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Letter from the Editor

Dear Reader,

Welcome to the Lent 2012 issue of *Rationale*. Since its founding, *Rationale* has aimed to provide LSE students with a platform on which to discuss and share their views and insights from the many diverse applications of economics. While its format and the nature of its content may have changed frequently over the years, in ways as unpredictable as the field it covers, this has always remained the purpose of *Rationale*. This year, you will find that the articles are more academic in their style and subject matter. I feel this is a step in the right direction and I sincerely hope it can be sustained and improved upon in years to come.

The focus of this issue is the current political and economic troubles facing Europe. Thanks to the wonderful diversity of public events we have access to here at the LSE, *Rationale* has had the privilege of interviewing numerous inspiring leaders from media, business, politics and academia for their views on the crisis. Thus, on behalf of everyone at *Rationale*, I would like to thank the LSE Events team for the opportunities they have given us and everyone we interviewed for setting aside time from their busy schedules to meet with us.

I would also like to thank all the writers for their time and effort. Without their contributions, this issue would not have been possible.

Lastly, I would also like to thank those who served on *Rationale's* Editorial team for their commitment and dedication to producing this issue.

I hope you find this issue of interest, and as we continue to explore ways to improve *Rationale*, please share your thoughts and ideas with us. I can be contacted at kaushal.inna@rationalemagazine.com, and I look forward to hearing from you soon.

Sincerely,

Kaushal Inna
Editor in Chief

Letter from Senior Editors

The Lent 2012 edition of *Rationale* focuses on a topic on everyone's mind today: the euro crisis. As time has progressed, worries have moved from the solvency of various states, to questions surrounding European banks, to the contagion that could spread out from Europe across the world economy. This magazine looks at three different pieces in relation to the euro crisis, while also offering a mix of articles in both the economic and political realm.

Our first article summarises a series of interviews conducted by Talitha Chin and Roshni Rajan of some of the world's leading voices on economic matters. It breaks down the outlook for the eurozone and the new political and economic arrangements that will be necessary to save Europe. Our second piece looks at what the welfare state might look like in a globalised world and one where many developed countries are facing huge fiscal crises. Jonathan Crowe argues that governments could learn a thing or two from the private sector in dealing with these problems. In our third and final piece crisis, Jeff Lupo examines the history of the IMF and its failures during the late 1990s that encouraged the foreign reserve build-up and subsequent savings glut that helped spark the 2008 financial crisis. He asks whether there is a role for the IMF in the future, especially and what that role might be.

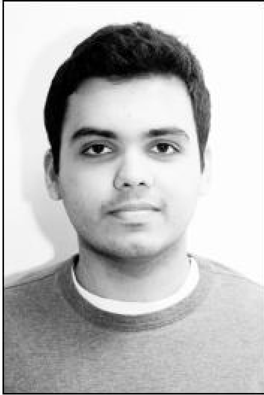
Our centre section looks at several topics regarding international economic relations and diplomacy. In the first article, Michael Motala studies whether the current system of international financial regulation, and especially the Basel Accords, is an example of good global governance. On a similar note, Tejal Patel looks at the domestic politics that underlie international commitments and asks whether they matter more than international politics. Sabina Voicu takes us through the history of the European Payments Union and concludes that it was a successful example of international cooperation, while Sofia Horta e Costa provides an analysis on the winners and losers of international trade in regard to different trade theories.

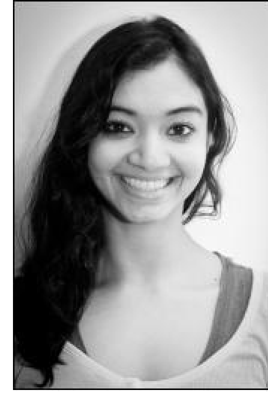
The rest of the magazine provides a broad range of articles on a variety of economic topics. Joe Raimondi details the development of a new supply route being used for economic development in Afghanistan following the Afghan War. Stephanie Gale argues that the current debate about social support in Britain pays too little attention to the incidence of taxation and who might really be funding these provisions. In our final article, Sophie Langlois looks at the changing nature of corporate boardrooms and their new-found focus on environmental and social responsibility in the age of globalization.

This edition of *Rationale* offers up a full serving of economic and political discourse, from writings on the euro crisis to political relations between economic actors. We are delighted to offer you a thought-provoking and intellectually challenging publication. We hope you enjoy reading it, and look forward to providing you with more of the same in the future.

Selena Lucien and Alex Grohovsky,
Senior Editors

Editorial Team





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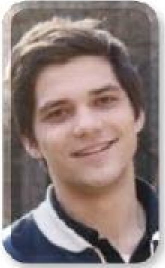
Jeffrey P. Lupo is a Masters student in International Political Economy at the LSE. He is interested in examining the ways in which deliberation processes affect the policy outcomes and democratic legitimacy of central banks.



Michael Motala is a Masters student in Global Politics at the LSE. He recently graduated from the University of Toronto's Trinity College with a Bachelor of Arts (Hons.) as an International Relations Specialist. Having worked at a leading Canadian public policy think tank and graduate school, his research interests are focused on the role of epistemic communities in international policy coordination.

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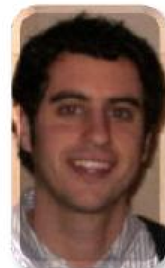
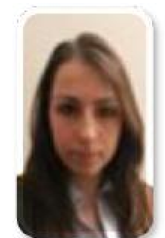


Joe Raimondi is a Masters student in Comparative Politics, Conflict Studies stream. His academic interests are in terrorism and political violence, counterterrorism and counterinsurgency, and state formation/state collapse, particularly in (but not limited to) the former Soviet Union, Central, and South Asia.

Andrea Varrasi is a Masters student in Global Politics at the LSE. He comes from Italy, where he studied Political Science and International Relations. His research interests are in global environmental governance, climate change diplomacy and the geopolitics of oil. He is currently conducting research on the role of business in influencing the implementation of carbon trading in the European Union.



Sabina Voicu is a Masters student in Conflict and Development at the Graduate Institute of International and Development Studies in Geneva. She received her Honours Bachelors degree with high distinction from the University of Toronto, where she specialized in International Relations, European Studies and Economic History.

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The Eurozone Crisis: Views from Above

Amongst a community of economists, one can hardly escape the refrain 'the Eurozone Debt Crisis'. Indeed, it is the latest global quandary to have had severe implications on every conceivable institution, aspiration and even individual. Seizing on this, the Rationale Magazine interviewed a few of the most influential people in the world on this subject—Phillip Coggan, Buttonwood columnist of The Economist, Dr Hans-Paul Bürkner, BCG's President and CEO since 2013, Ms Sri Mulyani Indrawati, Managing Director of the World Bank Group and Professor Jeffrey Sachs, Director of The Earth Institute at Columbia University and Special Advisor to the United Nations Secretary General, Ban Ki-moon. We bring you the low-down on their views on debt with regards to recent developments and articles on the subject.

Though 'debt crisis' became a quotidian phrase around the LSE only within the last few years, Mr Coggan reminds us that debt, seignorage and quantitative easing have been extant since the beginning of civilization. He begins his latest book 'Paper Promises' by citing the instance of Dionysius, ruler of Syracuse, Greece from 407 BC to 367 AD (Lynn, 2011) who 're-stamped one drachma coins as being worth two drachma, thereby cutting their value in half' (Coggan, 2011) **in** face of pressures to repay his lenders. Indeed, the 'inflation tax' implemented by profligate Roman emperors of the ancient world took the form of diluting the silver content of coins as a tactic to raise revenue. So if debt has been a persistent, inexorable 'disease' (Sachs, 2011), then what has made this crisis so unique?

In Ms Indrawati's own words, the biggest crisis that the world faces today is not merely of the eurozone, but a 'crisis of distrust'. To the extent that 'money transactions are an act of faith', the failure of the promise of a piece of paper to be legal tender belies a lack of faith of people in their governments. It is no wonder that the crisis has engendered the recent uprisings in Europe (TIME.com, 2012), which has become known as Europe's own Arab Spring. The financial exigency has created woes for the taxpayer, who is forced to stomach the injustice of being increasingly squeezed by corrupt governments. It is no wonder that Professor Jeffrey Sachs writes the following in the opening pages of his book about the debt problem in America, a parallel of Europe's: "At the root of America's economic crisis lies a moral crisis: the decline of civic virtue among America's political and economic elite."

Professor Sachs spoke at LSE of the American debt crisis as a failure of fostering ethical and equitable governance. In his speech at the LSE, he proposed that a retreat of government intervention, dismantling of the notion of public goods, deregulation of the financial industry and an assault on trade unions have fostered a system that 'amplifies inequalities'. In his view, the system's in-built function of moral hazard has engendered America's 'consumption binge', in which America is ironically 'squandering rather than investing in this generation' (of middle class society) (Sachs, 2011). Ms Indrawati and Professor Sachs highlight the ethical and social dimensions of the issue. The rewriting of global rules of borrowing and lending by those in power as 'heads you win, tails the taxpayers lose' (Krugman, 2008) has created a polarised society.

Not only is the crisis worse this time round because of its implications on individuals, but it also has more of a chronic effect due to its global nature and impact. Ms Indrawati highlights the fact that the crisis of the eurozone has stymied progress in eradicating poverty as countries have become increasingly 'inward-looking'. As the 'global economy has more balance', there needs to be greater 'collective responsibility' and any withdrawal of this share in ownership can prevent trade, which may be essential to fostering prosperity in emerging economies. As the world has become flatter, one country or one union's inundation in debt may easily flood the global economy.

Gandalf Greece and the Council of Elrond

Many people view Greece as the source of this inundation. The key question then is: what are the consequences for Greece and the

rest of Europe? Will Greece survive the currency union?

Larry Elliot from the Guardian alluded to the Lord of the Ring's Gandalf, who was part of the Council of Elrond, in describing the plight of Greece (Elliot, 2012). He writes, "The battle ends with Gandalf smiting the bridge with his staff, sending the Balrog plunging into a fathomless abyss. There's a twist to the tail, however. As the monster falls, one last swish of its whip curls round Gandalf's ankle and drags him down into the pit as well." In this light, Greece will either decouple the Eurozone, possibly during 2012 as BCG's CEO Dr Bürkner predicts, or perhaps survive as Europe's last bailout.

But in the wake of a second Greek bail-out on 21 February 2012, Mr Coggan may be right after all in that perhaps the country 'will remain within the Eurozone because the penalties for leaving it are so great'. Phillip Coggan explains the problem as follows: "Greece has three problems if it remains within the **eurozone**; too much debt relative to GDP, a large deficit and uncompetitive companies. As a country, you can default and deal with your large debt to GDP ratio and get subsidies from your neighbours to deal with the deficit problem but that doesn't solve the competition issue. This is one of the problems of fixing the value of your currency. Greece has pegged its currency to Germany and everything else has to adjust around it – prices can adjust but wages are sticky. Debt is also fixed in monetary terms so that makes it more difficult to repay it. As a consequence Greece is unable to deal with being uncompetitive."

In the medium term, however, both Mr Coggan and Dr Bürkner believe countries will leave the **eurozone**, but not the 'core countries'. Dr Bürkner vouches that the countries central to building the Euro, such as Italy and Spain, have put in place new governments and are thereby taking the 'necessary action to stabilise the country, and I think they will also stabilise the sentiment in the markets'.

Whither? A global Apocalypse? The emergence of partnership and engagement

Although most views on the outcomes of the crisis remain bleak, all four prominent figures we have spoken to either present a solution or respond in rhetoric exhortation, especially to the LSE students, to remain positive.

Mr. Coggan believes that the way out of the crisis is for China and the USA to take the reins of the new order, since 'the US needs China to fund it and China needs the US to buy its goods'. Yet even though the Euro may take a back seat, he genuinely believes in a 'degree of debt forgiveness' which will help countries continue to tide over in times of austerity.

Professor Sachs, on the other hand, uses presidential rhetoric in calling for a 'restoration of virtue' in order to pay for 'the price of civilization'. It is no wonder an online community, 'sachsforpresident.org', has been created as a campaign for Professor Sachs to be elected President.

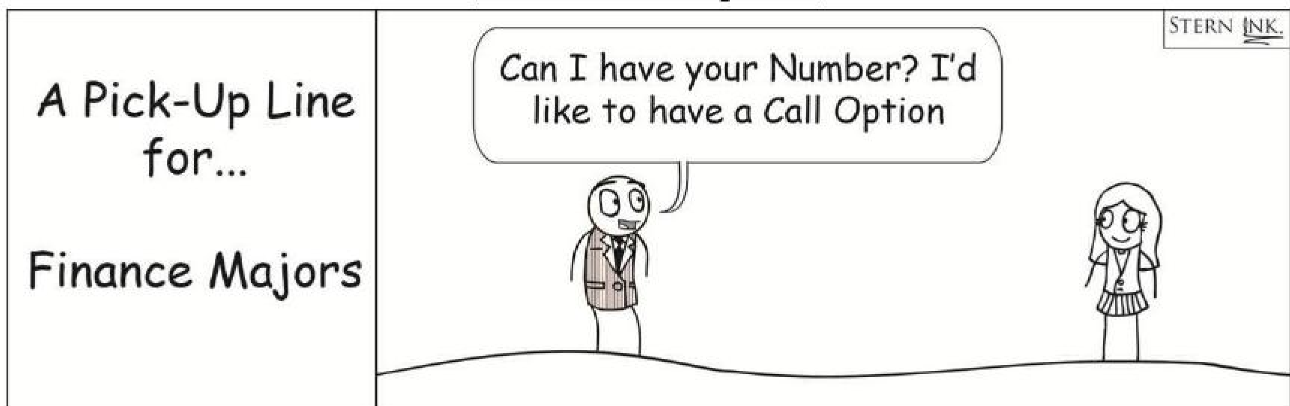
Ms Indrawati envisions a new system of power relations whereby a share in responsibility between developing and developed nations will allow for progress in international development: "The world has changed. Nations are facing their own problems. On very basic economic policy, they need an adjustment. But at the same time, emerging, developing countries are becoming more important. They are not a threat. They are becoming the source of the solution. Europe needs the rest of the world in order to rescue it when its domestic economy is weakened by the crisis. And that is why a new attitude towards partnership needs to be nurtured and developed. A new relationship based on collective responsibility between the European 'part one' countries and the emerging, developing countries needs to be built."

Finally, on a more positive note, Dr Bürkner's ending words: "I think the future is really bright. But it is only bright if you take responsibility. If you take life in your own hands, and if you get engaged, whether it is in a company, your own company, if you are going into government, if you work in NGOS—if you really make a difference, you can create a bright future. Quite honestly, what we have seen in the past decades and centuries is a very, very positive development, notwithstanding setbacks, notwithstanding wars and environmental issues.

I think overall mankind and womankind has made it work. And so I am positive that we will shape the future. We will make it happen. You can, everyone can play a significant role. Don't think that just because you are one of 7 billion you cannot make a difference. You can make a difference."

In essence, there is a 'way out of the woods' (The Economist, 2012) for Europe. Each crisis sees new adjustment and the emergence of a new system of partnership and engagement. So what Europe really needs is a 'New Deal', to weather its own Great Depression. Internally, it needs increased commitment to transparency and mutual compromise. Externally, it will benefit from aid from emerging nations and by cooperating with China and the USA. Finally, as Dr Bürkner has pointed out, what is often overlooked is the increased mobilisation needed from educated individuals. As the population ages and its workforce shrinks, Europe needs to depend increasingly on labour productivity in order to keep growing.

Finance Pick Up Line



A 21st Century Economic Model

The eurozone crisis, subsequent panic over national debts, and dismay over national credit ratings are leading scholars and policymakers to rethink basic economic assumptions underlying the welfare state. One significant realization in general should be that a welfare state is a hugely expensive endeavour, a fact that is evidenced in the dearth of funds available to many advanced democracies to finance welfare programs. Inside this capital shortage is another fact so subtle that it has been largely ignored since the advent of the welfare state: *the welfare state requires incredibly strong and productive national economies*. Without sustained revenues gleaned from economic growth, governments will find it difficult or impossible to accrue the funds necessary to supply the goods and services that they have long promised their residents.

Another critical point further complicates the analysis—the contemporary globalizing world is different than at any point in history. This globalizing world is transnationally interconnected. Global commerce drives contemporary economics. Scholars and activists at the 2012 World Economic Forum discussed the emerging global identity which has displaced national or regional identities, especially amongst the younger generation. Moreover, advocates and scholars of globalization - the compression of time and space across international borders through technology, communication, and the movement of persons and capital - argue that these developments are accelerating and that they threaten the primacy, sovereignty, and stability of the nation-state in contemporary affairs.

One of the central paradoxes of the twenty-first century is this juxtaposition between national welfare states requiring consistent revenues and a globalizing world economy moving away from strictly internal trade and commerce. Governments' ability to navigate this issue may impact global stability in the twenty-first century more than any non-national security issue. The need for strong national economies to raise funds for a national welfare system in spite of a globalizing economy raises a pressing question. If globalization is a prominent feature of the contemporary world, how can a government fund a welfare state whose structures are distinctly national?

Proposals on how to generate revenue to close the debt and fund the welfare state seem to rehash longstanding debates. Many on the political left call for higher taxes on the wealthy, while many conservatives favour cutting taxes to individuals and businesses - thus relying on a stimulated economy to amass sufficient revenue - and eliminating most government welfare programs. Both responses ignore some aspect of political reality. Liberals ignore that government expenditures often outstrip their incomes, leaving the tough fact that government spending will have to decrease to some degree. Conservatives, however, seem hesitant to admit that there is a limit to what governments can cut and that the national welfare state likely will remain in place for some time.

A more logical response is to find ways for national governments to amass revenues in a globalizing world. To increase revenues, governments historically regulate business and raise taxes. This simply will not work now. In a globalizing world, businesses can simply move to another country where they encounter less regulation and surrender less profit to government taxation. Secondly, a principle tenet of globalization is that transnational connections take place with more frequency and more velocity than at any point in previous history. The upshot has been that the trajectory of a globalizing world is towards fast connections across borders, yet regulation stunts growth and slows the rate at which business operates, thus explaining business leaders' aversion to it.

Twenty-first century governments, however, may be able to boost their revenues by drawing lessons from successful business models. Two, in particular, stand out. The first is the Facebook and Google model. Facebook and Google successfully profit because they charge other companies access to potential customers. Both accumulate a large base of potential customers and then charge money to businesses who want access to those customers, even when the returns on that investment may be very low.

National governments in the developed and developing world could do the same thing. These governments have large numbers of people living within their borders, thus giving them a collection of potential customers for prospective businesses. These governments can charge companies money to access their citizens, plus a small percentage of successful sales. This would do little to slow the rate of transnational connections, but it would give governments a way to profit from these transactions.

Another model that governments can employ is the Apple model. Apple makes the vast majority of its money off its hardware sales —iPods, iPads, and so forth. Apple uses software, such as iTunes, to entice customers to purchase its hardware. The correlation is that governments could make money from hardware being shipped into their borders—computers, cell phones, toys, and so forth. Governments could place tariffs on products that arrive at their borders fully assembled. This would encourage businesses to hire nationals to assemble or build products, ensuring high paying jobs for many citizens. This would produce revenues on income taxes, company facilities, individual worker discretionary spending, and more.

These ideas are aimed at raising revenues to continue some version of the welfare state, but they will not solve the problem alone. Social welfare programs need to be self-sustaining, or nations will find themselves driven deeper and deeper into debt with all the uncertainty and unrest debt brings. Those who traditionally criticize the neo-liberal policies that discourage governments from providing goods and services to citizens often argue that a government has an obligation to provide for its citizens' basic needs above all else. In reality, a government needs to create a social net for its vulnerable citizens while providing opportunity to those who can work. Governments will have to learn to say no to some who seek its help. If governments refuse this, they will find themselves constantly begging for help and at the mercy of other governments' charity or manipulation.

To amass revenues, governments should emulate globalizing businesses. In a globalizing world abundant with national welfare states, countries must adopt new economic policies that allow businesses to grow and produce revenue. As long as globalization and the welfare state remain prominent, employing models gleaned from successful companies is a strong first step.

Can the IMF Stay Relevant?

At the turn of the century, the International Monetary Fund was in disrepair and drifting toward irrelevance. Just over ten years later, however, the IMF finds itself at the centre of Europe's debt crisis and global economic politics. Will it once again be set adrift after the current crisis?

To the casual observer as well as the economist insider, the International Monetary Fund has undergone a multitude of transformations since its inception toward the end of the Second World War in 1944. In the first instance a product of the Bretton Woods conference and, more specifically, the correspondence and negotiations of the United Kingdom's John Maynard Keynes and the United States' Harry Dexter White, from its outset the role of the IMF in the global economy has been clearer in theory and intent than in practice.

First an institution whose use of capital controls provided relative stability to the global monetary system, in the late 1970s and 1980s a new generation of IMF policymakers saw it as their mission to break down barriers to capital movement to forge a global monetary system that resembled, perhaps somewhat ironically, the one that prevailed before the two world wars of the twentieth century.

Then came the 1990s. Truly a decade of global change, the IMF was now a remnant of a disintegrating post-war order in a global economy that was becoming more open and connected at a faster and faster pace. Before the end of the decade, the IMF appeared to have lost its step. Its response to the East Asian Crisis in 1997 led not only to vehement anger on the part of IMF programme recipient countries, like Thailand, but also to a corrosive discrediting of the institution as a whole, which developing and emerging market countries had begun to see as a tool of Western developed countries in general and the United States in particular.

Neoliberal. Washington Consensus. Free market fundamentalism. Not only did the vocabulary of the IMF's critics expand but so did the roster of those who were starting to speak out against it. Perhaps the most trenchant criticism around this time came from Joseph Stiglitz. A Nobel Prize winning economist whose résumé was as impressive as an academic-turned-policy-wonk's could be, Stiglitz's criticisms of the Washington Consensus was emblematic of how the tide of popular and elite opinion had turned against the IMF and the policies it proselytized.

Yet ten years later, the IMF is reinvigorated, recapitalized and repositioned at the centre of the global economy and its many ongoing crises. What does it need to do to secure its prominent position in global economic politics and avoid a lapse toward irrelevance? The answer lies in whether the IMF truly learned the lessons of the East Asian Crisis of the late 1990s.

The East Asian Crisis

In the 1990s the membership of the IMF was beginning to become stratified. At the top were developed Western countries like the U.S., which contributed a large amount of resources to the IMF and as a result had a large influence over the institution. These countries, however, were very unlikely to ever need to draw upon IMF resources. On the bottom were poor developing countries. These countries also would rarely need to borrow from the IMF because they rarely suffered acute financial crises due to the fact that they attracted small amounts of private capital in the first place. As Joseph P. Joyce, Professor of Economics at Wellesley College and Faculty Director of the Madeleine Korbel Institute for Global Affairs, points out, however, "in the middle you have this very interesting group of countries which are growing rapidly, which are attracting private capital to their countries, and, every once in a while, blow up." In the 1990s it was this group of countries which required IMF resource

Around this time there were two important changes going on inside the IMF. Capital controls — mechanisms countries use to regulate the inflow and outflow of private capital to their economies in order to, among other things, keep a stable currency — had begun to go out of fashion.

Secondly, the IMF began to consider new ways of attaching conditions to its assistance programmes. Whereas traditionally the focus was on trying to get countries to alter macroeconomic conditions, there was a growing consensus that the sources of crises came from something deeper in these countries' economies. Joyce notes that these new conditions, so-called Structural Adjustment Programs, were "based on the notion that these countries had a crisis not just

because, in a narrow sense, policies weren't being done right, but because there was some inherent problem within the economy caused by a lack of use, a lack of reliance on, market mechanisms to allocate resources."

These two factors — a global financial system characterized more and more by the free movement of capital and the IMF's change of thinking on conditionality — came together in the East Asian Crisis of the late 1990s, a pivotal moment both for the global economy and the IMF.

The Structural Adjustment Programs the IMF had recently endorsed and implemented in its assistance packages to countries like Thailand during the East Asian crisis turned out to not be so popular. In fact, the conditions — which emphasised fiscal austerity and privatisation above all else — were so harsh that most of the countries that received loans began to resent the IMF and started looking for ways to make sure they had the resources to mitigate future crises without seeking assistance from it. Countries like Japan, for example, attempted to do this by voicing support for regional monetary institutions like the Asian Monetary Fund. U.S. opposition to such an arrangement, however, ensured the AMF would have no chance of rivalling IMF influence in East Asia.

A second way countries did this — and one with far more deleterious effects for the global economy — was by building up large amounts of currency reserves, which as Jacqueline Best (2010), Associate Professor in the School of Political Studies at the University of Ottawa, points out, happen to be "the same reserves that helped to fuel the consumption-driven excesses of the West and to precipitate the current crisis". In other words, a straight line can be drawn from emerging market countries' disillusionment with and disengagement from the IMF beginning in the late 1990s to the global financial crisis of 2008 and the ensuing downturn.

The Challenges of the European Debt Crisis

The European debt crisis presents the IMF with a difficult set of circumstances. Its immediate concern is, of course, to mitigate the crisis and play its part in preventing a break-up of the eurozone or any other event that could possibly drag the global economy into another recession. What complicates things, however, is the IMF's long-term role in the global economy. To stay relevant after the crisis, the IMF's policies will need to be judged to have been effective in alleviating Europe's troubles while not having given special treatment to programme recipients simply because this time they happen to be Western developed countries. There are two factors that make both of these things exceedingly difficult to achieve.

First, the IMF is not the only actor concerned with or trying to mitigate Europe's crisis. European Union governments like Germany and France, in addition to the European Central Bank, are intimately involved in shaping the conditions under which euro area countries receive assistance. This makes it hard for the IMF to control its own fate in Europe in terms of policymaking because, as Joyce notes, it is very much constrained by these entities which "obviously have very strong beliefs about what should happen."

Secondly, due to the severity of the European debt crisis, the IMF has been forced to provide huge amounts of assistance to relatively small countries, like Greece, who normally would only be entitled to borrow a certain amount based on their quota share. This will make it difficult for the IMF to fend off accusations of special treatment. As Joyce notes, "the fact that the Fund has been relatively generous with the three European countries is well known amongst the previous borrowers of the Fund." With serious constraints on its policymaking and ability to shape its public image in the European debt crisis, the IMF very well might have even more ground to make up once it reverts back to trying to restore legitimacy with developing countries after the dust has settled.

How to Stay Relevant

To stay relevant after the current crisis, the IMF will need to do a better job of predicting crises or at least of moving the debate toward the most important issues. Advocacy of stimulus policies and capital controls in certain situations might be evidence this is starting to happen. The IMF needs to prove, however, that it has not changed its tune simply because it happens to be dealing with Western developed countries at the moment. To garner legitimacy and increase its effectiveness, the IMF needs to totally disabuse developing countries of the notion that countries in the West receive special

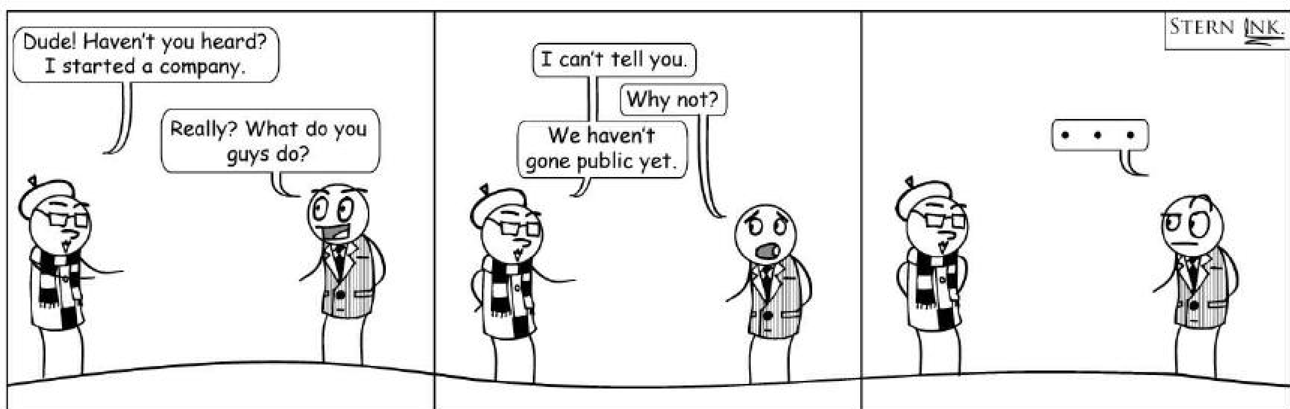
treatment. That is going to take time and possibly even another crisis, but there are concrete steps the IMF can take right away, like extensive quota and voting share reform, to start to earn the trust of developing countries.

The stakes are high. As Jeffrey Chwieroth, Reader in International Political Economy at the London School of Economics, notes, "without adequate reforms to restore the faith of emerging markets in the Fund, the risk is that these countries will continue to opt for self-insurance rather than collective insurance."

We've already seen the consequences of self-insurance once before. As the current crisis — which has done disproportionate damage to OECD economies — continues to play out, it should be obvious to Western countries that relinquishing full control over the IMF in return for a more stable international monetary system serves their interests.

The question is whether they have fully learned the lessons of the East Asian Crisis. Now that we know the worst remnants of the East Asian crisis were the imbalances that arose as countries self-insured outside the IMF, it is imperative to not repeat the mistake — with potentially even more harmful effects — this time around.

Have Not Gone Public



Successful Global Governance and Financial Regulation

Globalization and financial regulation are fashionable topics in the discourse on contemporary politics. There is a lively debate over the nature and implications of globalization as a phenomenon, and disagreements often centre on conjectures about the power of the state in the new *globalized* world. What the ongoing financial crisis highlights is the diminution of the state's capacity to unilaterally respond to global issues. Specifically the globalization of financial markets creates opportunities for banks to expand their risk activities without the concurrent upgrade of supervision and prudential regulation by national authorities (Eichengreen, 1999). The increased number of transactions and the velocity at which they occur has contributed to the instability of banking systems. And growing interdependence among international banks has created the possibility for contagion effects. The negative externalities affected by ineffective bank regulation now operate on a global scale. As such, the state has been forced to rethink its approach to financial regulation in the context of crisis, and recent foreign and economic policymaking has focused on the creation of instruments of global governance to manage and prevent future crises. How and to what extent does the current system of global financial regulation represent an example of successful global governance?

To answer this question it is necessary to qualify what is meant by 'the current system,' 'global governance' and 'success.' This paper will evaluate the success of the Basel Accords regulating bank capitalization and risk management as a current system of global government, and will infer some general insights on the success of global governance in the area of financial regulation. This paper argues that success of Basel can be seen as a mode of coordination among national authorities, while it is still difficult to evaluate the extent of implementation and soundness of the policies themselves. The case suggests that the most successful global governance is undertaken in areas requiring lots of technical knowledge and expertise, where the process is institutionally depoliticized, and there is political will generally supportive of the maintenance of financial stability. This paper begins with a brief history of global regulation from 1974 to present under the auspices of the Basel Committee, including the Basel I, Basel II & Basel III agreements. It will then contrast three analytical approaches to this process: hegemonic leadership, redistributive cooperation and discursive institutionalism. Together, they offer a fairly comprehensive analysis of the Basel Process; this paper seeks to build on gaps in existing scholarship by incorporating arguments made in more contemporary studies.

A series of financial crises beginning in the early 1970s gave impetus to the current system of global financial regulation under the Basel Committee for Banking Supervision. In 1974, the failure and liquidation of Herstatt Bank prompted the formation of the Bank for International Settlements (BIS) by the G-10: this served as the institutional framework within which subsequent multilateral agreements would take place (Kahler & Lake, 2009). The collapse of Banco Ambrosiano later in July 1982 demonstrated glaring deficiencies in international banking regulation, and central bankers in the G-10 countries turned to the BIS to develop recommendations for an international capital adequacy regime (Kapstein, 1992). In the 1980s the globalization of international capital markets and the attendant risks motivated a decisive shift in the strategies of global policymakers, from crisis management to crisis prevention (Kapstein, 1994). In this pursuit, central bankers in the United States and Great Britain shared two concerns: that a deterioration in bank capitalization would pose systemic risks; and that national regulation alone would impose a competitive disadvantage on their respective banks in international financial markets (Simmons, 2001).

Recognizing that the US and Britain together captured a significant portion of international financial markets, the Federal Reserve and the Bank of England negotiated a bilateral agreement in 1987. This served as a template for discussions at the G-10 later that year. Given that the risk-weighted capital adequacy requirement was now the standard for banks operating in New York and London, central bankers from the leading industrialized countries were motivated to join talks about regulatory convergence lest their banks be forced out of these crucial markets. On December 10, 1987, the Basel Committee announced that an agreement calling for

convergence of capital measurements and standards had been reached (Kapstein, 1992). Basel I came into effect in 1992, and was widely considered to be the most successful form of global financial regulation to date. By 1993, most banks operating in G-10 nations surpassed the minimum capital requirements outlined in the agreement (Simmons, 2001).

The early 1990s were a period of consolidation among financial institutions, giving rise to the notion that some banks were now "too big to fail" (Kapstein, 2006). By the late 1990s, as a result of mergers, the US had three of the largest international banks by market capitalization (Simmons, 2001). If these firms engaged in unregulated speculative activity that brought them close to failure, US central bankers would have to undertake morally hazardous bailouts to prevent the whole system from collapsing. The US would have to shoulder disproportionate risk given their market share in global financial services, and it was therefore in their interest to enhance the regulatory regime under Basel I. Regulators also had to contend with more sophisticated financial transactions made possible by the globalization of communications technology, and sought to eliminate incentives for regulatory arbitrage and promote better risk management (Herring, 2007).

At the global level, the Mexican Peso Crisis of 1994 exposed the increased risk of contagion effects, underscoring the need for further coordinated action through the Basel Committee. Following the Asian Crisis of 1997, authorities in Indonesia voluntarily adopted the capital adequacy criteria established in Basel I, demonstrating the scope and effectiveness of the Basel process in setting a global standard (Simmons, 2001). Although the Basel Committee has no enforcement power, it is an instrument of global governance that is uniquely capable of setting standards and promoting regulatory harmonization in the financial realm (Eichengreen, 1999). In 2004, the Basel Committee published recommendations for a new set of regulatory standards known as Basel II. However, as Herring argues, the three-pillared approach failed to achieve implementation because it contained seemingly irreconcilable objectives (Herring, 2007). It was not until 2010 that the Basel Committee was prompted to release new standards under Basel III, responding to the financial crisis of the late 2000s. The current regulatory environment is suitable for the implementation of new standards in the G-20, given popular support for enhanced bank regulation in pursuit of financial stability in many national political constituencies. Evaluating the success of the Basel Process will therefore be instructive for policymakers seeking to implement Basel III and engineer global financial regulation in the future.

There are three analytical approaches to the Basel Process in the literature on global politics. The first – hegemonic leadership – is advanced by Simmons and falls broadly in the tradition of realism. She argues that the United States, as the dominant actor in global politics, used unilateral political coercion to press for regulatory harmonization through international institutions (Simmons, 2001). Naturally it had a vested interest in capital adequacy regulation given its share of international financial markets and the concomitant exposure to risk. Seeking to explain how international regulatory harmonization occurs, she develops a theoretical model that explains the Basel Process in terms of an exogenous expression of domestic political economy (Simmons, 2001). Simmons views global financial regulation as a success because of the structural power the United States. Her argument is limited in two crucial ways. First, her assumption is that the US is unitary political actor with a fixed national interest; this limits any capacity to analyze developments at the domestic political level. And second, as pointed out by Woods and Mattli, the hegemonic leadership argument does not account for the emergence of transnational regulation as a collective response to transnational crisis (Woods & Mattli, 2009).

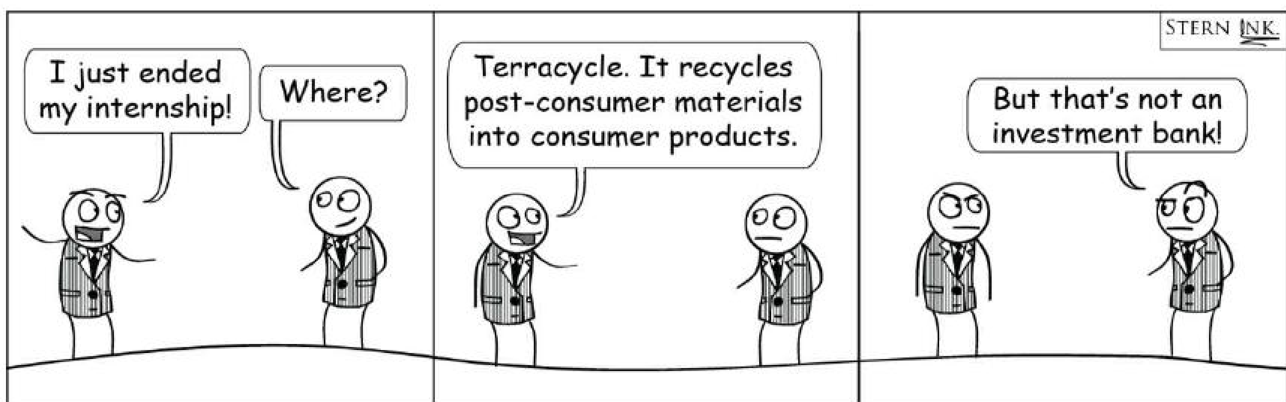
The second analytical approach – redistributive cooperation – is advanced by Oatley and Nabors. They deny the neoliberal tradition, which views the exercise of global cooperation as resulting in absolute gains or 'pareto-superior' outcomes for all participants. They find that the Basel Process does not demonstrate a joint gains logic; rather, it is redistributive insofar as it reduced the welfare of one government in comparison to another (Oatley & Nabors, 1998). Similar to Simmons, Oatley and Nabors argue that the United States used its structural power to force a multilateral agreement. The purpose was to disadvantage Japanese and German banks through policy convergence, as they were less capitalized and therefore previously more competitive in

international financial markets (Oatley & Nabors, 1998). The redistributive cooperation approach builds on the explanatory power of Simmons' theory of hegemonic leadership by defining the ultimate goal of US policymakers. It is limited in a similar way, however, by its exclusive analytical focus on the state.

The third approach – 'discursive institutionalism' – is a more recent development in the scholarship on global politics, and extends the analytical focus beyond the state. It examines transnational knowledge networks, or epistemic communities, and their role in shaping policy processes related to global governance. This approach is not concerned with the substantive content of ideational factors in international cooperation, and therefore constructivism is of little insight in the case of the Basel Process. Rather, scholars such as Schmidt analyze the interactive processes at work in a discourse (Schmidt, 2008). Global financial regulatory efforts are successful because they require lots of technical knowledge and expertise, often supplied by a small community of experts. Central bankers are able to apply this technical knowledge and coordinate with international counterparts because their institutions are depoliticized, and there is popular domestic support for financial stability – often conditioned by crisis. Kapstein argues that central bankers formed an epistemic community with consensual normative beliefs about financial regulation; through Basel, they were able to create a supranational regulatory agency that further insulated supervisors from domestic political pressures (Kapstein, 1992). This in turn reinforced the power and influence of the US Federal Reserve and the Bank of England as agenda setters in global policy coordination on financial regulation. The discursive institutionalism perspective broadens and refines the analysis of the aforementioned approaches by moving beyond the state and examining the role of transnational networks in the globalized world.

The process of globalization is causing an evolution of the contemporary risk environment in global financial markets. While global policymakers are currently engaged in an effort to manage the current financial crisis, the more substantial task remains anticipating and preventing future crises. The state has been forced to cooperate in order to develop a global regulatory regime, and its former capacity to act unilaterally has been transformed. While the effectiveness of the Basel Accords remains contested, the Basel Process demonstrates the capacity for authorities to coordinate policymaking, particularly through transnational knowledge networks. Effective global governance in the realm of financial regulation is uniquely possible because of the structural power of the US and the leading industrialized nations. To make the system truly successful, all that is needed is a measure of good ideas.

Terracycle



The Role of Domestic Politics in International Commitments

Scholars have frequently focused on the importance of interstate relations in the context of foreign affairs, but the way in which domestic policy alters state behavior within this context is often overlooked. Domestic political factors like the role of the state's internal institutions, such as ratification procedures, legislative rules, political system, and judicial models, all play a role in a diplomat's ability to negotiate an international commitment. Further, domestic politics is often the driving force to pursue an international commitment in the first place. This paper argues that domestic politics matter more than international politics in prompting states to make international commitments because domestic level issues operate to expand and contract a state's ability to pursue such commitments.

While Robert Putnam (1988) states that "[i]t is fruitless to debate whether domestic politics really determine international relations, or the reverse," he provides a theoretical "two-level" model to international negotiations which offers a useful framework with which one can see just how influential domestic politics may be during an international negotiation. Putnam suggests that a fundamental weakness of unitary actor models is their assumption that a given state can operate with a unified view of a given subject (Putnam, 1988). Rather, unitary actor models should recognize that a negotiator that operates as the central decision maker for a state must navigate both domestic pressures, as well as international pressures arising from the international negotiation itself (Putnam, 1988). As such, Putnam (1988) suggests that negotiations related to international commitments should be viewed as a "two level game," whereby a negotiator operates simultaneously on (i) a domestic level game board ("Level II"), where national groups and constituencies act to pressure state governments and (ii) an international level game board ("Level I"), where states seek to enhance their domestic good will while "minimizing the adverse consequences of foreign developments" (Putnam, 1988).

Putnam also identifies several important aspects of domestic politics that can influence a negotiator's "win set," or the range of possible agreements that would be acceptable at a domestic and international level (Putnam, 1988). Putnam states that international commitments are created where the two win sets overlap (Putnam, 1988). In essence, domestic politics operates to either contract or expand a Level II win set, which subsequently impacts the Level I negotiation process. For example, ratification of the agreement at Level II may limit the effectiveness of the Level I bargaining process because Level I players fear "involuntary defection" of an agreement due to the fact that an international commitment may not be ratified at the domestic level (Putnam, 1988). As a result, Level I players may be less likely to offer certain concessions or enter into an agreement at all.

An example of the impact of ratification procedures can be seen in negotiations related to the North American Free Trade Agreement ("NAFTA"). Under Article II, Section 1 of the U.S. Constitution, the President may enter into a treaty upon ratification of such treaty by 2/3 of the Senate (U.S. Constitution, Art. II, §2). Under the Trade Act of 1974, however, Congress restricted its ratification authority by allowing the executive branch to negotiate treaties that would then be either approved or rejected by Congress with no further amendments ("Fast Track Authority") (Avery, 1998; U.S. State Department, 2003). Authors such as William Avery have suggested that Fast Track Authority, as a domestic political procedure, expanded what would otherwise have been a more restrictive U.S. Level I win set in relation to the NAFTA negotiations because U.S. negotiators needed only a simple majority of Congress to pass the treaty, as opposed to the more challenging 2/3 majority (Avery, 1998).

Ratification procedures provide a good example of how institutional rules generally play an important role in determining the substantive outcome of an international commitment. For example, depending on domestic rules, the ratifying branch of a state may be forced to appease "quasi veto players" such as lobbying groups or other non-state actors (Hiscox, 2004). If rules allow for access and contact to members of the legislature or head of state, such non-state actors may exert pressure on international level negotiations by threatening to withdraw support for individual candidates or political parties, which will ultimately change the level of commitment by domestic politicians (Hiscox, 2004). For

example, in NAFTA negotiations, the U.S. auto-industry lobbied Congress and the U.S. Trade Representative heavily to raise country of origin requirements related to auto-parts in order to prevent Canada and Mexico from becoming export platforms for Japanese and European Automakers (Mayer, 1998). Automakers even went so far as to mobilize dealerships in a letter and phone campaign to Congressional members in order to achieve favorable country of origin terms (Goldstein, 1998).

Other Level II institutions may also impact a state's win set and therefore the ability of a state to commit to an international agreement (Putnam, 1988). Federal political systems such as those employed in the United States, for example, not only empower the legislature with a codified veto to treaty commitments, but may also empower "subnational state actors" with a quasi veto. In a highly federal system, states, provinces, or territories within a country may potentially act as a veto player to an international treaty that is negotiated at the federal level (Simmons, 2009). Beth Simmons (2009) has elaborated on the role of subnational players in the human rights context, noting "subnational governments can be expected to resist encroachment on their prerogatives that a treaty implies." Such resistance often hinders or prevents a binding international commitment because of the political need to appease these quasi veto players (Simmons, 2009). In some instances, subnational players may actually have a codified right to consultation, such as in Australia (Simmons, 2009). Such right operates as a restriction to the negotiator's win set because the provincial actor is no longer a "quasi veto player," but one with an enforceable legal interest in the process of the Level I negotiations (Simmons, 2009).

Further, domestic legal systems also play a significant role in narrowing or widening the win set of a negotiator with respect to international commitments. Because international treaties and agreements take on the force of domestic law in most countries, a country's legal system, particularly (i) a judge's interpretative leeway and (ii) the ease with which laws or "bad precedent" can be amended, plays an important role in whether a state will agree to binding international commitments (Simmons, 2009). Simmons notes that civil law systems operate on a series of codes or legal cannons which require judges to apply general principles to specific cases (Simmons, 2009). In contrast, the common law allows judges to apply a greater degree of judicial interpretation by focusing on specific facts and drawing out generalized rules which are then used as precedent for future cases (Simmons, 2009).

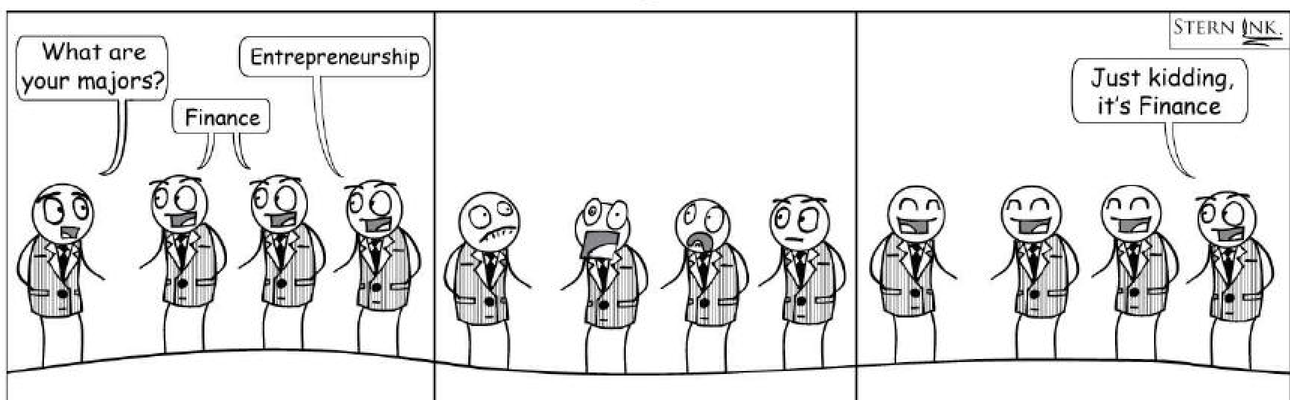
The issue then is the uncertainty that a common law judge will interpret the language of a given treaty in a manner consistent with the drafters' intent (Simmons, 2009). Further, "bad precedent," or a judicial interpretation that is inconsistent with the legislative intent of the treaty, has a trickledown impact because judges are bound to interpret later cases in a manner consistent with such precedent until the case is overturned or the issue is legislated upon. The combination of a greater degree of judicial interpretative discretion and a wider potential for misinterpretation of an agreement's provisions, therefore, are likely to narrow the Level II win set of a country that operates in a common law system.

Finally, the desire to achieve certain domestic policy objectives which would otherwise not be successful act as a motivating factor to enter into international commitments (Koenig-Archibugi, 2010). For example, the 1988 Free Trade Agreement between the United States and Canada ("FTA") created a bi-national institution that addressed claims related to countervailing duties ("CVD") and anti-dumping ("AD") cases (Goldstein, 1996). Under domestic law, the U.S. executive branch has significant control over areas of trade adjudication because it "can either choose to dismiss a case or fundamentally change the amount of relief granted based on national interest," with the exception of CVD and AD cases (Goldstein, 1996, p. 557). Despite the fact that President Reagan had no authority over CVD and AD cases, by incorporating these cases into an international treaty, he was able to "delegate control" over these disputes to a bi-national institution, thereby limiting the influence of opponents to free trade (Goldstein, 1996). Ultimately, although the FTA was very much an international level commitment, it "became an international solution to a domestic problem" (Goldstein, 1996).

Each of the aforementioned factors, (i) ratification and legislative rules, (ii) political and judicial systems, and (iii) domestic motivation, contributes to the idea that domestic policy issues influence an international negotiator's win set. Most importantly, these

factors highlight the notion that failure to reach a consensus at Level II can doom the prospect of reaching a binding commitment on Level I (Putnam, 1988). Put another way, domestic policy matters operate as a precondition for a final binding commitment to be reached at an international level. Without approval from a ratifying body or the sense that the judiciary will interpret the treaty appropriately, an international negotiator will face significant hurdles in attempting to negotiate an international commitment that contains terms favorable to his domestic constituents. Such a drastic result demonstrates the influence that domestic politics has on the negotiation of international commitments and provides an explanation for why domestic politics play a greater role in developing international commitments than international politics.

Majors



A History of the European Payments Union

The aftermath of the Second World War found the countries of Europe in a very precarious economic situation. Extensive plans for post-war recovery were drawn up, and the Organization for European Economic Cooperation (OEEC) was created in 1948 to administer the American aid provided through the Marshall Plan for a number of European countries. By 1950, however, the end of the Marshall Plan was in sight and Europe was still running a very substantial trade deficit with the USA. This was a significant problem, since strategic bombing during the war had destroyed most of Europe's productive capacity and the continent was in dire need of commodities from the dollar area. Unfortunately, wartime spending had depleted European gold and dollar reserves, and in order to conserve foreign exchange, most European countries placed extended controls over trade and payments. As a result of this, currencies became inconvertible and the OEEC chose to create the European Payments Union (EPU) as a system of multilateral agreements to rebuild European international transactions.

Although the literature on this topic is limited and very specialized, most authors praise the success of the EPU, in retrospect, and maintain that the creation of a payments union was superior to post-war bilateralism. What many do not consider is the third option: a return to current account convertibility. By analyzing national interests, reasons for adopting the payments union and ultimately the EPU's effects, the essay will reach the conclusion that convertibility would have in fact made Europe worse off than the EPU did. This analysis will go beyond international trade and payments interpretations, and explain the EPU's fundamental importance in moderating the sacrifices needed to bring a consensus on national income distribution. Such consensus was very much needed within each member state to attain macroeconomic stabilization and to foster post-war growth.

The importance of studying the EPU extends far beyond its academic value in the field of economics. Not only was it a successful example of international collaboration on the road to the European Union, but it was also an important step toward regional integration, being run by financial experts who answered to the OEEC rather than national governments. The resounding success of the EPU has made experts recommend similar solutions to rehabilitate payments systems in the former Soviet Union states. More recently an African Payments Union has been suggested to finance and support regional trade, while current account convertibility still remains an issue in countries like Sudan, Uzbekistan, Turkmenistan, Cuba etc. It is thus important to study the nature, purpose and economic impact of the European Payments Union so that it may be used as a model or a counter example in the future.

The period after World War I was marked by struggles over income distribution in almost every European country. During a world war, wealth redistribution usually occurs through inflation, wage compression and wartime garnishing of financial assets. After the First World War, disagreements between labour and capital owners over the distribution of income lead to resistance to taxation and eventually hyperinflation (Eichengreen, 1993). In order to avoid this after World War II, each side had to agree to sacrifice short-term gains for long-term benefits. Workers across Europe allowed real wage increase to lag behind productivity in order to provide incentives and resources for investment. The Marshall Plan helped reach this settlement by providing aid to be shared among capital and labour to ease hardships, but it only lasted four years. This agreement to defer consumption in such a time of struggle needed to be sustained somehow. This is where the payments union became imperative. The EPU strengthened Europe's terms of trade, which alleviated sacrifices in terms of living standards, so workers would not feel the need to militate for higher wages. Immediate current account convertibility, on the other hand, would have required large devaluations, which would have worsened the terms of trade and shrunken European incomes by a considerable margin, at least initially. Workers would have asked for higher wages and firms for higher prices, disrupting the fragile agreement over income distribution (Eichengreen, 1993). In such a situation, if governments refuse to satisfy wage and price demands, unemployment results. Thus, convertibility at the time was mainly rejected because it would have required deflationary policies (Kaplan & Schleiminger, 1989). The EPU, however, restricted imports from non-

European sources and had the same effects as a tariff. By reducing European demand for (mostly) US goods, the EPU reduced relative prices in Europe's favour. It "raised the level of European incomes consistent with the balance of payments equilibrium vis-à-vis the rest of the world" (Eichengreen, 1993). Therefore, the EPU was more than a device to reconstruct intra-European trade; it was vital for achieving external balance at a tolerable living standard.

It is useful at this point to take a brief look at the EPU members' national interests in 1950 to further show the payments union was by and large the better choice. Great Britain is perhaps the most interesting case. Although it (with Ireland) was the only signatory that did not meet the standard prerequisites for current account convertibility, Britain was also one of the most hesitant to join (Kaplan & Schleiminger, 1989). The UK's objections were perhaps stemming from its historical reluctance to become too closely linked with the continent. The main argument within the British government was that the exchange controls of the EPU were too porous to withstand the UK's large sterling overhang. That is, especially since sterling was increasingly used to buy goods from sterling markets and then the goods shipped and sold for dollars outside the sterling area (Rees, 1963). As late as 1952-1953, the British administration contemplated unilaterally returning to convertibility. Prime Minister Churchill was advised, in what was codenamed the ROBOT file, to respond to the UK's weak balance of payments and reserve losses by abolishing the EPU. ROBOT proposed restoring convertibility to the pound and allowing it to float down as far as necessary to balance external accounts. Churchill's advisor, Lord Cherwell, however, convinced the government of the unreasonable risks ROBOT entailed. Domestically, Cherwell argued, depreciation would cause rising prices and unemployment and the standard of living to plummet. Instead, Britain adopted restrictive budgetary measures and higher discount rates to balance its accounts (Kaplan & Schleiminger, 1989). The British government's decision to stay in the EPU once again shows the inexorable link between internal and external economic policies.

The rest of the EPU members had additional reasons for joining, on top of the national income distribution compromise that the union offered. Scandinavian countries were much on the same page as Britain, because they were very dependent on the British market. Norway was especially against removing discriminatory trade, being concerned about large creditors that might require large gold payments for exports. Nonetheless, the Scandinavian countries moved for the payments union once Britain decided to do so. The Netherlands, a constant debtor in intra-European trade, was very supportive of the EPU and of eliminating trade barriers from the start. France was largely indifferent to the EPU, but it was apprehensive about Germany being included into European circles. To that end, France wanted to make sure that it and the UK would stand as a counter balance to Germany in a payments union. West Germany itself was not in a position to argue. Eager to regain acceptance in Europe, Germany raised no objections to the payments union (Kaplan & Schleiminger, 1989). Finally, Belgium was in a unique position. Belgium's coal and steel was desperately needed throughout Europe, so the country found itself running constant surpluses with the rest of the continent. Belgium's greatest fear was that it would have to give too much credit to Europe, without being able to recuperate the equivalent in dollars (which it needed for its own imports). Through negotiations in June of 1950, Belgium accepted to join the EPU with the condition that it would have a quota of $375 million to use as credit (Kaplan & Schleiminger, 1989). It is evident, thus, that each member had its own national interests, but most of them were unopposed in both political and economic terms to the European Payments Union.

The European Payments Union is important in both the context of European integration and of the post-WWII growth miracle. As an institution, it is often overlooked perhaps because it only lasted 8 years. Its study is nonetheless very significant. As this essay has attempted to explain, the EPU turned the terms of trade in Europe's favour by introducing non-discriminatory intra- European trade and successfully administering much of the Marshall Plan. Joining the payments union did not require high devaluations as a return to current account convertibility would have, and eased the striking of a vital bargain between labour and capital. Workers agreed to defer consumption and accept a lag in wage increase in order to foster post-war investment. Although convertibility was at the time feasible from a balance of payments and trade perspective, the payments union was the better choice since it moderated

the effects of terms of trade improvement on the standard of living of each country. Furthermore, the fact that payments and trade were liberalized in Europe through an internationally coordinated and institutionalized process recognized and supported by the US, gave the whole procedure credibility. Workers were assured that the bargain would ultimately benefit them in the long run, something which was preferable to unilateral and easily reversible decisions for convertibility. Lastly, the comparison of the EPU to current account convertibility, and its ultimate triumph over the latter in 1950, demonstrate that external trade balance and internal harmony between labour and capital are very much connected. Policy makers in 1950 essentially realized that unlike in a theoretical context, in reality internal and external macroeconomic stability cannot be treated separately.

<table>
<tr><td>Countries</td><td>Devaluations in Relation to the US Dollar (%)</td></tr>
<tr><td>The Sterling Area except Pakistan</td><td>30</td></tr>
<tr><td>European Countries:</td><td></td></tr>
<tr><td>Austria</td><td>53</td></tr>
<tr><td>Greece</td><td>33</td></tr>
<tr><td>Denmark</td><td rowspan="5">30</td></tr>
<tr><td>Finland</td></tr>
<tr><td>Netherlands</td></tr>
<tr><td>Norway</td></tr>
<tr><td>Sweden</td></tr>
<tr><td>France</td><td>22</td></tr>
<tr><td>Germany</td><td>20</td></tr>
<tr><td>Belgium</td><td>13</td></tr>
<tr><td>Portugal</td><td>13</td></tr>
<tr><td>Italy</td><td>8</td></tr>
<tr><td>Other Countries:</td><td></td></tr>
<tr><td>Argentina</td><td>47</td></tr>
<tr><td>Egypt</td><td>30</td></tr>
<tr><td>Canada</td><td>9</td></tr>
</table>

Table 1: 1949 Devaluations (Eichengreen, 1993)

	Share of GNP	Share of Exports		
	All Countries	EPU Countries	All Countries	EPU Countries
1926	5.1	6.4	44.5	29.5
1927	5.5	5.8	40.6	29.2
1928	6.1	9.9	45.0	40.4
1929	5.9	9.8	45.8	39.7
1950	8.1	6.7	108.2	47.7
1951	6.9	5.6	77.1	33.9
1952	6.6	5.4	78.0	36.4
1953	6.5	6.4	79.5	45.4
1954	6.6	7.0	76.1	44.3
1955	6.2	6.9	75.1	46.0

Table 2: International reserves as a share of exports and GNP, 1926-1929 and 1950-1955 (Eichengreen, 1993)

Who wins/loses from increased trade and why?

In the context of growing dissatisfaction with liberal trade policies in both Europe and the US and the heated globalization/anti-globalization debate, this article examines the main positions in the literature on the distributional effects of increased trade. The focus of the article addresses the problem of uncompetitive industries in developed countries but it also briefly discusses large emerging economies such as India and China. The article tries to conclude on which theoretical approach best explains the consequences of trade liberalisation but does not attempt to argue in favour of any trade policy.

This paper will consider existing theories on trade preferences within industries, sectors, countries, and regions and will form conclusions on the winners and losers of increased trade by translating these ideas into the framework of the general debates on the benefits of an increasingly globalized economy. Possibly the best framework with which to explain the effects of increased trade is to use simple trade theory models in Dani Rodrik's approach to trade liberalization rooted in the notion of domestic adaptability to the international economic world order (1997; 2007). This takes into account both the benefits of the enlargement of markets and the ideological flaws of the Washington Consensus and additionally considers the role of domestic governance. There will always be winners and losers from increased trade across all classes, industries, and countries; this essay will acknowledge that gains and losses may be defined in terms economic, societal, ideological, and political gains amongst others. However, due to the limited scope of the paper, only a few of the most contentious topics of debate – such as employment, societal values and economic growth – will be discussed.

So as to better understand the controversy of 'winners and losers' in increased trade, it is useful to first outline the hyperglobalist argument for a global liberal economy as presented by the Washington Consensus and defended most vigorously by Martin Wolf in *Why Globalization Works* (2004). In the chapter entitled 'Traumatised by Trade', Wolf responds to criticism of the integration of the global economy by claiming that critics are wrong when suggesting, for example, that the rise of labour-abundant developing countries threatens the livelihoods of workers in developed countries whose wages are much higher. He addresses the problem by illustrating a relationship between productivity and wages, whereby analysing data that compares the ratio of wage to productivity per worker leads to the conclusion that 'it is not at all difficult for the workers of the high-income countries to compete, even if their wages are vastly higher' (Wolf, 2004). However, his analysis essentially dictates that if productivity were to rise (due to technological improvements, for example) and hence wages would rise but demand would fall due to competition from manufacturers in developing countries, then employment will fall. Wolf disregards the implications of this as demonstrated in the Specific Factors model of trade theory and dismisses it rather clumsily by drawing a comparison to the shift of people employed in agriculture that has occurred in industrial countries in the last century. He claims that a similar shift is to be seen in the future; this is a dangerous assumption of the transferability of workers' skills and production processes. The cost of changing industry of employment is high, and therefore all workers, landowners, and business-owners who own factors of employment in an import-competing industry will lose from liberalized trade. Although Wolf calls this 'hysteria', and claims workers can do 'a host of jobs' (Wolf, 2004), he shows a strange disregard for the fast pace of change seen in the present versus the time needed to adapt. If mobility of factors is treated as a variable (Hiscox, 2001), then increased trade could see losses across countries and industries who own factors in import-competing sectors. Uncompetitive industries in developed countries have been caught off guard in needing to adjust to competition – this is especially true with regard to labour intensive manufacturing – and this has produced short-term protectionist measures such as the Multi-Fibre Agreement (1974-2004).

According to the above approach the winners of increased trade liberalization are 'export-oriented developing countries' as 'global trade liberalization offers enormous opportunities for developing countries to expand trade and increase their welfare' (Wolf, 2008). It is thus only logical that countries open the global market should experience fluxes of

competitiveness and uncompetitiveness across many domestic industries, and the benefits of reciprocity in global trade are highlighted. It is however worthy to note that the biggest giant of the emerging economies – China – did not yield to neo-liberal models of an integrated global economy, and two very successful developing economies – South Korea and Taiwan – kept protectionist trade policies throughout their development (Wolf, 2005). Hyper enthusiastic proponents of a global liberalized economy offer a generally holistic approach based on which *states* benefit from increased trade in which *industries* and tend to overlook the details of specifically which *people* are likely to win or lose, and this can differ greatly. The models offered in trade theory are far too statist.

This perspective also suggests that the purpose of free trade – increased welfare and efficient allocation of resources – should be the top priority for any trade policy. Is this in fact important and who does this benefit? It is artificial to differentiate between consumers and workers, as all salary-earning individuals are inevitably consumers in their own right. Therefore labour in an import-competing industry may face both the losses of slumped wages and the gains of lower prices or the power of choice in their capacity as consumers. In addition, models such as the Ricardo-Viner theory which predict winners and losers of free trade simplify reality in that they fail to address the role of political and ideological externalities which create new and equally contested definitions of what it means to 'win'. Proponents of the above discussed perspective disregard the role of ideas that may be used to frame trade policy, such as questions of sovereignty, regional values and societal loss, which can see countries act irrationally. These ideas are a huge focal point of the other extreme side of the argument, which calls for protectionism.

In addition to questioning the economic benefits of an increase in trade, proponents of extreme protectionism such as the conservative political commentator Patrick Buchanan see free trade as a government's betrayal to the sovereignty of a nation and interests of its people. This argument claims that those who win from increased trade are the elites who benefit from exploitation of developing nations and disregard the losses brought to the workers at home: or in his own words 'American sovereignty and social justice are being sacrificed to the gods of the global economy' (Buchanan, 1998). He criticises the rational model of seeing free trade as a policy that people should be willing to pursue; it is not in their own interests. Although his language is perhaps at times overtly passionate, his somewhat Marxist take on the integration of the global economy might offer an insight into the social dimension to the losses of increased trade. The threat to national ideals is therefore a point worth considering, as these ideas might form the basis of a few of the conservative approaches to global trade whether directly or indirectly. In the extreme function of this argument, all national citizens of a country lose from increased (or facilitated) trade at the borders. This is an ideological win/lose game; it is argued that a multilateral economic order strains local values, and with the rise of international economic institutions, the creation of international trade law under the WTO, the standardization of products and markets through MNCs, and the decline of local commerce among others, there is little local sensitivity tied to increased trade. A cultural globalization is taking place, but it threatens the very essence of individuality.

Protecting the domestic production of basic necessities such as food and cotton agriculture may be seen as enforcing communitarian values of survival and self-sufficiency (regardless of the cost) for fear of external dangers. The 'loss' incurred by consumers due to the higher price of these goods is therefore a necessary cost for the survival of a community: the losers are the individuals, and the winner a specific industry-based community. This perhaps explains the anti-rational trade policies that governments make; although these may damage economic gains, they cause wins elsewhere. However, a classic example of the failure of this policy is the substantial cost of subsidising the sugar industry in the USA which is costing the US economy nearly $1 billion a year, the direct cost to consumers could be as much as $1.9 billion, and the US government spends close to an additional $1.68 billion a year in buying excess stocks 'to maintain those artificially high domestic prices' (Goombridge, 2001). Although the policy could be said to have a redistributive effect where the cost to each individual consumer per year is low, this policy benefits only a handful of producers and 'results in a net loss of welfare for the US' (Goombridge, 2001).

Nevertheless this calls for a debate (which falls outside the scope of this essay) on how much value is given to the community and on how to define which local industries are of such national responsibility to protect. 'There is no single national interest; there are many.' (Ravenhill, 2011), and herein lies the problem of governance.

David Held and Anthony McGrew's perspectives on the institutional structures of the global economy add an important dimension to mapping out the losers and winners in increased trade and why the gap between these groups seems to be diverging (Held & McGrew, 2007). Held and McGrew highlight the role of existing international trade rules in determining the losers and winners of trade and especially with regard to the North-South intractable inequality debate. Developing countries are interminable losers in increased global trade because of the mismanagement of global trade rules which favour Northern preferences (the problem of agricultural protection in the North is an example). Held and McGrew rightfully identify the need to reform institutions and widen participation in rule-making beyond the G8 so as to redistribute wealth and opportunities, and they acknowledge the challenges of global governance (Held & McGrew, 2007). They however fail to address the inherent differences in societal values and forms of government across countries that may reduce the possibility (and importance) of transforming the global economic order.

Theorists like Dani Rodrik are more cautious in their approach to debates regarding global economic integration. In his book *Has Globalization Gone Too Far?*, he argues that recent processes of global economic integration are exposing a 'deep fault line between groups who have the skills and mobility to flourish in global markets and those who either don't have these advantages or perceive the expansion of unregulated markets as inimical to social stability and deeply held norms' (Rodrik, 1997). Rodrik's analysis places value on the importance of maintaining domestic social stability whilst working toward integrated global economic structures. He identifies the threat of increased trade when this involved 'exchanges that clash with (and erode) prevailing domestic social arrangements (Rodrik, 1997) These theories serve to inform the perspective that although winners and losers can be identified by the Specific Factors theory, the problems of unequal domestic distribution cannot merely be simplified down to markets, but must also consider the role of national governance in trade policy formation. This identifies a difficult two-level game in domestic trade policy-making. Therefore the problem lies in the tension between liberalized trade, globalization, and reduced state intervention on one side and the growing need to provide social insurance and welfare on the other. The mismanagement of these tensions is dangerous for proponents of increased trade as 'a generalized resurgence of protectionism becomes a serious possibility' (Rodrik, 1997). Domestic insecurities and divisions must be reconciled. His more recent publication *One Economics, Many Recipes* tackles the reasons behind unequal economic and social distributions of the benefits claimed from trade liberalization. Assuming trade to be a competitive game where some must win and some must lose, recent trends have shown that it is the 'nature of institutional arrangements – national and global – that best support economic development over the longer term' (Rodrik, 2007). An important reason behind why some countries win from increased trade and others do not is the national political response to external forces which become the 'ultimate determinant of economic growth' (Rodrik 2007: 2). By using India and China as examples, Rodrik claims that their success is owed to the ability of using forces of economic integration to their benefit through their governments' 'concerted efforts to restructure and diversify their economies' (Rodrik, 2007). Rodrik's point is an important one, as it attempts to explain the relationship between market forces, international trade regulation, domestic policy-making, and economic growth as determinants of who wins and who loses from increased trade.

This essay has considered polar perspectives on the effects of liberalized trade so as to understand the reasons why there a certain losers and certain winners in a globalized economy. It has considered arguments of national growth, labour unemployment, and societal ideas in defining what it means to win and lose. A successful analysis of this problem considers the role of market forces and trade policies, but also the importance of both international and domestic governance in determining the great divide of a liberalized global economy.

Rationalist Approaches in Economic Diplomacy: The 2004-2009 Sino-Russian Oil Relations

This article aims to assess the behaviour of states in the world economy through rationalist approaches in economic diplomacy. The most relevant basic assumptions and key factors in rationalist theories will be examined, a review of rational bargaining theories and an analysis of the negotiation phases will then follow and a case study of the 2004-2009 Sino-Russian oil relations will finally provide an application of the theories to the reality of economic diplomacy. It will be evident how rationalist theories provide an excellent instrument to study relations between negotiators but neglect important domestic and exogenous factors that are best analysed by other approaches to economic diplomacy such as Putnam's two-level bargaining theory and constructivist theories.

Rationalist theories: basic assumptions, key factors and international relations theory

Rationalist approaches to economic diplomacy provide scholars with sophisticated analytical tools to understand how states negotiate over economic issues. Three main assumptions are made: firstly, actors interacting at the negotiating table are considered as unitary actors, that is to say that they act as a singular entity. Secondly, their preferences are fixed as the synthesis of different interests within the state. Thirdly, states aim to maximise the economic (and/or political) utility they will derive from the agreement.

Rationalist theories are directly linked to realist theories in international relations. Realism posits that states are mostly concerned with economic and political gain and will engage in negotiations with other actors only if there is a significant possibility of deriving concrete benefits. Tollison and Willett explained how a negotiation will continue until the gains that can be derived from reaching an agreement are exhausted, meaning that the maximisation of economic profit is what negotiators are primarily concerned with. It follows that actors will not enter negotiations if the potential agreement will not at least partially overlap their set of preferences.

Economic gain is not the negotiators' sole preoccupation. Particularly in democratic countries where elections are regular and free, governments will have to bear in mind the consequences of an agreement in terms of consensus and chances of being re-elected. Negotiators however do not possess complete knowledge of the facts: they are unable to predict the effects that the agreement will produce in the political and economic spheres, and thus will have to take decisions and make judgements with the limited information they have. Hence, bounded rationality is a distinguishing feature of the rationalist theoretical framework.

Bargaining theory and the negotiation phase

Rationalist theories are primarily concerned with understanding how states interact at the negotiating table. It is important to distinguish between two different approaches to bargaining: value creation and value claiming. 'Values' within negotiations can be defined as all the benefits deriving from negotiations, whether directly from the agreement or indirectly through, for instance, side payments, issue linkage and long-term gains. Value creation is an approach based on cooperation with the other parties to the conference; it seeks to maximise each actor's utility without undermining the others' gains and it configures a non-zero sum game wherein actors seek to move as close as possible to the Pareto frontier. Proposals and counter-proposals will be Pareto improvements, with the final aim being an agreement that is Pareto efficient. The parties will thus strive to engage in cooperative negotiations, which possess a number of distinguishing features. In the first place, what James Sebenius has defined 'negotiation arithmetic' will be characterised by issue addition and subtraction that strives to create a common zone of possible agreement, rather than one-sided gains. By adding different issues to the negotiation or by agreeing to not bring up potentially disruptive ones, negotiators can enhance a pre-existing zone of possible agreement or even create a new one. In addition, side payments can be made in order to compensate for a negotiator's disproportionate leverage that threatens to cause a deadlock in the negotiations. It follows that those who derive a disproportionately greater value from the negotiation may compensate the 'losers' with side payments and/or long term gains.

The following graph shows how parties interact and try to place themselves both as

close as possible to the Pareto Frontier and as distant as possible from their resistance point. A two-issue, two-party negotiation is taken into consideration. The resistance points indicate the minimum for either party to accept an agreement. The resistance points will be influenced by each party's BATNA (Best Alternative To Negotiated Agreement), which refers to what alternative course of action can be undertaken in case an agreement is not reached. The less desirable the BATNA, the lower the resistance point will be. The Pareto Frontier shows any possible agreement that cannot be improved upon without reducing either party's added value ('Pareto optimality'); the light-blue area highlights the zone within which Pareto improvements can be made while being located beyond the resistance points, below which an agreement is deemed unacceptable.

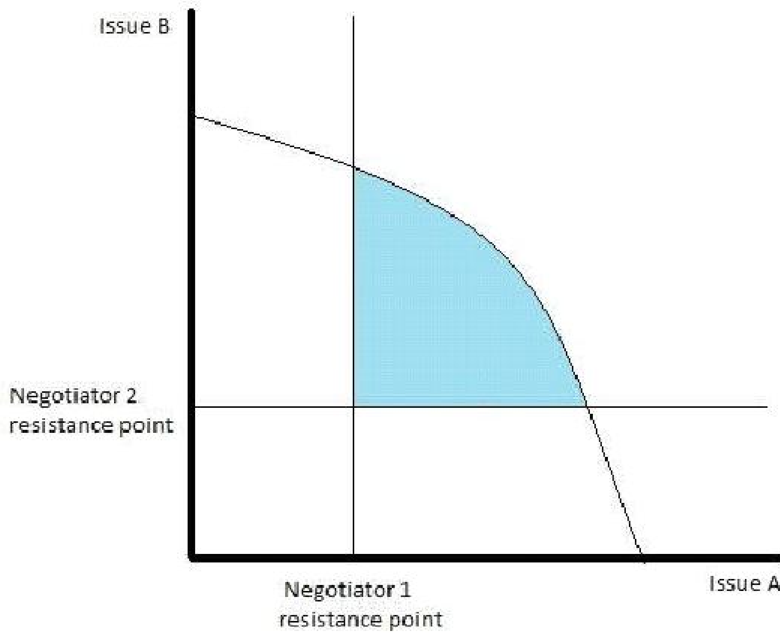


Figure 1 *A bargaining model that shows how parties seek to place themselves as close as possible to the Pareto Frontier and beyond their respective resistance points.*

This simple model takes into account two relevant factors. Firstly, it displays the resistance points and the Pareto Frontier, respectively the lower and upper limits of a negotiator's demands. Then, it permits an assessment of the relative economic power that results in discrepancies in leverage within the negotiations: the closer the agreement is located to a negotiator's resistance point, the lower its party's leverage. Each negotiator's best possible outcome is located at the intersection between the Pareto frontier and the other negotiator's resistance point, as there the agreement will be Pareto optimal while being as distant as possible from one's own resistance point. Negotiators thus act rationally and seek to place themselves in the area delimited by the Pareto frontier and the resistance points. The location of the agreement on the graph will be influenced by a number of factors, including (but not limited to) relative economic and political power, willingness to compensate for a loss in distributional value through positive issue linkage and side payments, economic and/or political conditions in the party's own country that may add further pressure on a negotiator and bounded rationality in seeking a political outcome that is not immediately related to the issues that are being discussed, e.g. seeking re-election. Patience can also play an important role in determining who holds more leverage. Generally, being more patient gives the negotiator higher bargaining power since the cost of waiting while not yielding to less favourable conditions will be inferior to the cost of waiting sustained by the other, more impatient party. Nonetheless, through a case study of OPEC's enforcement model, Lisa Blaydes argues that impatience can be a source of leverage in a negotiation when the signing of the agreement is followed by an enforcement model that resembles a prisoner's dilemma. This, however, is an exception to the general rule that the less impatient a party is, the more leverage and bargaining power it will hold.

Value claiming on the other hand implies a more competitive approach to bargaining. Actors will focus their strategies on maximising their own relative gain, usually not being concerned with the other party's utility. John Odell distinguishes between *offensive claiming tactics*, which seek to gain value at the expenses

of the other party, and *defensive claiming tactics* through which a party tries to stop the other from subtracting its own value. Value claiming usually implies a non-zero sum game in which the value derived from an agreement is fixed and the parties will have to compete in order to get the higher distributional value.

From theory to reality: the 2004-2009 Russian-Chinese oil relations.

Between 2007 and 2009 Russia averaged a production of 9.842 million oil barrels per day, exporting an average of 7.011 million barrels per day. Over this time frame China averaged a production of only 3,991 barrels per day. China's daily oil consumption is far higher than its oil production, averaging a daily net import of 4.8 million barrels per day, second in the world only to the US with 9.6. China's most relevant oil purchases before 2004 took place through the now defunct company Yukos, averaging 124,000 barrels per day. Yukos CEO Mikhail Khodorkovsky was arrested in 2004, causing Russian exports to China to shrink while a re-nationalisation of the oil industry was taking place in Russia. China would have had to bargain with the Russian Government as the new negotiator. China and Russia struck a deal in 2005, agreeing on 48 million metric tons of crude oil to be delivered in the five-year time frame between 2005 and 2009. As part of the original negotiations that took place in late 2004, China wanted to build dedicated pipelines from Russia to China. Russia refused, stating that they did not want to limit their export options by building a dedicated pipeline to China, which had to accept and signed the agreement. China's inferior leverage is due, arguably, to two factors: firstly, its impatience caused by the dire need for a new agreement with Russia and secondly, Russia's progressive nationalisation of the oil industry, which was making it a more unitary, coherent and ultimately patient negotiator, increasing its already strong leverage.

The situation changed however when China started to explore new solutions: they acquired major shares in oil giants Total and BP and acquired 100% ownership of two smaller companies, Udmurtneftegaz and PetroKazakhstan. By looking elsewhere, China was able to considerably improve its BATNA and, consequently, to raise its resistance point. This in turn caused Russia's leverage to diminish as its resistance point fell, until in 2009 it agreed to build a pipeline to Daqing in Northern China. This dedicated branch of the ESPO pipeline to China made a more ambitious agreement possible: Russia and China struck a 20-year deal in which Russia agreed to deliver 15 million metric tons per year in exchange for a $25 billion credit, a much bigger deal than the previous 5-year, 48 million metric tons agreement.

The following two bargaining graphs will show the Sino-Russian oil relations in 2005 and in 2009. Both axes are divided in two, with one segment representing the decision to build a dedicated pipeline to China, and the other representing the decision to not build. The two segments are respectively inverted because the construction of a dedicated pipeline in 2005 was highly desirable for China and slightly undesirable for Russia; hence, a lower resistance point that implies an undesirable yet acceptable agreement means building for Russia and not building for China. In 2005 China's resistance point is placed slightly below the building/not-building threshold in the not-building segment. Russia's resistance point instead is quite far above the building/not-building threshold due to the country's higher leverage in negotiations. The agreement is located closer to China's resistance point due to the country's weak BATNA caused by urgent necessity of imported oil, and it is projected on the non-building segments of the axes. In 2009 however the situation had changed: due to the aforementioned exploration of alternative possibilities on the part of China, the country's BATNA had considerably improved, causing its resistance point to shift across the building/not-building threshold, towards the building segment of the axis. Russia's leverage had consequently been weakened, causing its resistance point to shift inside the building segment of the axis.

Conclusions

Rationalist theories are an effective toolkit that provides scholars with a solid theoretical framework to understand how two or more parties interact at the negotiation table. They take into account various dynamics that occur when two or more negotiators seek an agreement. Nevertheless, the methodology has at least three shortcomings. Firstly, it ignores

significant spill over effects: the winners/losers from the agreement can be actors that do not take part in the negotiations, but that will anyway undertake actions to influence their course. In the case study, Japan's relevant but indirect involvement in the China-Russia negotiations cannot be included in the rationalist theoretical framework, but it was important in delaying the reaching of an agreement between China and Russia because it improved Russia's BATNA. Secondly, the negotiators' preferences are assumed as fixed but this is rarely the case, even when it comes to the resistance point which a number of events and decisions can shift. Lastly, negotiators are far from being unitary actors, due to the presence of pressure groups within the country that may influence and shape the negotiations and also due to various opinions within ministries and the government.

In conclusion, rationalist theories neglect important domestic factors and ignore how ideas and political culture influence negotiations. Nonetheless, they provide an excellent theoretical framework to understand how parties to a negotiation interact amongst each other, taking into account a vast number of factors and key issues that influence the negotiators' behaviour and reciprocal relations.

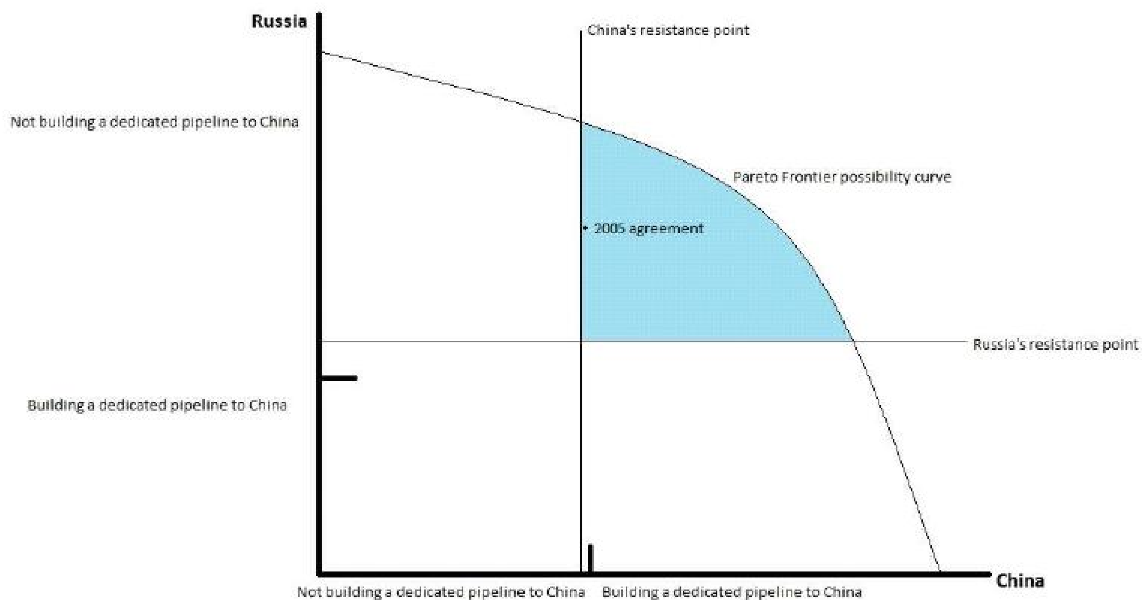


Figure 2.1 *A bargaining model that shows China-Russia 2005 oil agreement and their relative resistance points*

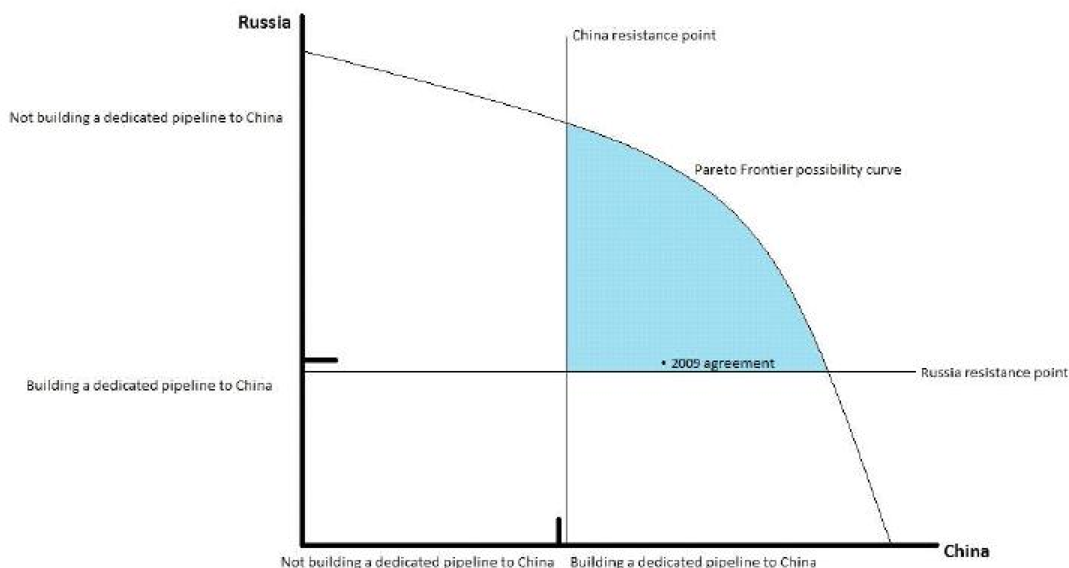


Figure 2.2 *A bargaining model that shows China-Russia 2009 oil agreement and their relative resistance points*

The NDN in the Context of the Modern Silk Road Strategy

On-going military operations in Afghanistan necessitate viable supply routes of non-lethal goods in the short term. Long-term stabilization efforts there and in Eurasia, more broadly, may require significant resources from a number of countries. The deteriorating security situation in Afghanistan, coupled with the souring U.S-Pakistan relationship, has been integral to the development of a new supply route that traverses Latvia, Russia, the South Caucasus and Central Asia. It bypasses and acts as a hedge to the traditional Pakistani one, which begins in Karachi and moves northward into Afghanistan. This new route, the Northern Distribution Network (NDN), is comprised of three distinct spurs and has been operating for almost three years. Thus far it has been an increasingly significant but relatively inefficient conduit for resupply operations to NATO-ISAF personnel in Afghanistan.

As the War in Afghanistan has (d)evolved over the past ten years, there has been a strategic shift towards counterinsurgency and state-building efforts as a consequence of increasing violence and instability. The NDN is a component to these efforts as well as the United States' Modern Silk Road Strategy (MSR) (Clinton, 2011; Central, 2011) aimed at developing a transcontinental commercial network in Eurasia, with revenues being generated from the transit trade (commerce as well as energy). This would function as an economic stimulus to the region, facilitate trade between Europe and East Asia, and most importantly would contribute to long-term regional stabilisation. Theoretically, such a network would have a "transformative effect on Eurasia" (Kutchins, Sanderson, & Gordon, 2009).

The NDN was originally designed as a "tactical response to concerns over pilferage, attacks, and dependency on supply lines in an increasingly unstable Pakistan" (Kutchins & Sanderson, 2010), essentially acting as a hedge against sole reliance on the Pakistani route. In the last year, the killing of Osama Bin Laden and the death of two dozen Pakistani soldiers due to a NATO attack on Pakistani soil have strained the U.S.-Pakistan relationship even more (Trilling, 2011), the latter being integral to the recent closing of the Pakistan-Afghanistan border at various critical resupply points. It has evolved from a "tactical response" to one piece within the more ambitious Modern Silk Road Strategy. According to Andrew Kuchins, Thomas Sanderson and David Gordon (2009), who have written extensively about the NDN's scope, the perceived benefits are tripartite. It "provides the U.S. with significant additional throughput capacity to Afghanistan, ends Washington's complete logistical reliance on Pakistan, and presents new opportunities for U.S. engagement in Latvia, Russia, the Caucasus and Central Asia."

The NDN's operational importance has grown in the past two years as the volume of cargo transported along it has increased, totalling approximately 75% of "all Afghan-bound, non-military cargo" by the end of 2011 (Tynan, 2011). Yet the operational costs are tremendous relative to the Pakistani route – not that there is a viable alternative at the moment. In late 2009, it cost 250% more per TEU (20-foot equivalent unit, a standard unit for measuring cargo) than the Karachi-Peshawar route and represented a "fraction of the overall commercial traffic in the region"(Kutchins et al., 2009). Between February and November of 2009, 4,500 TEUs were transported via the NDN, but this "represents just 12.5% of the total number of TEUs shipped through Pakistan in 2008" (Kutchins et al., 2009). Putting this number into a larger context, in 2007 there were 34,300 TEUs shipped between Kazakhstan and Uzbekistan (Preliminary, 2009).

More recent figures show that over the past two years the transit costs have come down, though still enormous compared to the Pakistani route. *Stars and Stripes*, the U.S. military newspaper, puts the average cost per TEU delivered via the NDN at $12,367, compared to $6,700 on the Pakistani route (Vandiver & Kuz, 2011). Due to recent Afghanistan-Pakistan border closings, the volume of cargo on the NDN will grow, though historically its share of Afghan-bound cargo has increased significantly over the past two years. It currently stands at approximately 40% of total U.S. cargo in Afghanistan and 52% of total NATO-ISAF (Coalition) Cargo (Vandiver & Kuz, 2011).

At the same time, the NDN is hampered by entrenched and systemic corruption, an unsurprising fact given its reliance on some of the most corrupt states in the world (Transparency, 2011). The NDN's viability is contingent on efficiently moving material

through these states and across international borders. As of yet, this efficiency does not exist for a number of reasons. One is the system of informal payments that exists, which adversely affects not just nominal but also time costs (Tynan, 2010) and prohibits fluid movement of cargo through the Central Asian states (Starr & Kutchins, 2010). Unfortunately, informal payments are one example among many in the larger context of political and operational issues that undermine the NDN's long-term viability.

Increasingly significant Central Asian supply routes also provide the authoritarian governments of these states with more leverage to effect in varying ways (Tynan, 2011). Not-too-distant events in Uzbekistan can illustrate the NDN's political costs on a broader level. Andrew Kuchins and Thomas Sanderson (2010) relate "two misunderstandings" in the U.S.-Uzbekistan relationship that came to the surface following the 2005 Andijan uprising and subsequent eviction of the U.S. from its base at Karshi-Khanabad. The first "concerned priorities and expectations" (Kutchins & Sanderson, 2010). Islam Karimov did not expect U.S. criticism of his regime's human rights record nor appreciate the U.S. supporting the "coloured" revolutions through the two years prior. The U.S. probably did not expect this pattern of behaviour to evoke such a strong reaction by Karimov. The second misunderstanding speaks more directly to the NDN's political costs, and one that is a "cause for caution" (Kutchins & Sanderson, 2010). Kuchins and Sanderson (2010) also argue that "Even in relations with small and comparatively obscure countries, Washington does not automatically have the upper hand. Central Asian nations have leverage, and will use it."

Increasing reliance on the NDN may create a misguided justification for the more ambitious MSR strategy, and evaluations of both the NDN and the MSR should account for several issues since the NDN is not just a tactical but also a transitional component to this strategy. First, what kind of criteria and time frame should be used to evaluate the relative success or failure of the Modern Silk Road? Additionally, if a transcontinental Eurasian commercial network is feasible, albeit costly and dependent on long-term, sustained commitments, to what extent is it contingent upon U.S. leadership coupled with investments from other states with vested interests? Namely, those states are India, China, Russia and Iran, whose projected role has been confounding for U.S. policymakers (Kucera, 2011). Finally, to what degree has the "potential for transcontinental trade linking East Asia, South and Southeast Asia, Europe and the Middle East"(Starr & Kutchins, 2010) romanticized visions for the future based on an untenable but convenient historical analogy? More to the point is John Heathershaw (Central, 2011) who declares that, "the New Silk Road is a cliché which gives the impression that various economic- and security- based initiatives are combined into a single strategic framework. This is not the case. Outside Washington, it has little meaning or purchase."

Social Provision: The Winners, the Losers and the Misconceptions

With extreme austerity measures being taken by the Coalition government, debates about the welfare state are taking place all over the country, from within Parliament to family dinner tables. Disagreements stem from who pays for social provisions to who benefits from it most. When real decisions are being made based upon such arguments, it seems more relevant than ever to pick apart the facts from the fiction and make our own judgements as to who wins from the way in which social provisions are funded, and if anyone could be argued to lose.

Social provisions can be funded either through direct taxation on the individual or through indirect consumption taxes. Direct taxation includes income tax and National Insurance Contributions and the amount paid is dependent on how much one earns; those who earn more pay more and thus direct, individual taxation is considered to be redistributive and progressive. Consumption taxes consist of the Value Added Tax which is charged on most goods and services that VAT-registered businesses provide in the United Kingdom and is the same for everyone and independent of one's income. According to Dean (2006), people on the average wage in the UK expect to pay 33% of their earnings annually in taxes, compared to in Germany where they would expect to pay 58%. Moreover, research by Horton and Reed (2010) found that the average benefit to households in 2007-2008 was around £21,400 a year. Social provisions can also be funded by taxation of corporations and businesses.

Funding for social provisions, however, is extremely controversial. A common argument is that it is the poorest members of society who benefit from it most. They are the "winners" as they pay less in tax but receive more from the state than those who are wealthier and "lose" because they pay more and receive fewer services in return. Sefton (2005) highlights that the net effect of fiscal reforms in the United Kingdom since 1997 has been to increase the incomes of the poorest two-tenths in society by over 10% and to reduce that of the richest two tenths by around 4%. This has been deemed by some to be unfair given their perception that those who are having their income reduced are actually receiving less back than those who are having it increased. It is certainly the case that health, education and housing subsidies were 2.1 times as valuable per head to those in the poorest fifth of society as to those in the richest fifth in 2000-01 (Hills, 2004). Sefton (2005) additionally found that spending on the National Health Service and state education disproportionately benefits the poorest households. Moreover, the UK's Office of National Statistics even confirms that poorer UK households benefit more from state intervention than richer households (Barnard, 2010). Perhaps, then, we have resolved the debate: the poor win and the rich lose.

However, these arguments do appear to disregard the effects of indirect taxation upon the poorer members of society, which if taken into account may lead to regressive effects. Dean (2006) argues that in terms of consumption taxes, people with little money may end up paying out a disproportionate amount. This claim does seem to have backing: 2010 findings of the Institute for Fiscal Studies show that the recent increase of VAT rates to 20% will be much more damaging to the poorest in society than the wealthiest. The report also highlighted the regressive nature of council tax in Britain, which represents 6% of gross income for those in the bottom fifth income group but only 2% for those in the top fifth. Furthermore, Fitzpatrick (1999) finds that those in the poorest decile actually pay out more of their gross income in the form of taxes than any of the other nine income groups. Sefton (2005) goes as far to argue that the overall tax structure of the United Kingdom is regressive in itself.

What such evidence does seem to highlight is the complexity of assessing who pays for social provisions. When discussing austerity measures, a focus upon direct taxation as a form of funding can neglect the key impacts that indirect taxation can have on poorer citizens; it seems both broad and vague therefore to argue that "richer citizens generally contribute more" when arguing about funding for education, healthcare and basic services. Such complexity needs to be taken into account for effective policymaking.

Moreover, the argument put forward that wealthier groups in society fund social provisions for the poor also appears simplistic and somewhat inaccurate in the face of evidence. What has lacked attention by policymakers in the past is the fact that a high

proportion of the social provisions that a citizen receives from the state is self-funded. In terms of redistribution through taxation, Dean (2006) distinguishes between vertical distribution, which refers to money that is transferred from the wealthiest in society to the poorest (i.e. income tax), and horizontal distribution, which is the idea that overall in a person's lifetime the taxation system is fairly self-financing. Hills (2004) finds that when we look at the total amount of redistribution affected by the welfare state, 75% is of the horizontal form and 25% is of the vertical. In addition to this the combined effect of taxes and transfers does appear to redistribute income from those parts of our lives when our earning capacity is greatest (early 20s to late 50s) to those when it is weakest. Fitzpatrick (1999) supports this, finding that of the £133,000 average gross lifetime benefits from the system, an average of £98,000 is self-financed.

It seems, therefore, that it simply just isn't the case that the richest citizens are funding the social provisions that the poorest use as the majority of it is funded by horizontal distribution as opposed to vertical. It seems unreasonable in light of this evidence to suggest that the wealthy "lose" in this sense whilst the poor "win" from the way in which social provisions are funded.

Perhaps when discussing social provisions, debates on who benefits from them can often be pessimistic and neglect the value of services experienced by all citizens, irrespective of wealth. If one is to redefine "winning" as having access to a wide range of services that are extremely beneficial, and if were not financed through taxation would otherwise be privatised, it seems enjoyment of such "in-kind" services is available to everyone. Horton and Reed (2010) argue that individuals do not have an awareness of the value of public services that they receive in return for their taxes; individuals are significantly better off with the provision of publicly funded welfare services than they would be without them. They also discuss how beneficiaries from social provisions are heavily dependent on factors such as geography, age and social situation. Lower classes may gain more from state funded education but middle-classes more from university funding. Perhaps in the debate concerning the "winners" of social provisions we may fail to acknowledge the relativity of the issue, not to mention the benefits that are accessible to everybody.

What, then, does all of this evidence mean? Perhaps it can help to dispel stereotypes that it is the poorer members of society who are constantly subsidised by the wealthier ones. Perhaps it raises relevant issues about how different forms of taxation can affect people differently. Perhaps it is optimistic, helping us to appreciate those services provided by the state that are so heavily under scrutiny constantly. Or maybe, for those who disagree, it will spur them on to try and counter what appears to be some strong and surprising evidence.

Tougher Corporate Boards for Tougher Times

Over the past few decades, corporate boardrooms have made notable progress in the wake of globalization. However, have they gone far enough to maximize their effectiveness?

Globalization has changed the nature of "doing business" and while the benefits of business without borders are obvious (more competition, economies of scale…), the social and environmental vulnerabilities and risks are still, in some cases, undermined at the decision-making table.

Undoubtedly, there have been many encouraging strides by corporations and their Boards of Directors to implement anti-corruption practices, to increase transparency in their disclosure of public filings, to report on the social and environmental impacts of their business activity, to demand director independence and diversity on their boards, and so forth.

Boards of directors have matured from the "schoolboy club" style of operation that once existed. The American 2002 *Sarbanes-Oxley Act* is one example of regulation that has influenced best practices of corporate governance in Canada and abroad. Boards are now expected to have a majority of Directors who are independent from management, to exercise good judgment, to be wise and be skilled in a useful area of expertise that is valuable to the decision-making of the corporation. However, often absent at the boardroom table are Directors skilled in ethics, corporate social responsibility, anti-corruption, environmental and/or human rights issues.

As corporations continue to grow in size and in impact, they should simultaneously be expected to contribute to the sustainability of their business operations and the environment that they may impact. While profit maximization is a key driver for any successful business, other stakeholder interests should also be addressed with care.

As the occurrences of corporate environmental and social disasters persist (BP Oil Spill, the Global Financial Crisis, NIKE, Exxon Valdez to name a few), Boards of Directors are increasingly looked to with reasonable scrutiny for their oversight, knowledge and understanding of the risks and vulnerabilities in the execution of business decisions. Corporate boards can best serve their shareholders when they are capable of providing well-informed and strategic oversight that go beyond financial performance. If boards are not equipped with "know-how" in risk management, including social and environmental risks, they potentially risk harming their reputation and driving share performance down.

Stephen Erlichman, Executive Director at the Canadian Coalition for Good Governance believes that, "a culture of integrity starting at the highest level – that's very, very important for companies…People have their own moral compass." A new business environment is emerging and boards can increase their effectiveness when equipped with the momentum and tools to compete in a forward-looking, responsible and sustainable global business environment or, it risks falling behind.

But aren't Directors constricted by their fiduciary duty to shareholders?

Absolutely. But this does not necessarily mean profit maximization at any expense. Essentially, the shareholders of the company entrust Directors with utmost confidence, to manage and to protect their money. The common expectation is that a director serves a shareholder first and foremost in maximizing profits. However, in an increasingly interconnected world, the line between sustainable business activity and profit maximization is murky and is increasingly interdependent.

As outlined by Andrew Kitching when discussing Director liability under the Canadian Business Corporations Act, some commentators assert that shareholders should only make up *one part* of the broader stakeholder interest in making decisions for the corporation. They believe that the shareholder primacy model, concerned primarily with profit maximization, actually restrains directors in their capacity to provide long-term guidance and leadership by sidelining stakeholder interests.

However, there is growing evidence that

shareholders can actually be better served with improved stakeholder engagement and consideration, beyond meager public relations campaigns. A UN Global Compact report states, "If stakeholders are adversely affected by a company's actions, shareholders' value will suffer. With the growth in pension and insurance funds and other institutional investors, shareholders are increasingly also company stakeholders…therefore these groups' needs are increasingly interconnected."

Moreover, shareholders are actually demanding change and are gradually pushing for strong corporate sustainability strategies.

A study conducted by Ernst & Young titled, "Shareholders press boards on social and environmental risks: Is your company prepared?" evaluated shareholder proposals from 2010 in the United States and found that resolutions focusing on environmental and social issues made up the largest portion of shareholder proposals. Moreover, it was concluded that shareholders increasingly believe that a robust social and environmental business model correlates strongly with risk management strategies and ultimately its financial performance.

A more recent collaborative study by The Conference Board and FactSet indicates that the number of shareholder proposals in the United States concerning social and environmental policy issues (243 proposals in 2011) continued to increase since 2007 despite the decline in other subjects, constituting 35.2 percent of the total number of proposals. This data represents the, "increasing sensitivity of shareholders to the long-term value generation potential of a cohesive corporate sustainability strategy."

A forward-looking trend is revolutionizing the expectations placed on corporations. Look, for example at the B Corps model, an organization that has successfully pushed for the creation of a new legal classification for corporations that "create a material positive impact on society and the environment."

The trend observed in Canada has been less active, with only 2 shareholder proposals related to social and environmental issues in 2010 from the S&P/TSX Composite Index. The S&P had only 254 corporations in 2010 compared to the American Russell 3000 and the S&P 500 corporations. This may reflect a cultural difference in activism or interest in environmental and social sustainability amongst Canadian and American shareholders.

At a recent lecture at the Rotman School of Business, Richard Ross, previous Chair and CEO of Inmet Mining Corporation, a Canadian mining company, elaborated on the decision-making process surrounding their involvement in the Ok Tedi mine in Papua New Guinea.

His main message was that mining companies today must "grow responsibly" to increase value for shareholders. Such an approach requires a sound knowledge and understanding of all aspects of corporate responsibility on behalf of management, directors and shareholders. It also requires a willingness on the part of companies to make decisions that may impact short-term profitability and growth with a view to minimizing longer-term reputational and financial risk. During Inmet's involvement, Ok Tedi was able to navigate that precarious balance between mitigating to the extent possible the environmental impacts of its operations while ensuring that the communities affected supported the continuation of the mine. Ok Tedi was also a very profitable source of earnings thereby ensuring ongoing support from Inmet's shareholders.

It was not until the other shareholders of Ok Tedi decided to follow a course of action which did not meet Inmet's view of sustainability that they decided to initiate negotiations with their partners to exit the mine. No doubt Inmet could have made a profit in the short-term by staying in the project, however the risk to their "social license to operate", which is the key to achieving long-term growth and value creation, could have been impacted.

As a leading force behind the first MBA program with a specialization in Global Mining Management at the Schulich School of Business, Ross explained that senior management of mining companies must now have, as a core competency, a strong appreciation for and understanding of all aspects of corporate responsibility. Ultimately they must have a clear vision of what sustainability "looks like" for their companies and to make sure that their directors and shareholders

understand the cost and opportunity of growing responsibly.

Boards of Directors have a strong duty of care to shareholders first and foremost, to ensure profit maximization. However, it is becoming increasingly evident that long-term sustainable value creation depends upon a robust social and environmental risk management plan. Directors can be most effective if they are strongly engaged and capable of addressing these increasingly complex risks. While corporate governance has made impressive strides in the recent past, Directors can be most effective when they better manage reputational risks and encourage profits in the long term. The growing trend toward responsible and sustainable investing supports a more balanced approach to the Director fiduciary duty, which suggests a stronger consideration for stakeholder interests.

Non Profit

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