Mario Draghi: Sustaining openness in a dynamic global economy


*   *   *

The global recovery is firming up. In some countries like the United States, this process has been visible for some years, in others like Europe and Japan, the consolidation of the recovery is at an earlier stage. So it is fitting that our discussions are now focusing not only on how to stabilise the economy, but also on how to make it more dynamic – while at the same time improving people’s welfare. At the centre of this debate is the question of how to raise potential output growth, which has slowed from around 2% in OECD countries in 2000 to around 1% today.

Without stronger potential growth, the cyclical recovery we are now seeing globally will ultimately converge downwards to those slower growth rates. Slower growth will in turn make it harder to work through the debt and demographic challenges facing many advanced economies.

With the population growth rate in those economies projected to slow, the burden of raising potential growth must fall on productivity. There are a number of areas in which domestic policies can encourage an upward shift in productivity growth, such as competition, research and development, and insolvency regimes.

But when thinking about the global economy, one of the key ingredients for raising productivity is openness. Open trade, investment and financial flows play a key role in the diffusion of new technologies across borders that drive forward efficiency improvements.

The social consensus on open markets has, however, been weakening in recent years. This is driven not so much by a belief that open markets no longer create wealth, but by the perception that the collateral effects of openness outweigh its benefits. People are concerned about whether openness is fair, whether it is safe and whether it is equitable.

As Karl Polanyi observed many years ago, if the dislocation created by an open market goes beyond a certain point, protectionism is society’s natural response. So a central element of efforts to raise productivity growth – and build a dynamic global economy – must involve responding to these concerns about openness. And this is a feat countries cannot accomplish by themselves. Although domestic welfare policies are, of course, essential to the task, a commitment to working together through multilateral institutions is just as important.

This is because fears about fairness, safety and equity ultimately reflect a lack of trust in other countries’ regulation and enforcement. One of the main reasons why multilateral institutions exist is to create regulatory convergence, and therefore to increase trust between countries.

And perhaps the most important area where this applies today is global financial sector regulation.

**Openness as the key to a dynamic global economy**

One of the key questions facing the global economy is whether the trend towards ever greater economic openness, which has defined the last three decades, is coming to an end. Temporary trade barriers have indeed risen from covering around 1% of products in 2000 to more than 2.5% today, with the crisis accelerating this pattern. The same is true of anti-dumping actions.

That said, at the global level openness is still viewed favourably; three-quarters of people
consider growing trade and business ties with other countries to be a positive trend. But those polled in rich countries are more negative than in the pre-crisis period.5

Given the established gains of trade, this is plainly a concerning trend for the global economy. International trade results in a more efficient use of production factors and in specialisation where comparative advantage exists, thereby raising productivity growth.6

And welfare gains from trade for firms and consumers follow from the wider availability of cheaper and better quality products.7

Moreover, for advanced economies the importance of trade may actually be growing. As economies converge towards the global technological frontier, innovation becomes more important for sustained productivity growth. And as OECD research has shown, openness to trade is a crucial factor in enabling an economy to benefit from frontier innovation.8

According to OECD estimates, in the case of a 2% acceleration in multi-factor productivity (MFP) growth in a frontier economy, the productivity spillover will be 0.3 percentage points higher for a country that trades intensively with the frontier economy than for one which trades less intensively. To put this in context, MFP growth has averaged only around 0.5% in OECD countries since 2000.9

Thus a turn towards protectionism would pose a serious risk for continued productivity growth and potential growth in the global economy. And this risk is particularly acute in the light of the structural challenges facing advanced economies.

Old-age dependency ratios are rising, putting more pressure on public finances. By 2025 there will be 35 people aged 65 and over for every 100 persons of working age in OECD countries, compared with 14 in 1950.10

At the same time, public debt levels have surged in those countries from 56% of GDP in 2007 to around 87% today.11 Only higher potential growth can provide a lasting solution.

So, clearly, to foster a dynamic global economy we need to resist protectionist urges. But to do so, we also need to identify how best to respond to protectionism.

The role of multilateral cooperation in making openness sustainable

Much has been written over the past few years about the negative effects of free trade and the need to pay more attention to those who benefit less from it. The debate has typically focused on the extent to which welfare policies can be used to share the gains of trade more evenly.

Though this is a complex issue,12 I have no doubt that making better use of public policies to support the more vulnerable members of society, not just financially but also through education and retraining, is a vital part of the equation. More work needs to be done in this area and it is important to learn from best policy practices.

But the other key question is: how can we work together to make openness sustainable? What role can multilateral cooperation play towards this goal? This is the angle I would like to address today. Its importance becomes clear when one thinks about the three main areas of concern that people have about open markets that I mentioned earlier.

First, there is the concern about whether openness is fair – i.e. whether all are playing by the same rules and applying the same standards. This manifests itself in fears about currency manipulation by trading partners, dumping practices and lack of reciprocal market access.

Second, there is the concern about whether openness is safe – i.e. whether it exposes people to
harmful spillovers from abroad. This is perhaps most visible, at least for economists, in the case of cross-border capital flows, but it also applies in areas such as agriculture and biotechnology.

Third, there is the concern about whether openness is equitable — that is, whether it disproportionately benefits some groups in society over others. Though it is not straightforward to disentangle the effects of trade and technology on inequality — and they may in fact be linked — the perception that openness contributes to inequality has become more widespread.

In each case, multilateral cooperation, leading to regulatory convergence, is a precondition for addressing the underlying causes of these concerns. To demonstrate this, let me draw on our experience of managing openness within the European Union.

As regards fairness, the point is obvious: regulatory convergence provides the strongest assurance that the playing field is level right across the European market. This is why, as borders have opened within Europe, common supranational powers of legislation and enforcement have strengthened in parallel.

For example, the Single European Act in 1986 not only launched the single market, it also substantially extended the powers of the EU to make laws, the role of the European courts to rule on them, and the powers of the Commission to execute them. The logic was that a single market could only be sustainable over time if all participants could be certain that they faced the same rules, and had recourse to the same courts in the case of infractions.

Despite the political events of last year, this symmetry between regulatory convergence and market deepening has, by and large, been a success. In fact, the free movement of people, goods and services within Europe is regularly mentioned in polls as one of the two most positive aspects of the EU, the other being peace among its Member States.

Similarly, what has permitted the Single Market to survive various financial and consumer protection crises is its ability to restore safety by adapting market-wide regulation and enforcement.

To give an illustration, the internal market for frozen foods overcame the mis-selling scandal of 2013, when horsemeat was sold as beef, in large part because it was met with an improved food labelling and EU-wide inspection regime that restored trust. By contrast, a perceived lack of regulatory convergence between the EU and other countries, especially regarding food safety, is one reason for opposition to preferential trade agreements, such as the TTIP.

More fundamentally, following the sovereign debt crisis, the euro area experienced first-hand the risks of a diverging supervisory and regulatory framework for cross-border finance — and faced a serious threat of financial market fragmentation when those flows reversed. Safety was restored by elevating supervision and resolution to the European level with the banking union. This was key to re-establishing trust in the banking system and reviving cross-border capital flows within Europe. These are only the first steps, but the direction of travel has been drawn.

When it comes to the effects of openness on equity, it is admittedly less obvious how multilateral cooperation represents a solution to the fears being expressed. As I said, such fears typically have to be addressed by national distributional policies. But there is also an important international dimension, in particular related to tax avoidance.

Indeed, the problem many have with openness is not just that it redistributes income between different social groups. Almost everything that happens in a market economy – skill-biased innovation, churning of firms – redistributes income in some way, and we have in place mechanisms to deal with those outcomes, such as tax systems.
Where trade may differ from these other market forces, however, is in the perception that, in Dani Rodrik’s words, it “undercuts the social bargains struck within a nation and embedded in its laws and regulations”.¹⁷

For example, increasing openness to trade and finance is perceived by some to shift the burden of taxation from footloose capital to labour, or to create pressures to reduce labour protections to boost the competitiveness of domestic producers – the “race to the bottom”.

Such perceptions, and the sense of injustice they fuel, are deeply damaging to public faith in open markets – and this is where multilateral solutions can play a role.

Addressing tax arbitrage between jurisdictions, for instance, can clearly best be achieved by countries cooperating via international institutions. Likewise, taking a stand against race-to-the-bottom dynamics that threaten labour protections, calls for a common regulatory approach. Again, our experience in Europe offers some insights into how this can work, as well as into some of the difficulties involved.

Thanks to its common legal framework, the EU has successfully upheld labour standards even as its market has expanded to lower-income countries. The Single Market has no doubt prompted some relocation of jobs across countries, and this has at times triggered fears of “social dumping”.¹⁸ But in fact openness has not fundamentally challenged labour protections.

One main reason for this is that safeguards central to the European social model have been progressively embedded in European law, ensuring gradual convergence in labour standards among EU countries. Thus, while there is still heterogeneity, the gap between them is narrowing.

Preferences about the degree and type of social and labour protection differ across the world, and I am not claiming that those in the EU should be a model for everybody. The point here is that through multilateral decision-making, the EU has successfully built and defended the single market, addressing the perception that openness is always a source of inequality.

At the same time, in areas where unanimous decision-making is more prevalent, Europe has not always used the potential of its multilateral structure to the same extent. This is the case, for instance, in combatting profit-shifting and tax avoidance, although progress is now being made,¹⁹ which clearly chimes with the mood of EU citizens.²⁰

In short, there are certain concerns about equity that can most effectively – and perhaps only – be addressed through multilateral actions. As such, in tandem with well-targeted welfare policies, they are a key part of the policy toolbox for making openness sustainable.

**Implications for the global economy**

Clearly, the European model involves several unique features. In particular, it depends on a relatively advanced political structure that helps reconcile multilateral cooperation with democratic control, which is difficult to replicate elsewhere. Still, EU countries are generally more open than other advanced economies and perhaps have fewer problems of skewed income distribution.²¹

So what lessons can we draw for the global economy from our experience?

The most salient is that, at a time when disaffection with openness is growing, multilateral institutions become more, not less important. They provide the best platform to address concerns about openness without sacrificing open markets.

So organisations like the WTO, which make sure that trade is governed by rules and is subject to fair arbitration, remain vital to ensuring that global trade is perceived as fair and safe – while at
the same time avoiding protectionism in disguise. And bodies that foster global cooperation, such as the G20, remain just as necessary to reconcile openness with equity. The OECD/G20 initiative to combat tax base erosion and profit-shifting is just one example of such cooperation.

That said – and going by our experience in Europe – the area where we need a special focus today is cross-border finance. Organisations that facilitate convergence in financial regulation and supervision, such as the Financial Stability Board and the Basel committees, are key in this context.

Within these committees, a substantial amount of work has been done since the crisis to strengthen microprudential regulation, as well as to design and calibrate macroprudential tools. This work has been essential for at least three reasons.

The first reason is that finance is the most mobile production factor, and therefore the most likely to cause dangerous spillovers. This makes convergence in financial regulation one of the most important components of a sustainable open economy.

And we should remember that diverging financial regulation would endanger not only financial openness, but also global trade, since they are often two sides of the same coin: finance and trade are complementary in spreading knowledge and underpinning global value chains. A striking feature of the global financial crisis was indeed the collapse in world trade: between the third quarter of 2008 and the second quarter of 2009 global trade volumes declined by approximately 15%.

The second reason is that we have only recently witnessed the dangers of financial openness combined with insufficient regulation. International financial flows both contributed to and propagated the global financial crisis and the ensuing collapse of trade, output and employment.

Financial integration only survived relatively unscathed because the global regulatory response was swift and decisive, creating a financial system that posed fewer risks to the world economy. Any reversal would call into question whether the lessons of the crisis have indeed been learnt – and thus whether financial integration can still be considered safe.

Third, financial regulation interacts critically with monetary policy. Lax regulation implies an underestimation by regulators of incentives which lead to behaviour that is individually profitable, but socially costly. Given the large collective costs that we have observed, there is never a good time for lax regulation. But there are times when it is especially inopportune.

Specifically, when monetary policy is accommodative, lax regulation runs the risk of stoking financial imbalances. By contrast, the stronger regulatory regime that we have now has enabled economies to endure a long period of low interest rates without any significant side-effects on financial stability, which has been crucial for stabilising demand and inflation worldwide.

With monetary policy globally very expansionary, regulators should be wary of rekindling the incentives that led to the crisis.

To design and agree, in reciprocal trust, a regulation that preserves financial stability without unnecessarily restricting the flow of credit to the economy, while revisiting the post-crisis regulatory framework where necessary, the FSB and the Basel committees remain essential. This is also because, for large economies, changes in domestic regulation have international consequences. Global financial conditions account for 20–40% of the variation in countries’ domestic financial conditions, as shown by recent research from the IMF.

**Conclusion**

Let me conclude.
To inject more dynamism into the global economy we need to raise potential output growth, and to do so with ageing societies we need to lift productivity growth. For advanced economies that are close to the technological frontier, this depends crucially on openness to trade.

Yet openness to trade is under threat, and this means that policies aimed at answering this backlash are a vital part of the policy mix for dynamic growth. Some of those policies can be implemented domestically, but some can only be effectively enacted through multilateral cooperation.

Multilateral cooperation is crucial in responding to concerns about fairness, safety and also equity. By encouraging regulatory convergence, it helps protect people from the unwelcome consequences of openness. And protection ensures that we do not lapse into protectionism over time.

The European experience provides some insights into the opportunities and challenges involved. It also shows the importance of ensuring that, at all times, openness remains under democratic control. Multilateral institutions are necessarily staffed by experts. But it is essential that they always remain accountable to elected representatives who set the parameters and have the final say.

---

1. Per capita potential output growth, OECD data.
5. Pew Research Center (2014), “Faith and Skepticism about Trade, Foreign Investment”, September. However, a Pew Research Center poll released in August 2017 found that, in the context of immigration, 68% of Americans believe that “America’s openness to people from all over the world is essential to who we are as a nation”.
6. The most recent review in the literature has been published by the IMF and confirms that international trade improves welfare and strengthens economic growth. See IMF (2016), “Global Trade: What’s behind the slowdown?”, *World Economic Outlook*, Chapter 2, October.
9. OECD data, unweighted average.
11. OECD data, unweighted average.
See, for example, Eurobarometer Spring 2017.

For a more extensive discussion of this point see Rodrik, D. (2017), “It’s Time to Think for Yourself on Free Trade”, Foreign Policy, 27 January.

See, for example, the ongoing debate on the Posted Workers Directive.


74% of EU citizens believe the EU should take more action in the field of fighting tax fraud. See Eurobarometer Spring 2017.

