured simply by purchases of equities by foreigners then indeed a world capital market has been developing over time. Total cross-border portfolio equity flows among developed markets, on a net basis, now exceed $1 trillion annually.[4] Gross purchases of equities are much greater in volume. For the United States alone, gross annual purchases by foreigners of U.S. equities in the year 2000 totaled $7 trillion. The comparable figure for gross purchases by U.S. residents of foreign securities in that year was $3.6 trillion. These figures are up by roughly a factor of 10 or more over the last decade.[5]

Another indicator of the growing integration of capital markets, at least among two of the world's major equities markets, is the rising number of cross-listings by corporations whose shares are traded on both the New York and London Stock Exchanges. Companies that cross-list incur the expense of complying with the rules of multiple exchanges, but nonetheless must also believe that benefits – in terms of accessing a wider base of potential investors and being more attractive to customers and suppliers – more than justify the costs.

A substitute for cross-listings, at least for trading in U.S. and European markets, is for foreign companies to trade as an American Depository Receipt (ADR).[6] Trading in ADRs in the United States in 2000 exceeded $1 trillion, or about 17 percent of trading in corresponding local markets. In that same year, 115 DR offerings took place in the United States and Europe, a 32 percent increase over 1999.[7]

To be sure, measures of cross-border integration based solely on the volumes of flows can be misleading because markets for equities are far from perfectly integrated, even among developed economies where one would expect political and legal risks, as well as information disclosure, to be roughly comparable.[8] Rather, investors tend to have a "home country" bias, in that they typically have far lower proportions of their portfolios invested in foreign stocks than is indicated by the relative valuations of those stocks as a share of the worldwide market.[9] Although various factors help explain why investors tend to invest disproportionately in stocks listed on home country markets - including language barriers, currency exchange risk, higher transactions costs on foreign stock purchases, variations in corporate governance, and risk aversion on the part of investors to putting their money into companies with which they are not familiar – it is likely that the disparity in the kind and quality of information disclosed by companies in different countries also plays a contributing role. By implication, therefore, if publicly held firms around the world all had to play by the same reporting rules – in the way they calculate their financial position and how published data are verified and audited – some of the home country bias very likely would be reduced. The net result, at least in principle, would be an improvement in the allocation of capital across national boundaries.

Why the focus on disclosure for the benefit of equity investors? The overriding reason is that the current system of disclosure – by law and by practice – has developed to satisfy the needs of equities

[4] "The Hunt for Liquidity", *The Economist,* July 28, 2001, p. 65.
[5] William L. Griever, et al., "The U.S. System for Measuring Cross-Border Investment in Securities: A Primer with a Discussion of Recent Developments," *Federal Reserve Bulletin,* October 2001, pp. 33–50, at 640.
[6] An ADR is a negotiable instrument backed by the shares of the foreign firm, which are typically placed in a trust with a local (U.S. or European) bank.
[7] Stijn Claessens, Daniela Klingbiel, and Sergio L. Schmukler, "The Future of Stock Markets in Emerging Markets: Evolution and Prospects," *Brookings-Wharton Papers on Financial Services*, 2002.
[8] In addition to the sharp rise of cross-border flows of portfolio capital, flows of more permanent equity (foreign direct investment), as well as debt capital (bonds and bank loans) also have risen sharply over the past several decades, faster than the growth of trade in goods and services (and GDP). For one guide to the data, see Ralph C. Bryant, *Turbulent Waters: Cross-Border Finance and International Governance* (Brookings Institution Press, 2002). See also Benn Steil, *Building a Transatlantic Securities Market* (Council on Foreign Relations, 2003).
[9] Linda Tesar and Ingrid Werner, "The Internationalization of Global Securities Markets Since the 1987 Crash" in R.E. Litan and A.M. Santomero Eds, Brookings-Wharton Papers on Financial Services, vol. 1, 1998, 281–372. For an excellent summary of the literature on "home country bias", see Karen K. Lewis, "Trying to Explain Home Bias in Equities and Consumption," Journal of Economic Literature, Vol. 37, 1999, pp. 571–608.

investors in particular. A related reason is that equities markets are of increasing importance and interest, not just in the United States, but around the world. For example, in the United States, the share of households investing in stock directly or through mutual funds rose from 32 percent in 1989 to 49 percent in 1998. Excluding pension fund holdings, equities have also climbed sharply as a share of household financial assets: from a low of 11 percent in 1982 to a high of 46 percent in the first quarter of 2000, before falling back to 33 percent in the third quarter of 2001.[10]

The table illustrates that stock ownership also has risen in other countries. The increase in equity ownership in Canada looks very much like that in the United States. However, stock ownership in Europe and Japan still lags the United States significantly.

Equity investors, or at least the industry of analysts and brokers who advise them, are interested in information that enables them to project future cash flows of the companies in which they hold stock. This is because, in principle, the value of a share of stock is simply the present discounted value of future dividends, which are derived from cash flows. Accounting information contained in income and cash flow statements and balance sheets is a critical input in most attempts to project future performance of firms. To the extent the market deems accounting information unreliable, investors confront information risk in making investment decisions. Higher information risks, in turn, make stocks less attractive than alternative investments, depressing stock prices.

Furthermore, equity holders (as well as creditors) have reason to be concerned about the validity of the numbers presented to the in financial reports. They cannot personally examine the books and accounts of corporations. Nor can they directly determine that corporate assets have not been misappropriated, liabilities understated, or net income falsified.

In short, investors have a very real interest in what corporations disclose, the trustworthiness of the disclosure, and how and when they disclose. Enron and the other accounting episodes, at least at this writing, have cast a pall over U.S. equities and until confidence in the numbers returns, that pall is not likely to be completely lifted.

The case for and against a single set of accounting standards

This paper began with two of the key reasons for having a single set of accounting standards worldwide: to improve the allocation of capital across national borders and to lower the overall cost of capital for the corporate sector. The Enron affair has added, in the minds of some observers (mostly outside the United States), a third advantage: that the adoption of IAS in particular would improve the quality of corporate reporting because international standards are superior to U.S. GAAP.

Equity Ownership In Selected Countries

Country	Initial share/number	Later share/number	Definition
Canada[a)]	23% (1989)	49% (2000)	Share of adults who own directly or indirectly
China[b)]	11 million (2000)	55 million (2000)	Number of investors
Germany[c)]	3.5% (1998)	7% (1999)	Share of adults who own directly or indirectly
Japan[d)]	14% (1989)	5% (2000)	Equity ownership of individual investors
Korea[e)]	2–3 million (1990)	7–8 million (2000)	Number of investors
Norway[f)]	14% (1994)	17% (1998)	Direct or indirect ownership

[a)] *Canadian Shareowners Study 2000*, conducted by Market Probe Canada on behalf of the Toronto Stock Exchange, www.tse.com/news/monthly-22.html. – [b)] "The Rise of a Global Shareholder Culture," Christian Science Monitor, July 2000, www.csmonitor.com/durable(2000/07/03/pl4s2.htm. – [c)] "Go Global," Kiplinger's Personal Finance, May 2000, www.kiplinger.com/magazine/archives/2000/May/investing/global1.htm. – [d)] "Japan's Missed Opportunity," The Globalist, June 2001, www.theglobalist.com/nor/gdiary/2001/06-29.shtml. – [e)] Christian Science Monitor, July 2000. – [f)] "Stock Markets Win the Masses," Christian Science Monitor, March 1998, www.csmonitor.com/durable/1998/03/25/intl/intl.7.htm.

Three arguments have been or can be adduced to support the third claim. One is the assertion that had Enron been required to report under IAS, it would have had to consolidate its many SPEs, and thus would have shown much higher leverage. This would have discouraged lenders from providing funds to the company, and while the firm may still have gone bankrupt, it wouldn't have been so large and taken down so many creditors when it did.

[10] E.S. Browning, "Where Is The Love? It Isn't Oozing From Stocks", The Wall Street Journal, December 24, 2001, p. C1.

A second argument in favor of IAS is that the IASB, at least recently, has been more out front on the stock option expensing issue than the FASB. To the IASB's supporters, this boldness demonstrates that the international board is less likely to be subject to political pressure than the FASB.

The third, and the broadest argument, advanced in favor of international standards is that they tend to be written as broad principles than as detailed rules. Somewhat paradoxically, broader discretion appears to some to be an advantage: pointing to the Enron affair, advocates of IAS claim that the excessive detail written into the U.S. rules invites clever managers, and their lawyers and accountants, to obey the letter but not the spirit of the rules. If firms instead had to follow broad principles, it is claimed, they would not be so tempted to engage in the kinds of evasive bookkeeping favored by managers of Enron and other companies involved in recent scandals.

How valid are each of these arguments in favor of a single set of accounting standards? The seemingly obvious claim that a single set of standards would facilitate comparisons of financial statements of companies from different countries in fact is undercut to some degree by one of the claims why IAS are superior to U.S. GAAP: namely, that the international standards allow for more discretion than their American counterparts. To the extent this is true, then companies reporting under this standard already have some significant degree of reporting discretion. The greater is this freedom, the less comparability there must be among financial statements of different companies. Even with the more detailed U.S. GAAP rules, companies have more flexibility in reporting their financial results than is commonly realized. Among other things, they can choose different depreciation schedules for fixed assets, make varying estimates of uncollected accounts, use different assumptions in determining the values of inventories (first-in, first-out or last-in, first out), and make assumptions necessary to estimate the cost of employee benefits that will be paid in the future. In short, because of the necessary flexibility built into both major sets of standards, companies' financial reports may be less comparable than advocates of a single set of world standards may realize or admit.

As for the alleged superiority of IAS – should they be chosen as the single set of stdandards – the verdict also is less clear than the IAS advocates claim. It may be true that on some issues – notably the expensing of stock options and consolidation of offbalance sheet entities – IAS indeed are superior to U.S. GAAP, at least at the current time. But the fact that IAS are more principles-based, and thus allow for more discretion, is not necessarily an advantage, especially in a legal system such as the one in the United States, where certainty of the rules can be important for firms and their managers and directors as a key to avoiding liability for financial negligence. Moreover, there is no reason why managers intent on manipulating earnings would be more constrained by more flexible rules than detailed guidance; indeed, it is quite possible abuses could be worse in a more flexible system.

In any event, standards-setters at both the FASB and the IASB hope to minimize any of these drawbacks associated with a single set of standards in order to improve both the quality of the existing standards and the comparability of the financial results of companies operating under a common set of standards. The new chairman of the FASB, Robert Herz, in particular, has publicly committed that the FASB will seek to harmonize its rules with IASB over the coming years.

Even if this is worthy objective, however, there is reason to be skeptical about its practicality. Although the specific differences between the two sets of standards can be exaggerated, the philosophical difference between the two is not easily bridged. The IAS principles are fundamentally different from some of the detailed guidance in U.S. GAAp. Rewriting one or both sets of standards to meet somewhere in the middle is likely to prove difficult.[11]

Of course, the practical problems could be surmounted if the FASB decided essentially to replace U.S. GAAP with IAS. But accounting standards do not exist in a static world. New business practices and especially new financial instruments – the proliferation of derivatives in recent years is a good example – constantly test the rule setters: how should the existing rules be interpreted to apply to new developments, or should the rules be rewritten to take account of them?

One danger of giving any body what amounts to a monopoly in setting standards is that, like private

[11] A listing of some of the key topics on which the two sets of standards differ is provided in the Appendix.

sector monopolies, the standards-setting institution has no incentive to move quickly. Indeed, as it is now, just look to the rulemaking processes of both the FASB and the IASB in their respective jurisdictions. Except for the recent haste in revising the SPE consolidation rule, the FASB typically has taken years before changing or updating its rules. The IASB's rulemaking process shown no greater speed. If the FASB gave way to the IASB, either by going out of existence or deferring to the international body, then IASB would have a worldwide monopoly over standards-setting. Is there any reason to believe that in such an environment, FASB would move more quickly than it does now? I have my doubts and point to the extensive delays associated with the proposed refinements of bank capital standards by the Basel Committee, a group of central bankers from the major industrialized countries, as a good example. If the Basel Committee can't speedily revise its rules for banks, which however complicated they have become are not nearly as comprehensive as the full body of accounting standards, then how can one expect the IASB, if given a monopoly, to move with haste?

Moreover, those who believe, as I do, that the main problem with FASB is that its rules can be too easily overruled by the Congress (which oversees the SEC, which in turn oversees FASB), will not necessarily find comfort in moving all standards-setting to the IASB.[12] The board of that institution has 14 members, from different countries, and thus different cultures. The size and composition of the board alone slows down decisionmaking. Furthermore, IASB, too, can be subject to political influence, and indeed, this would be more likely if FASB were to become less important or even dissolve. American interests accustomed to lobbying FASB, directly or indirectly through the Congress, would simply cross the ocean to London. In so doing, they would join companies and other interests from around the world. In short, granting the IASB a monopoly on standard-setting will not remove politics from the process; if anything, it may intensify it.

If, as seems likely, the IASB will be slow to adapt to new market-drive developments, there may be pressure within some countries for their national accounting standards-setters – assuming they continue to exist – to assert themselves by issuing "interpretations" or "clarifications" of certain international standards. This pressure is especially likely to surface in the United States, where the desire for certainty is strongly influenced by the liability system. But equal pressures may also exist elsewhere. For example, even though the EU has decided that IAS will govern reporting for stock exchange listing purposes by 2005, individual EU member states already remain free to accept or reject individual international standards. The net result is that if the IASB moves too slowly, the interpretations and even new rules set by the national standardssetters will gradually lead to a fragmentation of the international standards – or very much like the status quo. Thus, while IAS may, for a brief time, govern the world, that result is likely to be unstable, much like the inexorable decay of a radioactive element.

In sum, moving to a single worldwide set of accounting standards is far more problematic than its proponents may claim. For one thing, a harmonized set of standards is hardly assured. U.S. GAAP consists of more detailed rules than IAS; international accounting standards tend to be written in the form of broad principles (although the international standards also contain many detailed rules). Melding these approaches is likely to prove very difficult, even with the best of announced intentions of the IASB and the FASB. But even if the two standards-setters could surmount their philosophical problem, the single world body charged with overseeing standards in the future is not likely to be responsive to market developments, and if it isn't there is a good chance that a single set of standards would fragment over time. In the end, the quest for a single set of accounting standards to be maintained through time is somewhat akin to the search for the Holy Grail – a topic of interest but a goal out of reach.

Competition in standards

If the move to harmonization is as impractical or undesirable as I claim, then what is the alternative? The answer I propose here is a true competition in standards. Before outlining how this might come about, consider first the benefits of competition.

As in the private sector, competition should stimulate competing standard setters to keep pace with

[12] The best example of political influence defeating a standard, of course, is FASB's attempt in the 1990s to require expensing of stock options. The FASB has also been influenced in the past by the oil and gas and financial industries affecting those sectors.

market developments and thus help cure the foot-dragging problem that has troubled the FASB and that very likely would plague the IAS if it were given a worldwide monopoly over standard-setting. More importantly, competition is the only system that I believe is capable of diluting the role of political influence in standard setting. This is because, in a competitive environment, standard setters must please investors as well as reporting firms and their auditors for their standards to have relevance in the marketplace, and, hence, be adopted by companies.

Admittedly, competition among accounting standards-setters would differ in two important respects from competition among firms. Standard setters do not have to satisfy the test of profitability that is the yardstick of success, if not survival, of private firms. In addition, the standard-setting competition I discuss in more detail shortly would entail competition between just two standard setters, U.S. GAAP and IAS. In this sense, accounting standards setting competition would take the form of duopoly, a very limited form of competition.

These are both fair points; nevertheless, even the limited form of competition suggested here is superior to a monopoly in standards. Although it is true that standard setters are not motivated by a desire to earn profits, the members of these boards still desire to be relevant and for their standard-setting bodies to exist. In a competitive environment, both of these conditions cannot be met unless investors value the standards themselves. The duopoly problem, to be sure, is a real one. But a choice between two standards is better than a choice of only one.

A competition in standards could be introduced in one of two ways. One approach, pushed hard by many Europeans, would be for authorities in at least the industrialized countries to mutually recognize certain standards for stock listing purposes. Since as a practical matter the rest of the world outside the United States is moving toward or has already adopted IAS, this option amounts to allowing a competition only between IAS and U.S. GAAP.[13] Key to this proposal is that the United States, which currently requires foreign companies using IAS to reconcile their accounts with U.S. GAAP, would no longer insist on this requirement. At the same time, to keep companies from "gaming" the system, firms would have to continue reporting under the standards they choose for some set period of time (say 10 years).

An alternative way of introducing competition in reporting standards would be to allow more competition among exchanges by permitting investors in participating countries to access foreign stocks directly within their home country borders – for example, through computer screens based there – rather than having to engage a foreign broker to execute trades abroad. Benn Steil recommends this option, not just for reporting standards, but also for the entire system of disclosure and corporate governance rules.[14] In particular, Steil suggests a system of mutual recognition of exchanges wherein host countries, such as the United States, allow exchanges from other countries with reasonable acceptable disclosure regimes to impose their own rules on corporations whose shares are initially listed on those exchanges, but which are also traded on exchanges in the host country, provided those countries afford U.S. exchanges reciprocal rights. In this way, competition among exchanges, each with different listing requirements, would bring about competition in disclosure systems, including accounting standards.[15]

The exchange-competition model, however, has two substantive drawbacks relative to the firm-choice model. For one thing, embracing exchange competition requires a tolerance for competition among entire systems of corporate governance, insofar as these systems are the subject of listing requirements of the exchanges. In contrast, a policy of allowing firms on any exchange to choose its own reporting standard (within a predefined list) entails a much more limited form of competition. Second, in order for firms to choose among reporting standards under the exchange competition model, the firms must actually list their shares on another exchange. While this may not be as burdensome as it once was, multiple listing still does entail some additional cost. In contrast, if firms listed on a single exchange are allowed to choose

[13] Although European firms would appear unable to choose U.S. GAAP, because the European Commission (EC) has adopted a regulation requiring them to report only under IAS by 2005, it is possible that if the United States allowed companies from the EU listing on American exchanges to use IAS, the EU might return the favor at least by allowing U.S. companies to continue using U.S. GAAP if they chose.

[14] Steil, op. cit.

[15] Ibid. The main virtue claimed for exchange competition is lower trading costs. But the Council Report also suggests that competition in disclosure regimes would encourage more disclosure.

among reporting standards, they need not pay the additional expense associated with listing on another exchange simply to take advantage of its different disclosure system.[16]

Given the apparent momentum behind the current attempts to harmonize IAS and U.S. GAAP, I fully recognize that policy makers in the United States are not likely any time soon to embrace the competition-in-standards approach advocated here. Aside from the vested stake in pursuing the single set of standards, one predictable objection to a competition in standards is that it would lead to some loss in transparency arising from investors having to interpret financial reports prepared under different sets of standards.

I believe that any such fear is overstated, however. As already argued, even under a single set of standards, firms have discretion in reporting their results, which means that investors do not now have the ability to make »apples to apples« comparisons that advocates of the current system may believe are possible. Moreover, under a regime of competitive standards, private sector analysts would have strong commercial incentives to translate or reconcile reports prepared under different standards. Admittedly, in the absence of a full reconciliation requirement, analysts would not have access to all of the information required to make totally accurate translations of financial results from one standard to the other, unless firms voluntarily provided the requisite data. But estimated reconciliations are still likely to be of use to investors. And corporations would provide the requisite data for more complete reconciliations if the markets rewarded them for doing so.

Another objection against a competition in standards might be that the "market" for accounting standards, like the one for operating systems in personal computers or videocassettes, is a natural monopoly. If this were true, it is conceivable that meaningful competition would be short-lived, resulting in a single winning standard. Such an outcome is indeed possible, but is not an argument against running a competitive race in the first instance and, in the process, realizing the benefits from that competition while it lasts. In any event, it is not at all clear that competition in accounting standards would reduce to monopoly.

Enforcement of disclosure standards in a global age

I have argued elsewhere (with my colleagues) that the main problem revealed by the accounting scandals in the United States was not a defect in the accounting standards, but in the mechanisms for enforcing those standards.[17] At first blush, the failure in enforcement seems confined to the auditors who should have detected the accounting irregularities in each case. But the public debate surrounding the scandals helped spread the blame to some of the other "gatekeepers" in the corporate arena as well: members of boards of directors who failed to properly supervise management or the auditors; research analysts who "hyped" stocks when they knew better (and especially when they had conflicts of interest due to their employment at firms that stood to benefit from large underwriting or merger and acquisition fees from the same companies the analysts covered); the credit rating agencies that failed to foresee financial problems in some of the companies; the self-regulatory body governing the auditing profession (the AICPA); and the principal regulator, the SEC, which to its credit helped uncover many of the earnings misstatements but has failed to discipline negligent auditors in the past.

As noted at the outset of this paper, various reforms have since been adopted in the wake of the scandals of 2002 to strengthen each of these gatekeeper functions. One of the controversial aspects of these reforms, the Sarbanes-Oxley provisions in particular, is their application to foreign firms, especially foreign accountants, whose activities in the United States are subject to the new oversight board. Foreign firms view these provisions as an unjustified assertion of extraterritorial jurisdiction; Americans view them simply as an application of national treatment.

While this controversy may continue, a more interesting enforcement issue lying ahead, assuming the effort to harmonize accounting standards pro-

[16] Another possible objection to allowing mutual recognition of exchanges is that it could expose smaller, less sophisticated investors to greater risks (if the foreign exchanges so recognized did in fact contain higher risk stocks, with less transparent or effective corporate governance rules than may apply in the home country). If this objection were valid, it could be satisfied by restricting access to foreign exchanges doing business in a home country only to institutions and wealthy, sophisticated individuals.

[17] Benston, op. cit.

ceeds, is whether and to what extent nations and/or their exchanges will seek to harmonize accounting enforcement or compliance measures and procedures. Indeed, if the main impetus behind harmonization of reporting standards is to improve comparability of financial reports, that objective cannot be attained – even if the world accepts a single set of standards – as long as there are significant differences across (and indeed even within) countries in the effectiveness of compliance with those standards. Note the emphasis on "effectiveness"; it is not important that nations harmonize the mechanisms of enforcement – selfregulation, government regulation, corporate governance measures, and liability regimes – but instead the results of the measures they do employ.

This is far easier said than done. There are no well-defined metrics for assessing the quality of financial reporting by companies from different countries. Even if countries agreed to use the same compliance or enforcement mechanisms, there is no easy to assure that these instruments, such as regulation or liability, are implemented with equal vigor and effectiveness across countries.

In principle, enforcement results could be harmonized if nations agreed to cede enforcement of the quality of audits to an international supervisory body. But this is highly unlikely to happen any time soon because governments are not keen on giving up their sovereignty on enforcement matters. Even the Basel Committee – which has carried out the most ambitious international effort at harmonizing financial regulation to date – does no more than promulgate standards (analogous in the disclosure realm to the IASB's development of international accounting standards); the Committee does not enforce them, leaving that job to national authorities.

Before the Enron scandal broke, there was an effort within the accounting profession to bring great harmony to audits. Under the auspices of the International Federation of Accountants (IFAC), a Forum of 30 of the largest accounting firms in the world issued a proposal in September 2001 to establish a peer review system for periodically and randomly reviewing the audits by those firms of "transnational" companies. The aim of this proposal was to establish some uniformity in audit results, initially for companies doing business in different countries (and then perhaps for a wider group of firms).

The Forum proposed to assure compliance by its members in two ways. First, peer reviews of randomly selected audits would be conducted. Second, if these reviews found that the audits were significantly below GAAS or that the numbers attested to were misleading in that they violated essential GAAP prescriptions, the firms would be fined and the individuals who carried out the audit would be disciplined. In addition, member firms would pledge to dismiss their partners who were found to have been seriously negligent. The firms also would require their audit and confirming partners to sign agreements stating that they had conducted their audits appropriately, and that if the Forum decided they did not, that they would abide by any Forum sanctions (such as the order to resign from a firm and/or pay monetary damages).

Investors then could choose between statements attested to by members of the Forum, by a competing group or groups, or by other auditing firms. Clients who want audits by Forum member firms that permit them to uphold the agreed upon standards would have to pay the cost. Those firms believing a lesser audit product to be worthwhile could make that choice. The market would determine which alternative was best.

The Forum exercise continues, but in the wake of the various accounting debacles in the United States, self-regulation appears to have been discredited, at least for the time being and in the form in which it was undertaken. However, in the absence of any other constructive international effort to harmonize compliance with reporting standards, it would be a mistake to write off the Forum of 30 initiative. It may be the only practical way in the short run of bringing greater conformity to audit results, at least for a subset of companies, those with operations in multiple countries.

An alternative way of indirectly producing greater harmonization in enforcement would be through competition among exchanges, assuming national governments allow it. Exchanges with listed firms adhering to high quality accounting standards and enforcement should attract issuers and investors alike, and take market share away from exchanges with less stellar records in both these areas. Policy makers should therefore give more serious attention to promoting competition among exchanges, since this may also be an effective and practical way to bring about the greater harmonization in

and reliability of reporting that investors appear to want. Indeed, one advantage of competition among exchanges is that this could produce greater conformity across a wider class of firms than just the multinationals that are the object of the Forum of 30 exercise. The untested element of exchange competition, however, is whether the quality of accounting standards and compliance with them would be valued by issuers and investors in choosing stocks listed on competing exchanges.

Conclusion

For those interested in the subject of corporate disclosure, these are interesting – and indeed exciting – times. But not by choice. The scandals surrounding the disclosure failures and shortcomings associated with Enron, Worldcom, and certain other large public companies have put the spotlight of public attention on accounting and disclosure policies in a way many may never have imagined, or certainly welcomed.

After the dust has settled on the reforms adopted in the United States in response to these developments, policy makers in that country and elsewhere are likely eventually to turn their attention to how disclosure rules and practices ought to be changed in light of the increasing globalization of equities markets. At this writing, there is momentum behind the harmonization of the very different rules of U.S. GAAP and IAS, and perhaps the replacement of the former with the latter.

This article takes a skeptical view of harmonized standards, questioning both the feasibility and the wisdom of the enterprise. Instead, it embraces the virtues of a competition in standards, either through mutual recognition of U.S. GAAP and IAS, in particular, or through recognition of the rights of exchanges from different countries to conduct business abroad.

Meanwhile, relatively little attention has been focused on ensuring greater conformity across countries in compliance with standards. As of this writing, the only practical way of furthering this objective, however discredited in the wake of Enron, is the peer review mechanism proposed by a group of multinational auditing firms. Greater competition among exchanges might also promote more conformity of audit results across national boundaries.

Appendix

Key Areas of Difference Between IAS and U.S. GAAP

Although too numerous to discuss in detail, there are a limited number of areas in which international accounting standards differ from U.S. GAAP. This appendix lists some of the more notable examples. Aside from the philosophical difference discussed in the text, the specific differences include:

- Methods of accounting for leases
- Rules for consolidating off-balance sheet entities
- Accounting for goodwill and other intangibles
- Accounting for mergers and acquisitions
- Recording of research and development expenditures (capitalization versus expensing)
- Differences over “fair value” accounting (although both sets of standards generally embrace the concept)
- Accounting for financial instruments
- Treatment of stock options
- Line of business, or segment, reporting
- Presentation of financial results (in financial statements)

Strong Deterioration of Fiscal Positions in the OECD

Fiscal positions have sharply deteriorated during the recent downturn, both in headline and in cyclically adjusted terms (Figures 1 and 2). The momentum of fiscal consolidation weakened in the late 1990s as rising tax receipts and overoptimistic growth projections led to tax cutting and new spending initiatives. In the United States, Canada and in many EU member states (including Austria, France, Finland, Germany, Ireland, Sweden, and the United Kingdom) revenue declines were particularly abrupt in 2002. The room for new tax reductions is now limited and will require effective restraint on the spending side. Once the recovery is underway, it will be of utmost importance to consolidate swiftly for structural balance and tax objectives to be met.

In the United States, the swing from a surplus of 1.4% of GDP in 2000 to a projected deficit of 4.2% in 2004 is due to the huge tax cuts of 2001 and 2002 and the costs of the Iraq war and reconstruction. The fiscal deterioration in the euro area appears to be predominantly cyclical. In Sweden (the surplus is declining from 4.8% of GDP in 2001 to a projected 1.2% in 2004) and the United Kingdom (going from a surplus of 3.9% of GDP in 2000 to a projected deficit of 2.2% in 2004), however, it also reflects a sizeable loosening of the fiscal stance. As foreseen in the EU Treaty, the excessive deficit procedure has been activated for Portugal (projected deficit of 3.2% of GDP in 2003), Germany (projected deficit of 3.7% in 2003), and France (projected deficit of 3.6% in 2003).

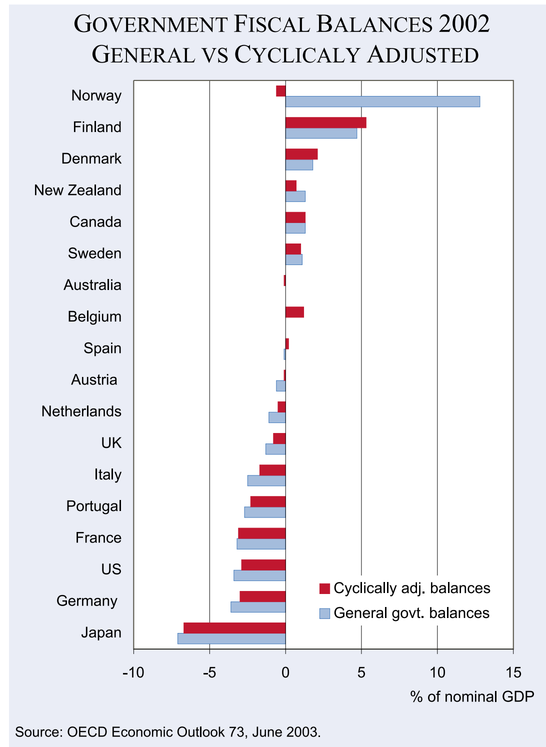
Against this background, the EU Commission proposed to postpone the target year for reaching close to balance or surplus positions from 2004 to 2006 (originally the target year was 2002) in order to avoid pro-cyclical fiscal decisions in the midst of subdued economic activity. At the same time the Commission put forward a requirement for member states that are still far from a "safe" position to reduce their structural deficits by half a percentage point per annum, starting in 2003. This approach was endorsed by euro area finance ministers.

H.C.S.

Figure 1

Source: OECD Economic Outlook 73, June 2003.

Figure 2



Source: OECD Economic Outlook 73, June 2003.

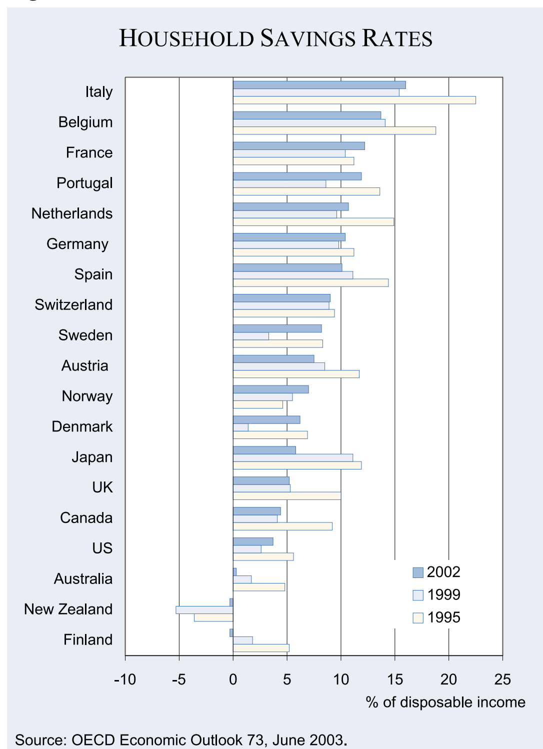
Italy and Belgium Remain the High Savers

In the late 1990s household savings rates fell to their lowest levels in decades. High asset prices boosted the wealth of private households, inducing them to raise their spending. With spending outpacing income, the savings rate declined. This effect was most notable in the United States where household savings rates fell to just 2 percent of disposable income. This was topped only by New Zealand, whose savings rate even turned negative.

When the asset price bubble burst, equity prices plummeted. By September 2002, broad equity price indices had fallen by over 40 percent from their 2000 peaks in the United States and the United Kingdom, and by close to 50 percent in the euro area and Japan. Employees saw a large share of their retirement assets evaporate, as pension funds and insurance companies reevaluated their portfolios. This asset shock has contributed to a rebound of household savings rates.

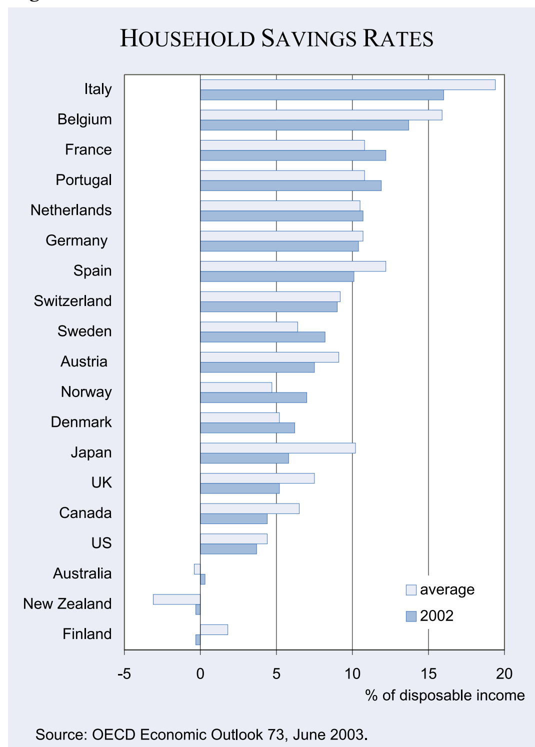
With few exceptions, savings rates in the OECD increased again in 2002, although still falling short of their longer-term average. Besides the wealth effect, household spending has also been depressed (and savings increased) by the job uncertainty created by the general economic slowdown.

Figure 1



Source: OECD Economic Outlook 73, June 2003.

Figure 2



Source: OECD Economic Outlook 73, June 2003.

Despite the fluctuations of household savings over time, the high savers are still the same: Italy at 16 percent and Belgium at close to 14 percent. Other countries with two-digit savings rates include France (12.2%), Portugal (11.9%), the Netherlands (10.7%), and Germany (10.4%). At the low end of the range we find the formerly high saver Japan (5.8%), Norway and the United Kingdom (5.5%), Canada (4.4%), the United States (3.7%), Australia (0.3%) as well as Finland and New Zealand (– 0.3%). The OECD projects generally higher household savings rates for 2003 and 2004.

H.C.S.

World Economic Survey*

World Economic Climate brightens

In July 2003 the World Economic Climate continued its recovery, which had begun in January but was interrupted by the escalation of the Iraq crisis in March and early April, (see Figure 1). At 91.3, compared with 83.2 in the previous survey, the climate indicator is now approaching its long-term average (1989 – 2002: 93.7). The assessment of the current economic situation remained at an unsatisfactory level, whereas the expectations for the next six months clearly brightened.

World economy: Start of a recovery?

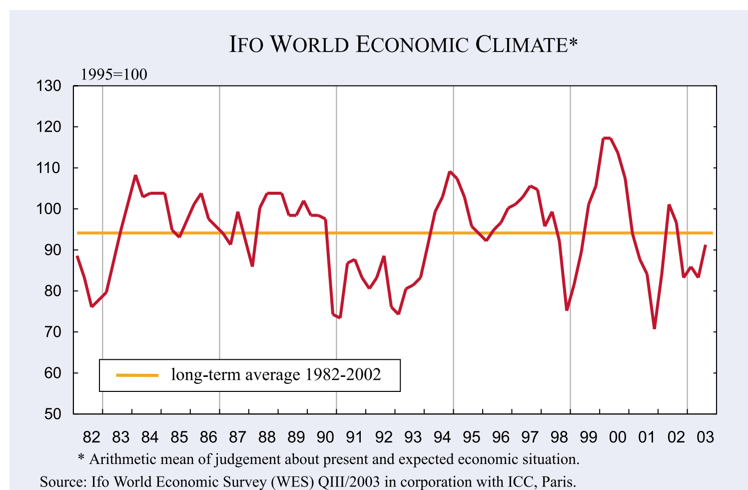
In July 2003, the renewed upward movement of the economic climate index, which had already set in by the end of April became more apparent.[1] It is still too early, however, to interpret this improvement as the onset of a global economic recovery. For such an assertion experience dictates several positive survey results of both, assessments of the economic situation and economic expectations for the next six months. Whereas, according to the latest survey results, the assessments of the current economic situation remained below satisfactory on the world average, mostly reflecting the deterioration in the United States and Western Europe, the economic expectations for the next six months clearly picked up. Thus, in the majority of the other countries polled, the chances for an economic upturn are on the horizon.

For the interpretation of the current improvement of the economic climate a review of its development over the last two years can offer valuable clues. In October 2001, after the terrorist attacks in the United States, the economic climate indicator reached an all-time low. In January and April 2002 the overall indicator bounced back, mainly driven by optimistic expectations. However, at this stage apprehension that this improvement of the indicator was not yet signaling the onset of a world-wide recovery proved true, and in July and October 2002 the world economic index slipped into a "double dip". This new strong setback of the economic climate was mostly due to the escalation of the Iraq crisis. With the end of the main war activities in Iraq on April 9, the economic expectations clearly brightened compared to the period of the looming geopolitical crisis in 2002 and the beginning of 2003. This positive trend of economic expectations gained momentum in July, but as mentioned, it is still too early to draw conclusions concerning the strength of the upturn.

United States: Economic climate improves

In the United States, the assessments of the current economic situation remained almost unchanged, while the economic expectations became clearly optimistic. The war economy accompanied by high

Figure 1

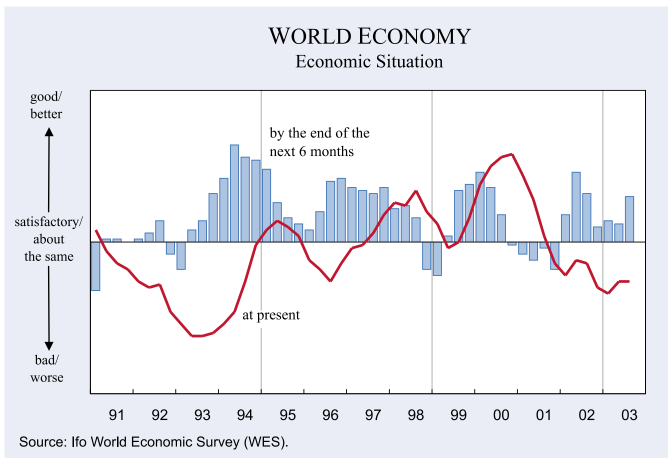


* Arithmetic mean of judgement about present and expected economic situation.
Source: Ifo World Economic Survey (WES) QIII/2003 in corporation with ICC, Paris.

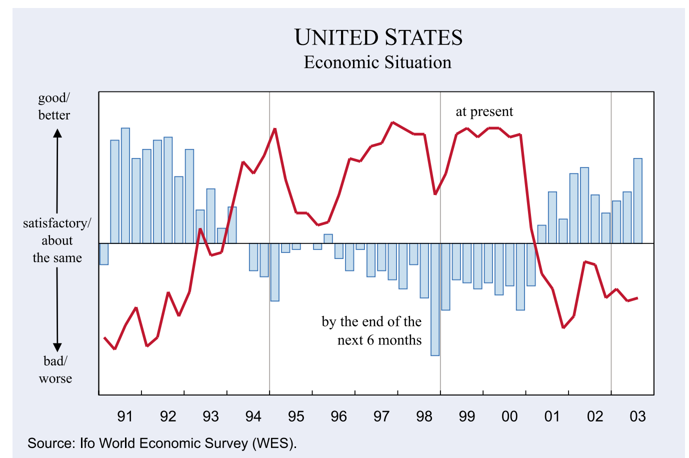
* The survey is jointly conducted by the Ifo Institute and the Paris-based International Chamber of Commerce (ICC).

[1] A separate analysis of survey data that came before and after 15 April 2003 showed striking differences. In the first group, the world economic climate was significantly lower than in the January survey (79.6 compared to 85.9). In the second group, i.e. responses submitted after April 15, the overall indicator stood at 86.8 and thus slightly higher than in January 2003 (85.9).

Figure 2



Source: Ifo World Economic Survey (WES).



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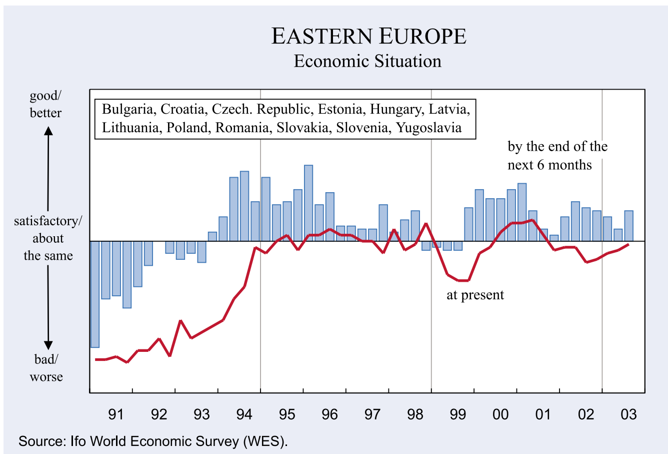

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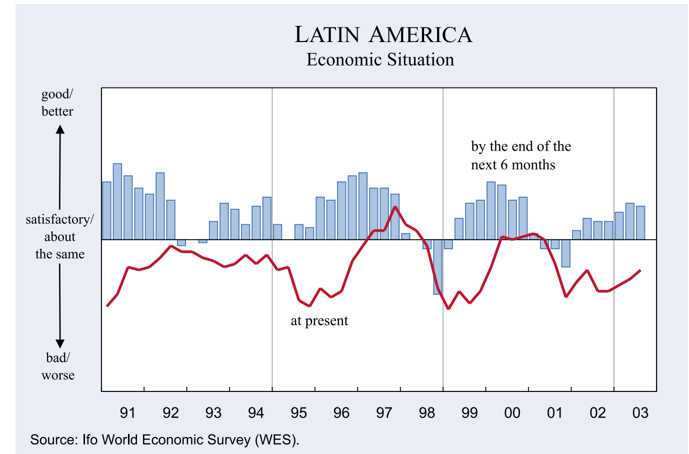
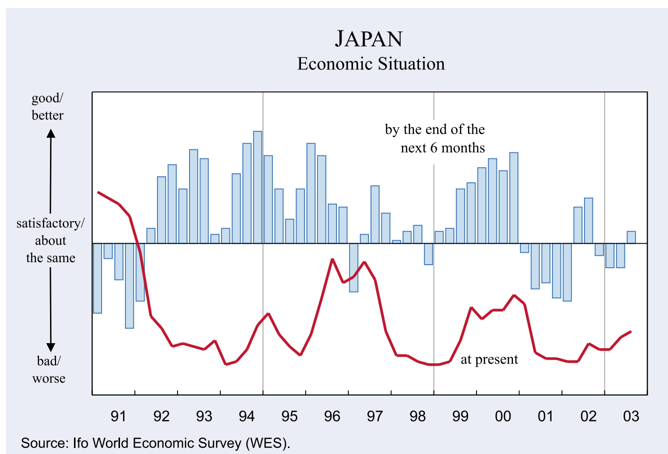
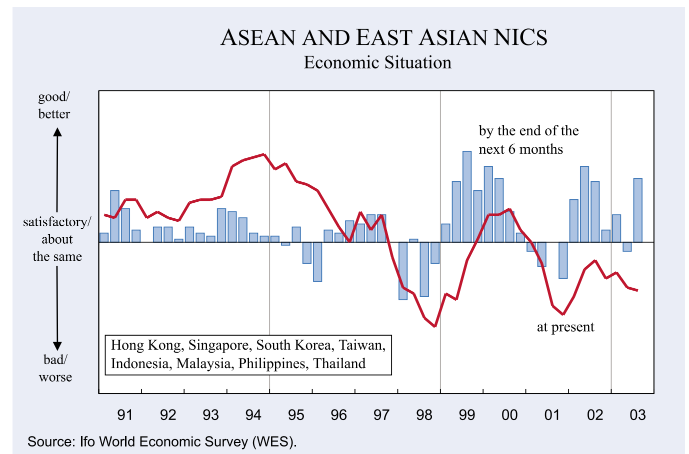


Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

public deficits has strained the economic climate in the U.S. Accordingly, economic performance remained weak in July, whereas the optimistic expectations reflect the hope for a post-war recovery in business sentiment. In particular, capital expenditures and private consumption are expected to improve. (Fig. 2).

European Union: Economic climate indicator rises slightly

The assessment of the current economic situation in most Western European economies remained below satisfactory. However, expectations for the next six months improved relatively strongly in almost all European countries (see Figure 3).

The lowest marks for the current situation were given by WES correspondents in *Portugal, Germany* and the *Netherlands*. Economic performance also remains weak in other countries, with *Finland, Greece, Luxemburg* and *Spain* being positive exceptions. The near-term prospects generally became positive in all EU countries with the exception of *Ireland*, where WES correspondents expect the slowdown of economic growth to continue in coming months. Despite the continued appreciation of the euro, sentiments regarding the export outlook became more optimistic in almost all countries of the euro area, except *Belgium, Ireland* and *Spain*. Among the non-euro countries, *Denmark* and *the United Kingdom* appear to be faring significantly better economically than all the other European countries, with a bright outlook for the next six months.

Eastern Europe: Favourable economic climate continues

Having been almost unaffected by the general economic downturn in Western Europe during 2002, the economic climate in Eastern Europe remained favourable also in July 2003 (see Figure 2).

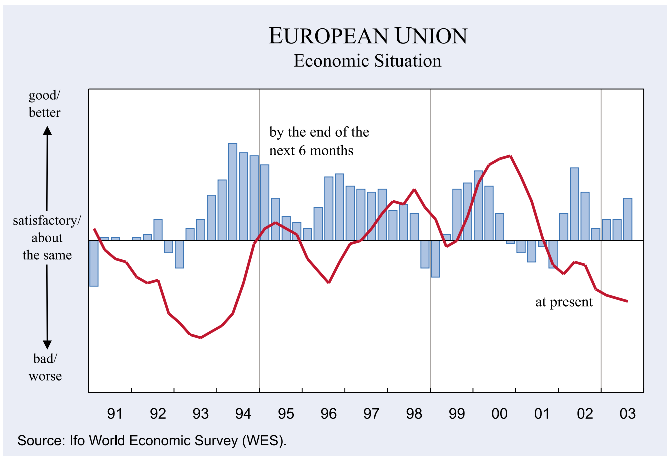
The majority of Eastern European economies have shown considerable robustness in recent years, despite their thorough restructuring processes. In particular in the Baltic States – *Estonia, Lithuania* and *Latvia* – WES experts have considered the economic situation to be on a highly satisfactory level for two years now. The outlook for the coming six months suggests stabilisation of these economies at the current "good" level. In *Slovenia, Slovakia, Albania, Bulgaria* and the *Czech Republic* the present economic situation was assessed as "satisfactory" with prospects remaining highly positive. To a lesser degree this holds true for *Poland*, where the depressed overall economic climate does continue to improve. In *Croatia* and *Serbia/Montenegro* WES experts considered the present economic situation to be below the "satisfactory" level. In *Croatia*, no major changes are expected in capital expenditures and private consumption, whereas the export sector could strengthen in the coming months. In *Serbia/Montenegro* the overall outlook is for an improvement. The assessments of the current economic situation in *Romania* and *Hungary* worsened in July and are now also slightly below the "satisfactory" mark. Fixed investment is predicted to remain stable, whereas exports are expected to pick up in coming months.

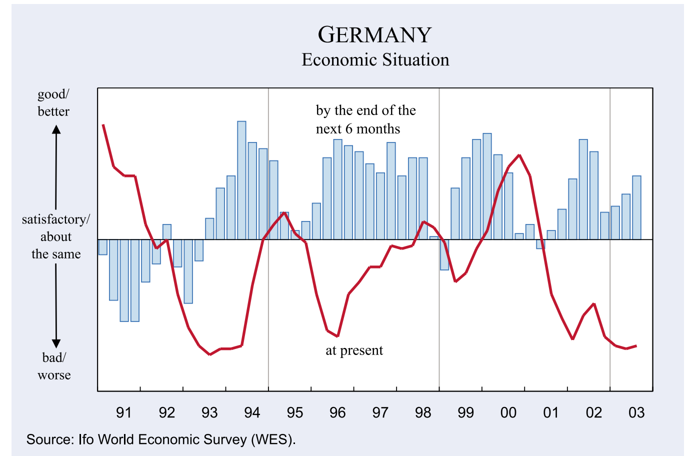
Latin America: Economies expected to pick up

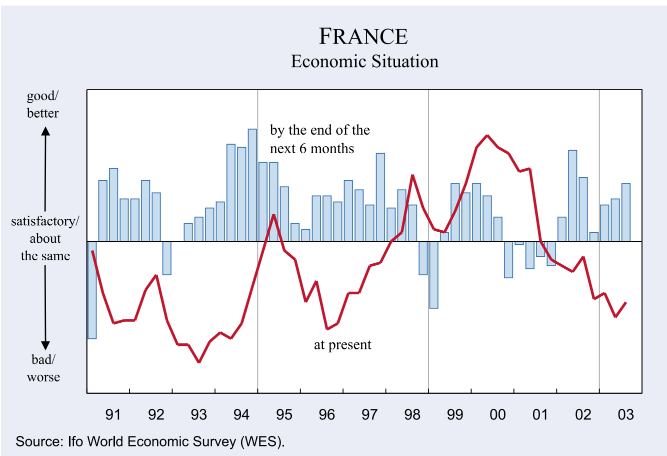
According to the recent survey, both the assessment of the current economic situation and the expectations for economic developments in the next six months promise an improvement of the economic climate in South America. However, the vast majority of WES experts surveyed in this region judged the present economic situation of their country to be below a "satisfactory" level (see Figure 2).

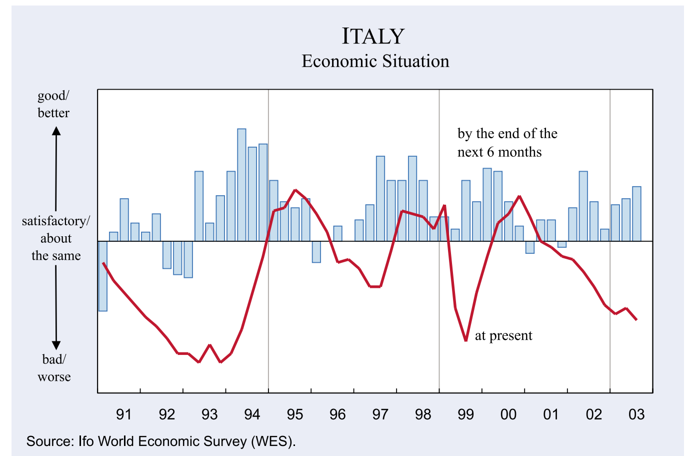
In *Brazil*, the largest economy in this area, the economic climate – though slightly less favorable than in the previous survey – will remain very moderate in the coming six months. Fixed investment, consumption and in particular exports are expected to strengthen by the end of the year. In *Chile* the assessment of the current economic situation has left the negative range, and expectations for the next six months improved even more. Growth of domestic demand is expected to become more dynamic. Positive assessments of the present economic performance came also from *Peru*. The panel's forecast for the coming six months reflects a stabilisation of the current positive state. In *Colombia* the economic situation had already shown signs of recovery in the four preceding polls. In the April survey the assessments of the current economic performance almost reached the "satis-

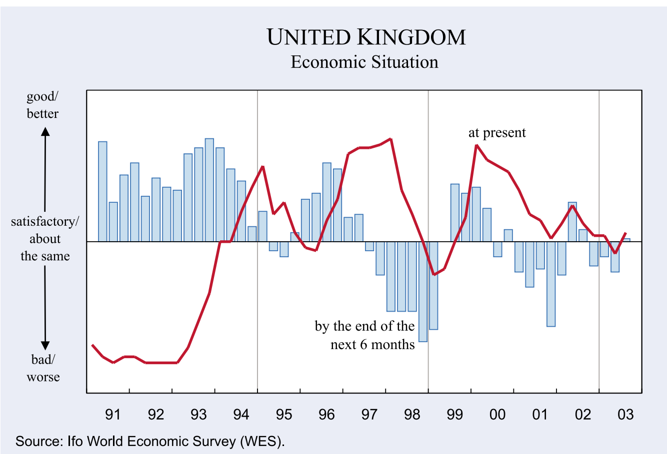
Figure 3

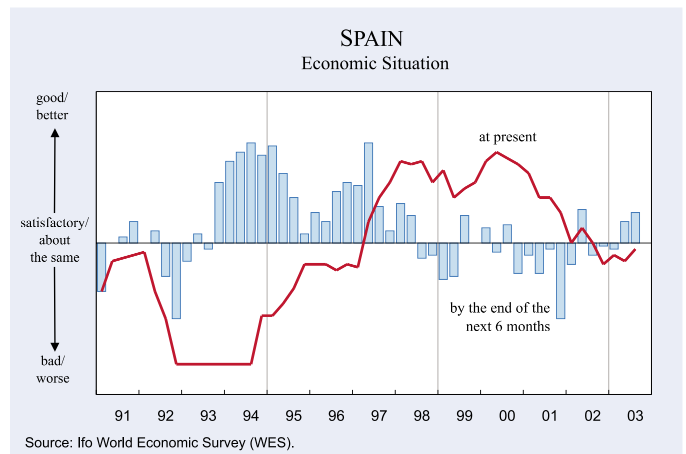












factory" level. The otimistic expectations for the next six months, in particular in the export sector, give hope for a continuation of this positive trend. Not satisfactory but somewhat better than the Latin American average is the economic climate in *Mexico*. Since the beginning of 2003 the economic situation has slightly improved and was considered close to satisfactory in April. This trend will continue in the coming months, reflecting a rather stable state of the economy.

In *Argentina*, the long-expected recovery from the economic crises has become more dynamic, according to the recent survey results. The assessments of the current economic situation are better than in the previous two surveys, though far below the satisfactory level. Exports are expected to pick up strongly in the coming months, as will private consumption and capital expenditures.

In other countries of the region, in particular in *Panama, Paraguay* and *Uruguay*, the assessment of the current economic situation fell below "satisfactory". But as in the April survey, stronger economic growth is forecast for the coming months. Less encouraging is the assessment of the present economic situation in *Bolivia, Ecuador* and *Venezuela* where the short-term expectations also point to further deterioration. In *Bolivia* and *Ecuador*, the export sector provides some impetus for more dynamic growth. *El Salvador* is the only country in the region in which WES experts expect the currently satisfactory economic situation to deteriorate considerably in the coming months.

Asia: Economic climate indicator bounces back

In the April survey the Asian region as a whole had registered the strongest deterioration of the economic climate indicator compared with other regions of the world. In the July survey, however, the economic climate improved considerably and even slightly surpassed its long-term average. The recent pick-up is mostly attributed to the optimistic expectations in all WES countries of the region for the coming six months. The positive impetus most likely derived from the fast containment of the SARS epidemic.

In *Japan* the depressed economic situation still shows only weak improvement, according to WES experts. Expectations for the next six months did turn positive again, however.

In *Thailand* the present economic situation as well as economic expectations remained at a high level, with capital expenditures, private consumption and the export sector expected to grow in the course of the next six months. In *Malaysia* the present economic situation remained almost unchanged, judged slightly above satisfactory, and economic expectations are for positive changes in the course of the next six months. In the *Philippines* the current economic situation reached the "satisfactory" level and is expected to continue its stabilisation course. The current economic development in *Singapore* changed for the better, confirming the optimistic expectations of the previous surveys.

In *Indonesia, South Korea* and *Taiwan* our panel's responses concerning present economic performance remained in the negative range in July. The outlook for the next six months is lackluster in *Indonesia* and *South Korea,* but is positive in *Taiwan*. in *Hong Kong* the current economic performance deteriorated. The private consumption sector, which felt the negative impact of the SARS epidemic most, is expected to recover, however, as is the overall economy in the coming months.

Inflation: Slowdown expected

World-wide consumer price inflation is now expected to be 2.8 percent in 2003, significantly lower than the estimate in the previous two surveys (3.2 percent). In the *Euro area*, the 2003 inflation rate is now seen, for the first time, below the 2 percent mark (1.9 percent compared with 2.1 percent in the April survey). A higher inflation rate than that of the April survey is only expected in Italy (2.6 percent compared with 2.4 percent). *Switzerland* and *Germany* remain the two countries with the lowest expected inflation rate in Western Europe (0.7 percent in the case of Switzerland and 1.1 percent in the case of Germany).

At 2.0 percent, expected 2003 inflation figures in the *United States* are lower than in the April survey (2.3 percent). Thus, the disinflation process appears to continue in the second half of this year. Asia still shows by far the highest degree of price stability (1.1 percent compared to 1.4 percent in April 2003). Deflationary trends still prevail in *Japan*

(unchanged at – 0.5 percent in 2003) and *Hong Kong* (– 1.6 percent compared with – 1.1 percent in April). Also in *Taiwan*, where consumer prices are expected to stagnate in 2003, the danger of slipping into a deflationary cycle is still not completely averted.

The 2003 inflation outlook for *Central and Eastern Europe* remained unchanged (4.3 percent). The only countries in this bloc still having very high inflation rates are *Romania* (14.2 percent), *Serbia/ Montenegro* (8.9 percent) and the *Slovak Republic* (8.4 percent).

In *Central and Latin America* expected overall inflation is now somewhat lower than in the April survey (9.0 percent compared with 10.7 percent). By far the highest inflation rate in this region still prevails in *Venezuela* (45.8 percent) though here, too, the inflation trend is expected to slow down somewhat. The inflation outlook for *Africa* is worsening (17.4 percent after 14.6 percent in the April survey). However, this is mainly due to the catastrophic situation in *Zimbabwe* where a hyperinflation of now about 525 percent is expected in 2003, following a rate of about 135 percent last year. In *South Africa* 2003 inflation is expected to settle at 7.3 percent (compared with 8.3 percent in the April survey), down from 9.5 percent in 2002.

Interest rates: Further decline expected

More WES experts than in the previous three surveys expect a further decline of **short-term interest rates.** In *North America* (in *Canada* even more so than in the *United States*), the previously expected rise of short-term rates in the course of the next six months has now been replaced by an expected trend of stable or even slightly declining rates. In *Australia*, confirming the results of the previous survey, short-term interest rates began to fall and are expected to level off further in the course of the next six months. In *Western* and *Eastern Europe* the downward trend of short-term interest rates is still intact and expected to continue in coming months. Thus, the participants from the Euro area think a further monetary easing by the European Central Bank to be likely. In *Africa*, particularly in *South Africa*, panellists still see a high likelihood of rate cuts in coming months. In *Latin America,* too, the trend of rising short-term interest rates appears to be broken; in the months to come, short-term interest rates are expected to decline somewhat, with the exception of a few countries like *Colombia* and *Venezuela*.

Long-term interest rates are expected to remain stable in the coming six months or even decline somewhat following the sharp increase in previous weeks. This world-wide trend also characterises *Western Europe* and the *United States*. In *Canada* and *Australia*, where – in the April survey – a pronounced increase of long-term interest rates was correctly anticipated, the trend of bond rates in the coming six months is now expected to level off. In *Latin America*, WES experts see room for a decline of long-term interest rates, particularly in *Brazil*. In *Asia*, bond rates are expected to remain stable or decline somewhat, with the exception of *Japan* where the increase of rates is expected to continue. In *Eastern Europe,* long-term interest rates are expected to also exhibit a falling trend in the coming six months.

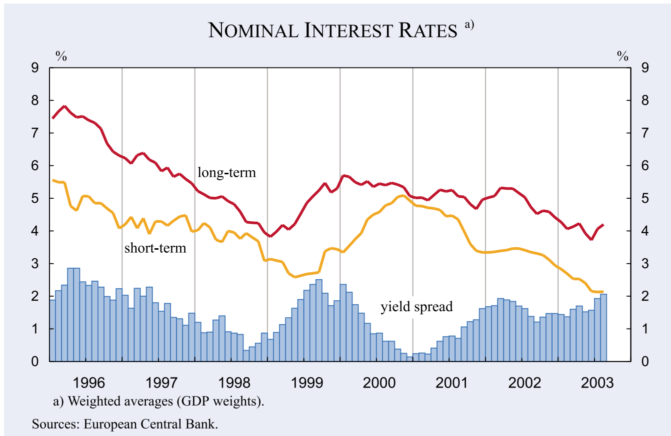
Currencies: Euro seen to be overvalued

The euro is considered overvalued – even more so than in the previous survey. The degree of overvaluation is now almost as pronounced as in the case of the British pound sterling. Correspondingly, the US dollar is said to be undervalued for the first time in about five years. The current level of the Japanese yen is assessed as more or less appropriate, with a small bias toward undervaluation.

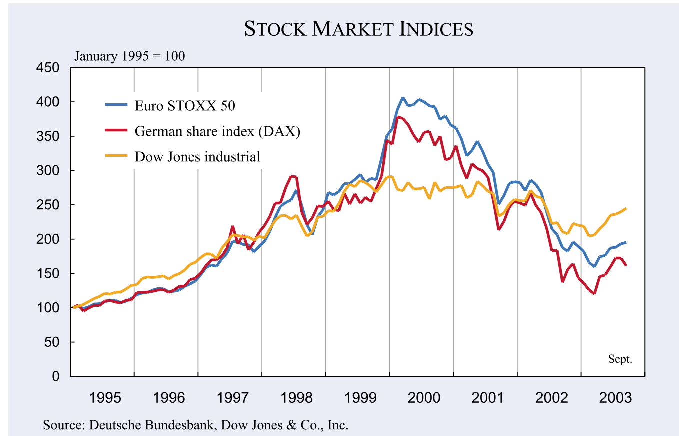
The perceived overvaluation of the euro is a widespread phenomenon, particularly pronounced in North America. The US dollar is seen as undervalued against own currencies particularly in Western and Eastern Europe as well as in Latin America. The own currency appears to be generally undervalued in Canada, Australia, New Zealand, Estonia, Latvia, Serbia/Montenegro, Saudi Arabia and Colombia. On the other hand, the own currency is seen as generally overvalued particularly in Venezuela, Nigeria, Turkey and again most pronouncedly in Zimbabwe.

In addition to the general assessment, WES experts were again asked about the likely trend of the US dollar exchange rate in the next six months. On average for all 91 countries covered, the US dollar is expected to gain in value. The main exceptions from this general trend are Australia and New Zealand as well as Norway.

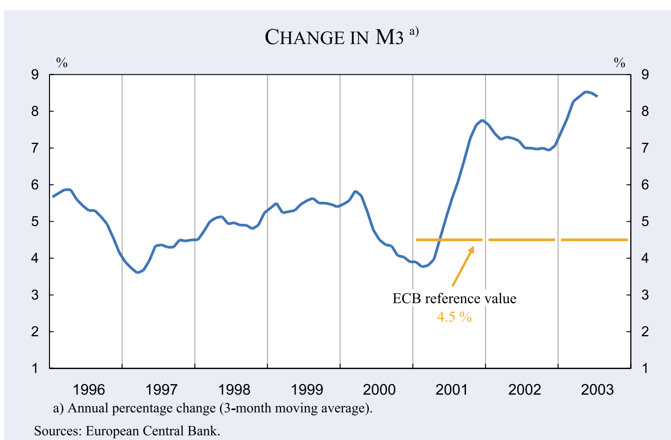
FINANCIAL CONDITIONS IN THE EURO AREA



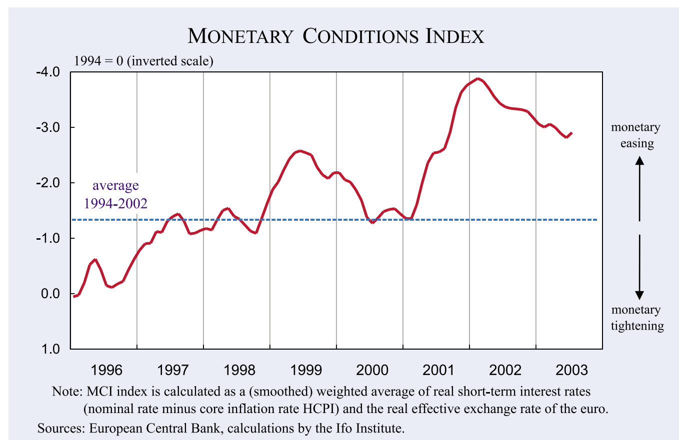
Short-term (three-month) interest rates have been declining since May 2001, when the ECB started to reduce its key interest rates. The latest step with 50 basis points to 2.0% was taken in early June 2003. Since then money market rates have remained more or less unchanged at about 2.15%. Long-term (ten-year) bond rates followed a downward trend until June when they averaged 3.72%, but have risen since to an average of 4.2% in August. The yield spread has therefore widened again to 2%.



Stock prices reversed their downward trend in March/April 2003. Only the German DAX whose rise had been steepest, suffered a decline in September.

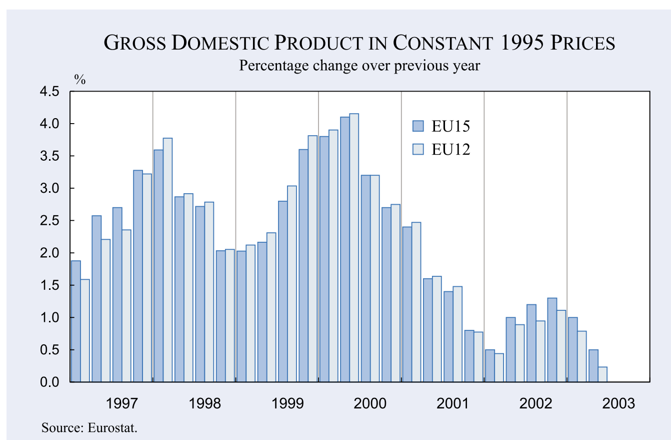


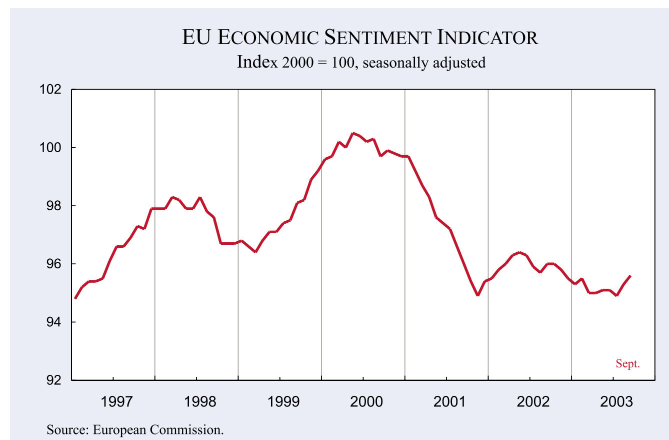
The trend of strong growth of the broad money supply M3, which has been observed since mid-2001, has continued although the annual growth rate of M3 declined to 8.2% in August from 8.6% in July. The 3-month average of the annual growth rates of M3 over the period June to August 2003 stood at 8.4%, compared to 8.5% in the period from May to July.



The monetary conditions index, which is based on real short-term interest rates and the real effective exchange rate of the euro, rose again, indicating renewed monetary easing. This was the result of a decline in both components of the index.

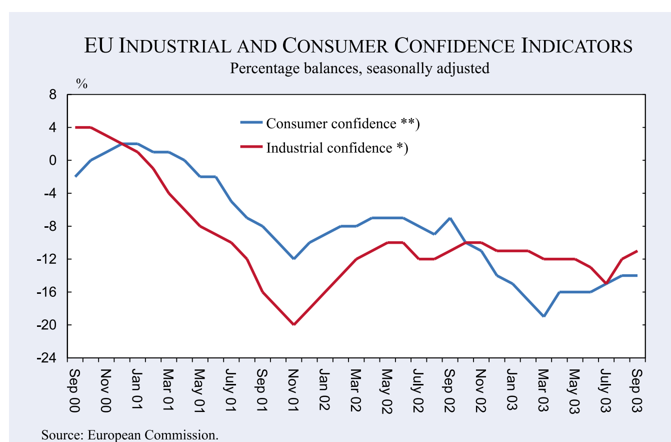
EU SURVEY RESULTS

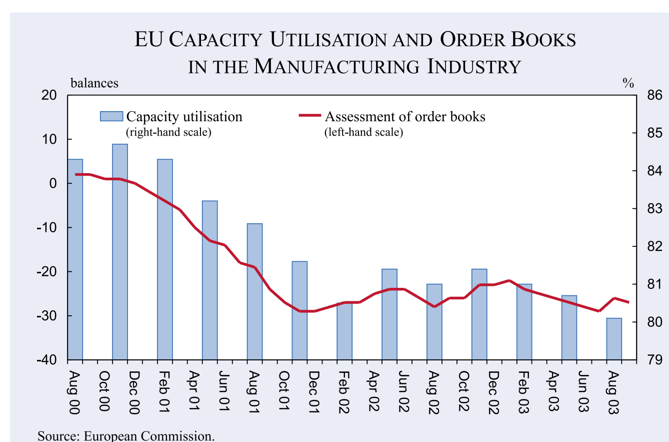




In the Eurozone, real GDP growth declined during the second quarter 2003 by 0.1% compared to the first quarter. In EU-15 it remained unchanged. Compared to the second quarter 2002, real GDP grew by 0.2% in the Eurozone and by 0.5% in EU-15, following growth of 0.8% and 1.0% respectively in the first quarter. Compared to the first quarter, second quarter growth fell especially in the Netherlands (– 0.5%), Denmark (– 0.5%) and France – 0.3%), but rose most in Spain (0.7%) and Finland (0.6%).

The economic sentiment indicator for the EU continued its improvement in September. Following its increase by 0.4 points in August, the indicator rose 0.3 points in September, reaching its highest level for this year. The improvement was due, in particular, to a rise in confidence in the industrial and retail sectors, while confidence in the construction sector and among consumers remained unchanged. The positive results in the EU were dominated by developments in the euro area. Except for Spain, France and the Netherlands, all euro area countries showed improvement in economic sentiment.



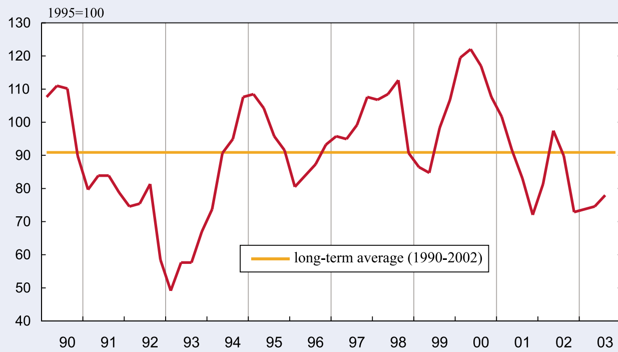


* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

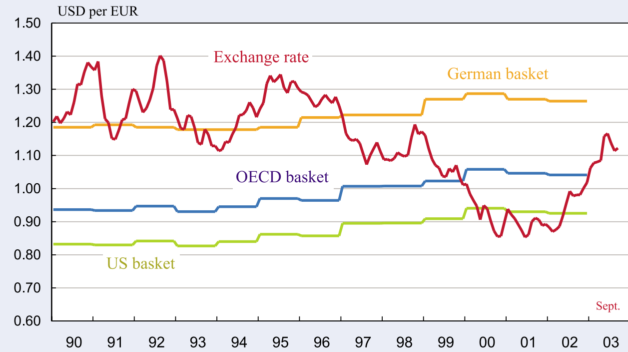
Following its continuous decline since autumn of last year, *industrial confidence* in the EU showed an improvement for the second month in a row, bringing it back to the level recorded at the beginning of 2003. In the euro area, the indicator reached its highest level since mid-2001. The rebound was particular vigorous in Belgium, Germany, Italy and Luxembourg.
In contrast, *consumer confidence* remained unchanged in September, following a small increase of 1 point in August. The indicator had seen a substantial improvement since March, with one short-lived interruption in May, but remains quite markedly below its long-term average.

The improvement of industrial confidence was primarily due to substantially higher production expectations. The *assessment of order books,* however, which had improved noticeably in August, deteriorated slightly in September. In the euro area they remained unchanged; improvements in some countries were offset by deterioration in others. *Capacity utilisation* in the manufacturing industry continued to decline in the third quarter of 2003, with a substantial drop to 80.1 from the second quarter (80.7).

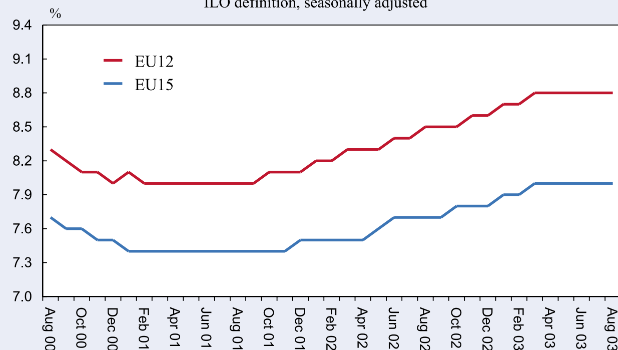
EURO AREA INDICATORS



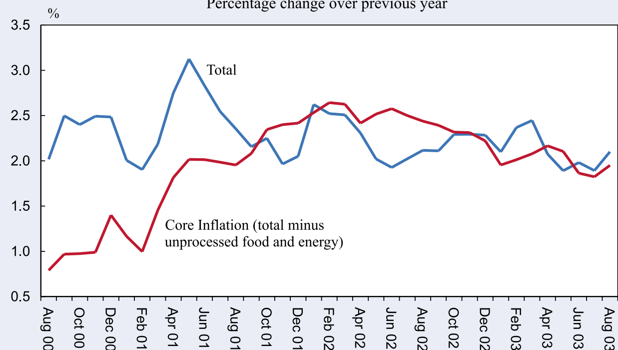
The Ifo Economic Climate for the Euro Area in the third quarter of 2003 improved for the third time in a row, but at 78 is still quite a bit below the long-term average of 90.9. While the experts' assessments of the current state of the economy again worsened slightly, expectations for the next six months improved substantially, indicating that a recovery may finally be around the corner. The most unfavourable assessments of the current state of the economy were given for Portugal, Germany and the Netherlands, whereas the assessments for Finland, Greece, Luxemburg and Spain were relatively positive. Expectations improved everywhere except in Ireland where a further slowdown of the still rapid economic growth is expected.



The exchange rate of the euro against the dollar, which had been rising since April 2002, fell in July and August, but rebounded in September when it averaged $1.12. If the purchasing power parities of the US basket of goods and the German basket are taken as lower and upper bounds, there is still room for the euro to rise in coming months.



In August 2003, the seasonally adjusted unemployment rate of the 12 euro-area countries remained at the level of 8.8% that it had reached in March (August 2002: 8.5%). The same was true of the average unemployment rate of the EU-15 countries which remained unchanged at 8% (August 2002: 7.7%). The lowest rates were registered by Luxembourg (3.8%), the Netherlands (4.1%), Austria (4.5%), and Ireland (4.7%). At 11.4%, Spain continued to record the EU's highest unemployment rate. Italy's rate fell from 9.0% (July 2002) to 8.5% (July 2003).



The harmonised index of consumer prices (HICP) was 2.1% higher in August than a year ago and is estimated to have risen again by 2.1% in September. This is an increase from the 1.9% increase in July. Core inflation, which excludes the prices of energy and unprocessed foods, also rose from 1.8% in July to 1.95% in August

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