4. Multipolarity and regional integration

4.1 ARE WE MOVING TOWARD A MULTIPOLAR WORLD ECONOMY?

The economic geography of the world is rapidly changing. The economic contraction and the financial crisis caused by the burst of the sub-prime bubble in the US primarily hit advanced countries where unemployment rose, government budgets deteriorated and prolonged economic stagnation followed the sharp recession of 2008–2009. Outside advanced countries, the consequences of the financial crisis were less severe and emerging economies quickly returned to their previous rapid growth. The different impact of the financial crisis on advanced and emerging countries should not be a surprise because an examination of world development patterns over the last 15 years shows that new economic powers are already eroding centuries-old European and North-American supremacy. We know that, after World War II, the US overtook the UK as the world's leading country and that in the Cold War period the two American and Russian superpowers ruled a bipolar order where alternative social, political and economic models faced off. After the fall of the Berlin Wall in 1989 and the subsequent implosion and disintegration of the USSR, bipolarity ended and Russia, along with many Eastern European countries, started a difficult transition period toward the market economy. Many observers interpreted those dramatic events as the triumph of the 'American century', an era in which the only remaining superpower, the US, would dominate politically and economically for many years. Twenty years later, the reality has proved quite different (Fukuyama, 1992; Kagan, 2008; Kupchan, 2011; Palma, 2009; Zakaria, 2011): the US originated the most severe economic crisis since the Great Depression of the 1920s, sovereign debt besets the EU and in Asia, Japan is unable to come out of a lengthy period of economic stagnation. Meanwhile, India, the largest democracy in the world, is rapidly growing, China has become the world's leading exporter, the second largest economy in absolute GDP terms[1] and the main purchaser of US Treasury Bills; Brazil and South Africa are modernizing and establishing themselves as the main economic and political hubs

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in their respective continents. The successor of the second superpower of the Cold War era, Russia has completed the transition from a planned to a market economy and has been able to return to the international economic scene as a leading actor due, in part, to its vast endowment of natural energy resources (Aslund, 2007; Hanson, 2004; Malle, 2008). Figures 4.1a, 4.1b and 4.1c give a clear picture of the changing world economy. In the year 2000, the group of advanced countries[2] produced 80 per cent of world GDP, leaving a mere 20 per cent to the others (see Figure 4.1a). Ten years later, the share of emerging and developing economies rose to 34 per cent (Figure 4.1b) but, according to the IMF, the share of this group of countries is bound to further enlarge and in 2016 emerging and developing economies will double their share, totalling 41 per cent of world GDP at the expense of advanced countries whose contribution will fall from 80 to 59 per cent (Figure 4.1c).

Figure 4.2 tells us what is behind such a radical change in the balance of world economic power: in the 2000s, emerging countries have grown twice as fast as advanced countries. Furthermore, in 2008–2009 advanced economies went into recession, while emerging countries merely suffered a slow-down in economic growth. Looking at individual countries in both groups, other trends of interest emerge. Figure 4.3 shows anticipated changes in GDP in the three major economic areas in the group of advanced countries: the EU, Japan and US. The sharp decrease in the contribution of the US to world GDP is striking. In 2000 the US produced about 31 per cent of world GDP but, according to the IMF, in 2016 that share will fall to around 20 per cent. Figure 4.3 also shows the halving of the Japanese contribution to world GDP, expected to fall from 14.49 to 7.41 per cent. The EU share of world production should be more stable, with a small expected loss of around three percentage points. According to these projections, among advanced countries the US is likely to pay the highest price for the rebalancing of the world economy in terms of relative GDP shares.

Who gains the most from this trend? Emerging and developing countries are rather heterogeneous and comprise a large number of states. However, few of them are acquiring special status both at global and regional levels because of their dimension and/or economic development. In 2000, the BRICS – Brazil, Russia, India, China and South Africa – had a GDP share of just 8.41 per cent which had more than doubled by 2010, reaching 18.18 per cent. The forecast is that in 2016 the joint BRICS GDP will triple on 2000 to 23.8 per cent, above that of the EU. This rebalancing of the world economy is highly significant, but closely related to the performance of the Chinese economy (Figure 4.4). Among BRICS countries, South Africa is still far from reaching true global status as an

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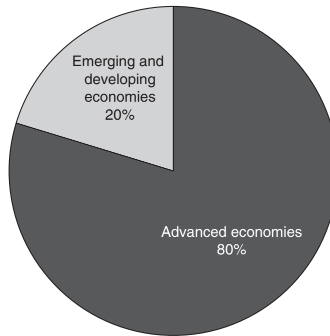

Figure 4.1a Shares of world GDP (2000)

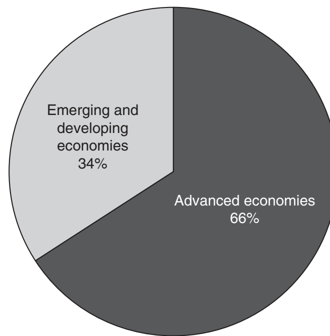

Figure 4.1b Shares of world GDP (2010)

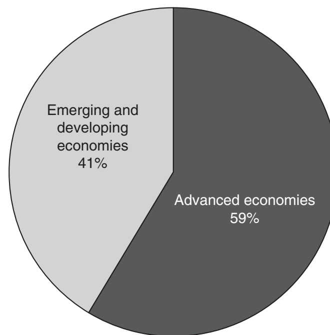

Figure 4.1c Shares of world GDP (2016)*

Sources: IMF World Economic Outlook Database
* IMF estimates

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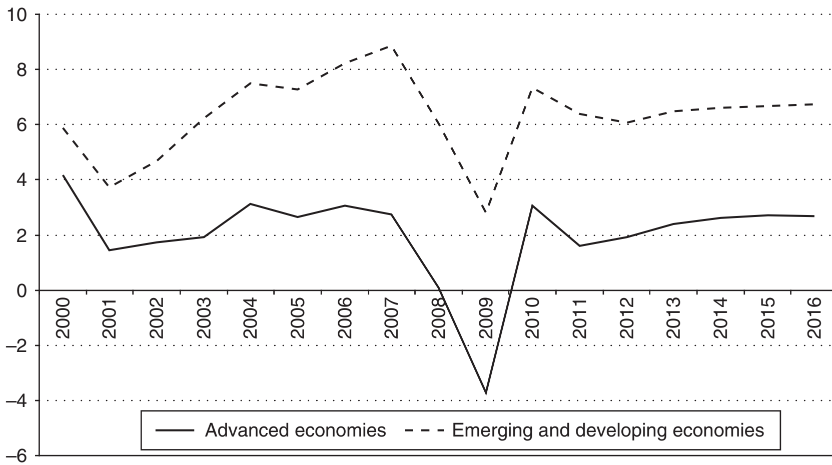
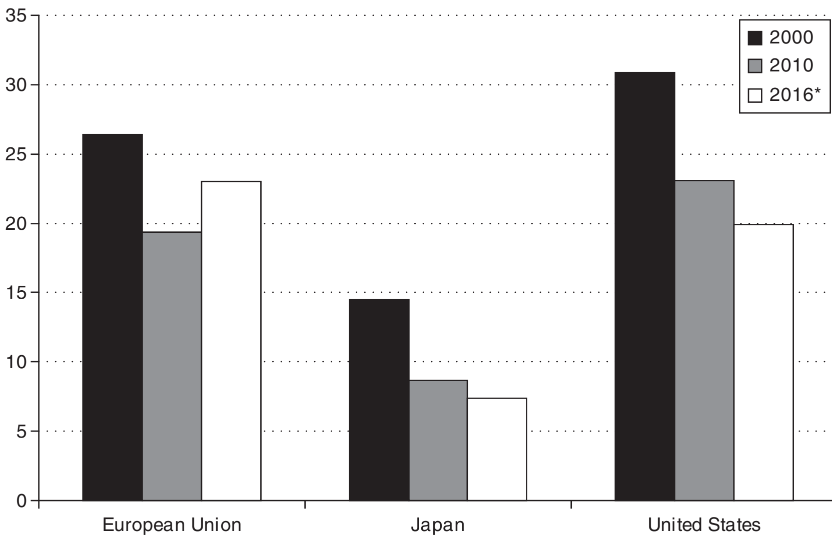


Source: IMF World Economic Outlook Database
* IMF estimates

Figure 4.2 World rate of growth (2000–2016)*



Source: IMF World Economic Outlook Database
* IMF estimates

Figure 4.3 Shares of world GDP: EU, Japan and the US (2000 – 2016)*

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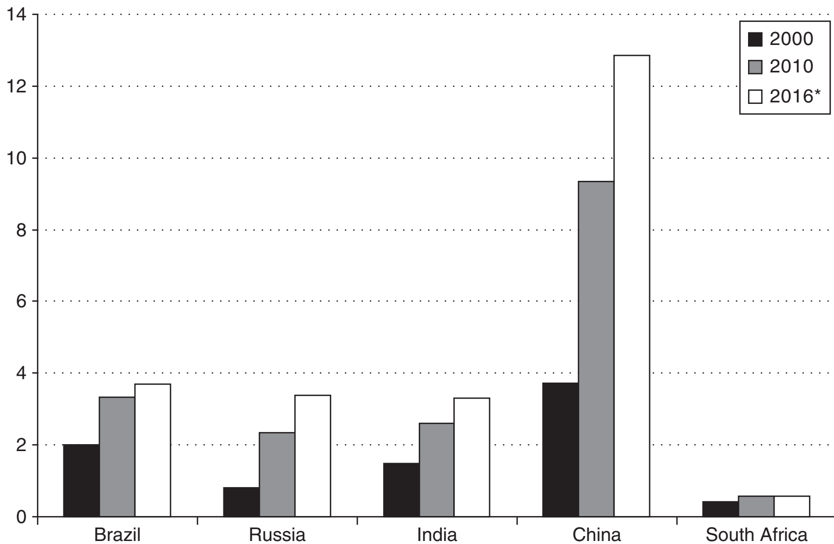

Source: IMF World Economic Outlook Database
* IMF estimates

Figure 4.4 Shares of world GDP: BRICS countries (2000 – 2016)*

economic power, although it is the dominant economy in Sub-Saharan Africa.

Economic projections over a long time horizon are risky and subject to error but the evidence suggests that, under the plausible assumption of unchanged trends in the medium term, the coming decades are likely to be characterized by a multipolar economic order. In the new economic order, countries outside the US and EU will drive world economic growth. In this regard, the theoretical concept of a 'growth pole' recently revamped by the World Bank (2011) may be of use. According to the World Bank definition, a country is a growth pole when domestic growth strengthens growth in other countries as well. This happens when the country is at the hub of a large international network of economic and financial links, so that there is positive spillover from the pole to peripheral countries in the network.

Growth in one country may help the growth of other economies directly and indirectly. The more intense the international trade, the transfer of technology, FDI investment flows and migration, the more likely it is that partner countries benefit from the development of the 'core' country. A straightforward example of a new important growth pole is China, whose

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emergence as the main industrial pole in Asia is undisputed. According to the World Bank (2011: 20), in the period 2004–2008 along with the EU and the US, China consistently ranked at the top in terms of its ability to activate economic growth in Asia and other parts of the world. Indices of regional polarity show that Saudi Arabia and the other BRICS countries (Brazil, India, Russia, and South Africa) are the main drivers of economic growth in their respective regions (World Bank, 2011: 21). At the same time, other emerging countries such as Mexico, Malaysia and Turkey are strengthening their network of international economic relations and exert a positive influence on world economic growth well beyond their national borders.

A country may be a powerful driver of trade and industrial links but in the absence of truly international financial activities, it cannot hope to become a true world pole. In this regard, a phenomenon that further supports the vision of the coming multipolar world is the rapid growth of international financial flows and FDI originating from emerging countries. Chapter 2 presented and discussed the fact that China and other developing countries are accumulating dollar reserves, purchasing American financial assets and financing the US government deficit. FDI by emerging country-based companies have reached a significant threshold and will further increase in the near future. The geographical dimension of this phenomenon is global, involving both south-south and south-north directions. Major emerging countries are investing in other developing countries but are also purchasing companies in advanced countries. China, for example, is financing infrastructural investments in Africa in order to gain access to strategic raw materials that are abundant in that continent while at the same time acquiring companies in the EU and the US, as can be seen from the acquisition of IBM's personal computer business division by the Chinese company Lenovo in 2005 (Cheng and Ma, 2010)[3]. Another well-known example of expansion is the Indian company Tata, which has made significant investments in the European steel industry and is now a global actor in the world steel and automotive industries (Brautingam, 2010; Evans, 2010; Gu, 2009; Liu, 2007; Mohan and Power, 2008; Strauss and Saavedra, 2009; Taylor, 2011; Wang, 2007). According to the World Bank (2011: 85), in the period 1997–2010, 33 per cent of FDI flows to low-income countries came from the UK, with China scored second at 14 per cent and South Africa, with a share of 5 per cent, performing better than Canada, which sourced 4 per cent of FDI directed toward less developed countries. This evidence clearly shows that emerging countries are not only important international traders and producers of real goods but are also strengthening their strategic position in global financial markets, as the surge in new international bond issues from those

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countries demonstrates (World Bank, 2011: 98). In the absence of unpredictable catastrophic events, current trends are therefore driving the world economy in the direction of multipolarity.

4.2 THE GLOBAL ECONOMY AND REGIONAL INTEGRATION

In a multi-polar, globalized world, countries large and small find it natural and convenient to cooperate with their neighbours; processes of regional economic integration have become widespread and are today a prominent feature in the spontaneous evolution of the world economy. In Europe, the European Union (EU) is a large integrated area comprising 27 countries; Canada, Mexico and the US created the North American Free Trade Area (NAFTA); in Asia, the Association of Southeast Asian Nations (ASEAN) comprises ten countries (Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar and Vietnam); in South America Argentina, Brazil, Uruguay and Paraguay form the MERCOSUR; in Africa the Organization for African Unity (OAU) promoted the establishment of an African Union; in South Africa, the Southern African Development Community includes 15 countries. These are but a few well-known examples of many other experiments in regional economic integration aimed at improving the economic growth and welfare of member countries through the elimination of internal trade barriers and the establishment of common rules.

Why have integrated regional areas become so common in the global world economy? Often, as the gravity model suggests (Anderson, 1979; Anderson and Wincoop, 2003; Bergstrand, 1985; Deardoff, 1998)[4], trade between countries is more intense the closer the countries are geographically. Other factors, such as the sharing of a common history, language, social habits and political institutions seem to positively affect international trade. This simple approach shows why, in the presence of common borders, geographical proximity, cultural and political affinities, the incentive for establishing regional economic agreements is often strong. The advantages of deeper economic integration between countries go beyond the usual arguments about the benefits of free trade based on comparative advantage and international specialization. A coalition of small to medium-sized countries gives individual members a better chance to face up to international competition and political pressure from larger economies. Economic integration resulting in free trade areas (FTAs), customs unions or economic unions creates conditions that, because of access to a larger market and economic synergy, allows member states to

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improve economic efficiency and achieve faster growth based on a more competitive environment where companies can exploit economies of scale and consumers can choose from a wider range of goods and services. FTAs are agreements in which countries set reciprocal trade tariffs to zero but maintain independent trade policies in relation to countries outside the FTA; hence members may apply different tariffs to the same third country. In customs unions, on the other hand, external tariffs are uniform and members cannot follow independent trade policies. It is clear that customs unions require a higher degree of internal coordination between members than FTAs. Of course, economic agreements of this type may involve distant countries too, if there is a mutual interest in establishing economic relations. For example, the desire to diversify trade flows and reduce excessive dependence on a large neighbour or the opportunity to access promising new emerging markets may result in closer economic cooperation and integration between very distant countries.

Global multilateral trade agreements, as promoted by the WTO (formerly GATT) since 1948 through nine complex negotiation rounds[5], offer economic benefits to participating countries, but it is evident that regional treaties leading to FTAs, customs or economic unions are often simpler to set up, manage and implement since they involve fewer governments than global multilateral discussions between a hundred or so countries which, all too often, have different points of view and conflicting interests. However, the increasing spread of bilateral and regional integration raises the important problem of how this trend relates to WTO multilateral agreements, and the regulations for international trade accepted by 153 countries. The problem is that any bilateral or regional economic agreement determines de facto preferential treatment in favour of member states, a circumstance which may violate the basic non-discriminatory rules of the WTO. The most significant innovation in international trade practice introduced by the WTO was the requirement for any trade agreement to achieve the unanimous approval of countries participating in the multilateral negotiations; in addition, when some members agree on favourable bilateral trade tariff concessions, the agreement must be extended to the other WTO members. For example, if during WTO negotiations a group of countries decides on a mutual tariff reduction in steel products, the same reduction applies to all other WTO partners. Furthermore, the agreement becomes operational only after final approval by all WTO members. This mechanism, known as the 'most favoured nation' clause (MFN), accomplishes the result of generalizing tariff and trade policy concessions where they are agreed upon by small groups of countries.

Since the end of World War II, MFN has been a powerful legal mechanism enabling continuous multilateral reductions in trade barriers in the

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world economy. Without MFN, a prisoner's dilemma would arise because no country would have the incentive to make the first move to reduce its own trade barriers, such as import tariffs, quotas or export subsidies, in the absence of a credible commitment by all other countries to behave in the same manner. Every country would be better off eliminating the costs and distortions associated with protectionism but none would do so for fear that trade partners would keep the protection of their domestic market intact. In that case, countries abolishing tariffs would incur a net loss because they would find it more difficult to sell their products abroad; at the same time, foreign countries could freely access their markets at the expense of national producers. In the real world, when negotiations involve few countries, a simultaneous reduction or elimination of tariffs can be achieved without too much difficulty. However, on the one hand, although regional processes of economic integration certainly promote free trade among members through reduced internal protection, on the other hand there is also a temptation to protect the internal market of the FTA by means of higher tariffs levied against external third countries. In that event, integrated regional areas would actually segment the world market into separate 'economic fortresses' rather than contribute to the development of global free trade. Therefore, regional treaties, FTAs or customs unions are not the solution to the problem of achieving a more integrated world economy to the benefit of all. Only simultaneous multilateral trade concessions can positively affect global trade and this requires a negotiation mechanism that binds every participating country to the MFN principle. A notable exception to the prohibition of preferential agreement between WTO members is the Generalized System of Preferences (GSP) the WTO established in favour of a group of less developing countries (LDC). The GSP allows developed countries to grant LDCs preferential access to their domestic market on a voluntary base and this exception to the general principle of the most favoured nation is justified by the recognition that in LDCs a full and rapid adoption of the WTO rules would be too costly and reduce welfare sharply so these countries need a longer period of time to adjust their domestic economies to a free trade environment (Stiglitz and Charlton, 2005).

FTAs, customs unions and integrated regional areas existed before the creation of the GATT. This explains Article XXIV of the WTO Charter, which contains provisions for the regulation of these agreements. The basic idea is that FTAs, customs unions or economic unions in regional areas, involving a limited number of countries, are permitted if they follow general WTO rules for free trade. The unavoidable positive discrimination in favour of internal members of regional unions has to be supplemented by the respect of WTO rules with regard to all other WTO members. In

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other words, countries in an integrated regional area or FTA can internally reduce or eliminate tariffs in order to increase trade between them but they cannot raise tariffs above previous levels against non-member countries in the WTO without explicit negotiation. Notwithstanding the fact that a growing number of countries have decided to join the WTO (154 members including Russia at the end of 2011), in practice many of them also joined local FTAs.

Since the establishment of the WTO, global and regional trade agreements have gone hand in hand with regional agreements, which have become increasingly popular in the last 20 years. Data shows that in 1990 there were 27 FTAs, in 2008 there were 421, up 15-fold (Matsushita, 2008 and 2010). Today, in the world economy FTAs are important and the largest four – the EU, NAFTA, MERCOSUR and ASEAN – represent about 60 per cent of total world trade. In this regard, the stalemate of the multilateral WTO Doha Round reinforced an existing tendency toward the establishment of integrated regional areas. In the absence of a new global agreement on international trade and trade-related issues that are still open or are outside the Doha Round Agenda, bilateral and regional treaties may look like a best rather than a second best option to countries ready to better integrate their economy with that of their closest economic partners or willing to sign agreements on controversial subjects that do not encounter universal support in WTO negotiations. In this sense, local agreements on topics the Doha Round decided not to discuss further, such as investments and competition policies, may be a useful addition to the WTO set of rules. The negative side is that the lack of coordination between FTAs may produce a disorderly accumulation of different rules which could complicate rather than simplify international trade and investments.

To sum up this discussion, regional economic agreements are a very important aspect of the world economy, offering individual countries the way to achieve a stronger position in a rapidly changing international economic environment. At the same time, without a supranational perspective and effective method of cooperative multilateral negotiations, these agreements can segment the world market and ultimately reduce world trade and welfare rather than increase them, as the literature on trade creation and trade diversion shows (Balassa, 1967; Freund and Ornelas, 2010; Fukao et al, 2003; Kreinin, 1959; Matsushita, 2008). The lesson of the 1930s when, in the aftermath of the 1929 crisis, isolationism, nationalism and protectionism spread all over the world, eventually leading to the disruption of international trade, global depression and World War II, must not be forgotten, especially today when recovery after the world financial crisis of 2008 is still uncertain.

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4.3 REGIONAL INTEGRATION: EUROPE AND THE OTHERS

A comparison of existing regional experiences shows that the degree of integration between countries varies from simple FTAs to the sharing of complex supranational institutions as in the case of the EU. Chapter 6 discusses the problems and serious risks the EU is facing because of the sovereign debt crisis. Undisputedly, the EU has been the most successful experience of integration among developed modern countries. Based on an intuition of Ernesto Rossi and Altiero Spinelli, the authors of the famous Ventotene Manifesto (1941), the EU is the result of a long process of political and economic integration starting after World War II and involving an initial core of six founding countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) led by leaders of the stature of Konrad Adenauer, Alcide de Gasperi, Jean Monet and Robert Schuman. The motivation behind European integration cannot be understood if secular conflicts among European nations causing two world wars and several European conflicts are forgotten. The long-term goal of the founding fathers of modern Europe was to prevent future devastation in Europe via political and economic cooperation and integration, guaranteeing peace and prosperity in the Old Continent. In the intentions of its founders, the final stage of European integration was intended as a federal European state, not merely a customs union or common market. Stable, peaceful economic relations between nations need strong political cooperation and in this perspective, in the light of the conflicts between France and Germany which contributed to two world wars, post-war European leaders have understood that only the permanent linkage of European nations provides the basis for a peaceful future. Former ECB Chairman, Jean-Claude Trichet, made this point clearly, referring to Adenauer, during his speech on 24 October 2011 at Humbold University in Berlin:

> As Konrad Adenauer said in Aachen 57 years ago: "Gerade wird man die Mahnung verstehen, dass Europa uns heute Schicksalsgemeinschaft ist. Dieses Schicksal zu gestalten ist uns übergeben" [Above all, people will understand the call: that Europe, for us today, is a community with a common destiny. It's up to us to shape that destiny].

~~These are the deep roots of European integration that distinguish it from all other major economic integration projects, none of which have moved much beyond the economic aspects of relations between states, even where they take the EU as an inspiring example, as is the case of ASEAN. ASEAN was set up in 1967 and aims at promoting regional~~

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growth through social, political and economic integration. The founder members are Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei. Later on, Cambodia, Laos, Myanmar and Vietnam joined the area, which today includes ten countries. The ASEAN focus on the Asia and Pacific region allows the organization to actively collaborate with other major countries, such as China, Japan and South Korea, an aggregation known as 'ASEAN + 3'. In the economic field, ASEAN countries signed a FTA in 1992, whose implementation began in 2002 with the prospect of completion in 15 years. However, the tariff level in the ASEAN FTA may range between 0 and 5 per cent rather than simply being set to zero (Plummer and Clock, 2009: 17). In addition, ASEAN is more open to trade with external partners than the EU. Trade among member countries counts for about one quarter of their total trade, while the figure is two thirds for the EU. ASEAN's most important trade partners are China, Japan, the US and the EU, areas with which ASEAN have very close bilateral trade quotas, varying within a narrow range between 12 and 15 per cent of ASEAN trade. In the Bali Summit of October 2002, ASEAN members agreed on the project for transformation into the ASEAN Economic Community (AEC) by 2020. The major goals of the AEC initiative are to 'establish ASEAN as a single market and production base making ASEAN more dynamic and competitive with new mechanisms and measures to strengthen the implementation of its existing economic initiatives. . .' (ASEAN, 2008).

The EEC and EU experience inspired the AEC project despite the differing starting conditions of the two areas. As stated above, European integration was strongly motivated by the post World War II economic and political environment, including the division of Europe into Eastern and Western zones under the military and political influence of the US and USSR. In Asia and the Pacific area, these problems do not exist. The differences in the economic development and socio-political structures of ASEAN countries are greater than was the case in Europe at the beginning of its integration. Finally, today's international economic environment is very different from that of the 1950s, when the world and European economies were fragmented and countries were relatively closed, whereas today the world economy is largely globalized and ASEAN countries are already open to international trade. Hence it is unlikely that the AEC project will follow the path taken by the EU, particularly with regard to building supranational institutions and relinquishing national sovereignty. The efforts of ASEAN countries to build a new economic community are at the initial stage; much has still to be done to go beyond a simple FTA.

The NAFTA is another major area of economic integration. It was set up by Canada, Mexico and the US in 1992 and became operative in 1994.

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NAFTA is a free trade area but, unlike the EU, not a customs union, since members can follow independent trade policies in relation to third countries. NAFTA seems to have reached its economic goal of successfully strengthening relations and trade flows between the three countries. As shown in Chapter 2 (Tables 2.1 and 2.2), Canada and Mexico have consistently been the first and third trading partners of the US over the last 13 years. According to data from the Office of the United States Trade Representative and the US Bureau of Economic Analysis, total US trade with Canada and Mexico amounted to $1.6 trillion in 2009 – 45 per cent of the American external trade – while US FDI in other NAFTA countries totalled $357.7 billion, an 8.8 per cent increase on 2008. In the same year, NAFTA FDI in the US increased by 16.5 per cent. Despite these excellent results, political and social support for NAFTA in the member states has not been strong, with opposition in the US, Canada and Mexico alike. In Mexico, dislike of NAFTA has even taken the extreme form of armed opposition, as in the Zapatista insurgency in Chapas. Unlike the ASEAN area, NAFTA is not expected to change its nature as an FTA into a more integrated economic union such as that implied by the AEC project.

European integration is an older, dissimilar process. The current structure of the EU emerged through lengthy, gradual integration based on the challenge of post-war economic reconstruction and the founding of the European Community of Steel and Coal (ECSC) in 1952, leading to the creation of the European Economic Community (EEC) in 1957 and to European Economic and Monetary Union in 1992. In this long, stop-and-go journey, the number of European states in the project has continuously grown with membership increasing from the initial six countries in 1952 to 27 in 2007 following five enlargement rounds, the most recent adding Bulgaria and Romania. Now, the EU is a significant albeit incomplete political entity and an economic giant which, with just 7 per cent of the world's population, generates about 20 per cent of world trade flows and rivals or surpasses the US in many economic areas (see Table 4.1). According to data from the EU Commission, about two thirds of EU member trade occurs inside the union with EU partners, showing a high level of economic interdependence.

Economic integration is not the only aspect of the EU; the EU has developed common policies in many social, educational and health fields, and cohesion fund programmes provide member states with financial resources for reducing territorial economic disequilibria. The EU is not (yet) a federal state with a government able to raise taxes and issue bonds. Its financial resources are limited to 1 per cent of EU GDP and depend entirely on transfers by national governments.

The EU is not merely an FTA but a complex economic, monetary and

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Table 4.1 *US and EU macroeconomic comparison (2010)*

	USA	EU
Population (a)	309,997	501,126
GDP (PPS evaluation) (b)	14,526.550	16,242.256
Per-capita GDP (PPS evaluation) (b)	46,860.242	30,455.224
Export of goods(b)	106.52	1712.48
Import of goods (b)	159.43	437.36

Source: Eurostat, IMF World Economic Outlook Database, OECD Main Economic Indicators
(a) thousands; (b) billion dollars

political union with supranational institutions such as the democratically elected European Parliament, the European Council and Commission, the European Central Bank (ECB) and the European Court of Justice[6]. The EU is a full customs union which abolished internal trade barriers in 1968. As to political barriers, the Schengen Treaty removed internal frontiers, so that intra-EU borders were not only de facto but also de jure abolished. In a further step forward, in 1992 the Maastricht Treaty established the single European market, a large economic area where the goods, services, citizens and capital of member states can move unrestrictedly. On the basis of the principle 'one market, one currency', the Maastricht and the Lisbon treaties laid down the stages and refined the rules, leading after 1999 to the introduction of the ECB and the euro. On the whole, these achievements are impressive, particularly because they were obtained through cooperation and collective negotiation. However, the push toward the institutional and political unification of the Old Continent came to an abrupt stop when the European Constitution, signed by EU heads of government in 2004, was rejected by French and Dutch citizens in two separate referendums one year later. Since then, no further steps toward deeper political integration have been attempted and the project now appears to be facing the opposition of many European countries. After more than a decade of accelerated integration and enlargement, some respite became necessary. Today, it is not clear whether the process of political integration in Europe will resume or encounter further obstacles. The negative impact of the international financial crisis on the European sovereign bond market, alongside divided and uncertain reactions from European policy makers, have made default by a European state a real possibility for the first time in the history of the EU. Should this happen, the very survival of the euro (and the EU) would be jeopardized because the political, economic,

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monetary and financial ties between European states would rapidly disseminate the effects of the default throughout the Union. Chapter 6 includes a detailed analysis of the European sovereign debt crisis. Here we limit ourselves to suggesting that the EU will only avoid the high costs of an uncontrolled debt crisis and reduce the likelihood of European collapse by resuming and completing the process of political integration, leading to a federal state where common monetary policy goes hand in hand with common fiscal policy.

This brief review of the main steps in European integration indicates that supranationality and the 'communitaire' method are trademarks of the EU. Supranational institutions mean that the decisions taken at EU level prevail over national policies and that member states must integrate their legislation with EU regulations. Uniquely, member states have gradually surrendered part of their national sovereignty to European institutions as is most evident in the European Economic and Monetary Union established by the Maastricht Treaty, setting up the European Central Bank, a supranational institution issuing the common European currency and managing European monetary policy. What was so new about the introduction of the euro was that independent states in Europe voluntarily gave up one of the major elements of national sovereignty by transferring the control of monetary policy to a common supranational institution.

Much has been written about the theory of optimal currency areas and on the costs, benefits, defects and sustainability of the EMU (De Grauwe, 2007, 2009; Issing, 2008; Eichengreen, 1997; Kenen, 1995; Kenen and Meade, 2008; Masson and Taylor, 1993; McCallum, 1999; McKinnon, 2004; Mulhearn and Vane, 2008). A detailed analysis of the relevant literature is outside the scope of this book. Here we focus on the very different nature of EMU compared to all other, past or existing, monetary unions, whether national or multinational (Bordo and Harold, 2008). National monetary unions have a single monetary authority or central bank, national borders define the dimensions of the monetary area and central national authorities manage both fiscal and monetary policies. In other words, in national monetary unions, fiscal and monetary sovereignty are at the national level. In multinational monetary unions, each country retains its domestic currency and independent central bank; no single monetary authority exists in the currency area. At the same time, the exchange rate between the currencies of the countries in the union is fixed, making national currencies interchangeable. In this type of union, the survival of the area depends on close coordination between national monetary authorities. The Latin and Scandinavian monetary unions are examples of international monetary unions, while the US, Germany and Italy are cases of national monetary unions.

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In these three countries, political unity preceded monetary unification. The US became an independent state with a formal constitution in 1789, after the War of Independence. However, a central bank, the Federal Reserve System (FED), was not created until more than a century later, in 1913. Until then, no single central monetary authority existed. Each state regulated the issue of bank notes as it saw fit and many decades passed before US monetary union was achieved.

Italy became an independent state in 1861, under the leadership of the Kingdom of Sardinia, which unified the Italian peninsula politically and militarily, after centuries of division into small independent states under the dominion of foreign powers (for example, north-east Italy was part of the Austrian Empire). Before political unification, a large number of different metallic currencies circulated in the Italian states, making monetary reform urgent after unification. The new Italian government decided to abolish the old currencies and adopted a monetary standard based on the lira (originating in the Kingdom of Sardinia). However, here too, no single central bank was established on unification; in 1884, as many as six different banks were issuing notes. The Italian central bank, the Banca d'Italia, was established in 1893 as a merger between four major Italian banks, including three of the six issuing banknotes. Later, in 1926, the Banca d'Italia became the only authorized money issuer in Italy (Frattianni and Spinelli, 1997). If the creation of a national central bank signals the completion of monetary union, in Italy more than 30 years were needed to achieve it.

German unification was similarly driven by one dominant state, the Kingdom of Prussia. As Italy, before the unification the fragmentation of Germany into free towns, municipalities and small states meant that each independent zone or city had its own coins and banknotes. The first step toward monetary simplification occurred under the Zollverein, a customs union created by 38 German states in 1834, when northern members adopted the thaler as its monetary unit and southern states adopted the gulden. In 1871, after political unification, the German government introduced a new currency, the mark; the central bank was established four years later. Once again monetary unification was neither rapid nor linear.

Quite different is the history of the major international monetary unions of the nineteenth century. Belgium, France, Italy and Switzerland founded the Latin Union in 1865, while Denmark, Norway and Sweden joined in the Scandinavian Union in 1873. Unlike the UK, which adopted the gold standard (and abandoned it in 1931 during the Great Depression), the Latin Union adopted a bimetallic standard, in which both silver and gold coins circulated. It coordinated the creation of token coins with the same silver content in order to prevent the seignorage of one country at

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the expense of others. Because these Unions did not regulate the issue of paper money, member states retained a great deal of monetary autonomy (Bordo and Harold, 2008: 8). The Scandinavian monetary union was the 'natural' consequence of a situation in which the three countries were using the same unit of account, the risksdaler, and the coins of each country circulated in all. As with the Latin Union, small differences in the silver content between national coins produced money flows from one country to another, and the need for a common coinage emerged. The Scandinavian Monetary Union adopted the gold standard and introduced a new unit of account, the krona. Krona minted in each country had the same gold content. The adherence to a common international monetary standard facilitated the functioning of the two unions, simplifying coordination of the various national monetary policies (Bordo and Harold, 2008; Bordo and Jonung, 1997; Redish, 2000). However, the inconvertibility of currencies and the economic strains produced by World War I brought an end to these experiments in monetary union. In the interwar period, the attempt by the UK, Italy and other countries to return to the gold standard, failed. After World War II, the Bretton Woods exchange rate system was essentially based on the dollar, albeit formally on gold.

Monetary unions are usually created out of the desire to facilitate trade by reducing exchange rate uncertainty, eliminating the costs of multiple currencies and preventing unfair trade policies based on competitive devaluations and seignorage. They are more fragile than national unions because the lack of a single monetary authority renders the implementation of common policies more difficult and the fact that states in the monetary union maintain full political independence makes it less costly to abandon the union in the face of external shocks, diverging domestic economies and/or contrasting economic policy goals than to remain in the union. In contrast, the economic, political and human cost of breaking national monetary unions is very high; usually it is the result of political turmoil such as revolution or civil war ending in the dissolution of the political unity of the country. The peaceful political and monetary division of a state – such as the division of Czechoslovakia into the Czech and Slovakian Republics – is very rare. More common are forms of disintegration such as the former Yugoslavia, with civil war and atrocities on a huge scale.

How do the main features of the EMU compare with these examples of monetary union? The EMU is not an international monetary union because the Maastricht treaty established a common, independent, supranational monetary authority, the ECB, to direct monetary policy for the whole area. Nor is it a national monetary union because the EU is not a national federal state; each member state is independent. Therefore,

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compared to previous monetary unions, the EMU is unique, as is the introduction of a new single European currency in 17 different states without war or imposition by a single, dominant state. Due to its size and importance, Germany dominated the monetary policy of the EU prior to the creation of the EMU. Although other monetary authorities were formally independent, they followed the Bundesbank policy stance on interest rates and inflation. Paradoxically, after the birth of the euro, the EMU's participating countries lost their formal monetary sovereignty but, at the same time, they gained substantial sovereignty through a mechanism of collective decision-making and via a supranational institution where the German point of view is not necessarily dominant. The reasons why Germany accepted the EMU, giving up its strong mark and dominant position in European monetary policy, are explained in section 6.4. Briefly, European monetary union resulted from the attempt to solve the economic and political problems of German reunification and in order to assure lasting benefits to all the European countries asymmetrically affected by it. Once again, a discussion of the benefits and costs of the EU and the EMU makes no sense without an overview of the historical and political events behind them and the economic and political costs of failure.

4.4 RESERVE CURRENCIES AND MULTIPOLARITY

Chapter 2 analysed global imbalances and asymmetries in the international monetary system, suggesting the need for a supranational world currency and the creation of supranational monetary institutions. Chapter 5 further discusses these topics. The final section of this chapter attempts to answer the following question: without major reforms of the international monetary system, what is the likely evolution of the world in which the dollar remains dominant? If trends in real and financial markets have anticipated changes in foreign exchange markets, then one guess could be that a multipolar international monetary system is likely to emerge in the near future. The international supremacy of the dollar as a reserve and world currency was undisputed until the appearance of the EMU. In the 1950s and 1960s this supremacy was based on the economic dominance of the US; later, after the demise of Bretton Woods, its supremacy remained intact largely due to the lack of viable alternatives. The only implicit competitor of the dollar was the German mark but it was not an international reserve currency and Germany did not have the political will to promote extensive use of the mark in the foreign exchange market. Only after the creation of the EMU and subsequent introduction of the euro did an

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alternative to the dollar appear (Bergsten, 2002; Chinn and Frankel, 2005; Dutta, 2005; Fiorentini, 2005). Today, the rapid emergence of China, both as the major Asian economy and as a global economic pole, along with the persistent stagnation of Japan, has many observers thinking that, in a few years' time, the Chinese renmimbi will become the third international reserve currency alongside the euro and dollar (Fratzscher and Mehel, 2011; Jayakumar and Weiss, 2011; Kelly, 2009; World Bank, 2011).

The coexistence of multiple reserve currencies is not new, although one currency has always dominated. In the nineteenth century, gold was the basis of the international monetary system and the value of national coins and paper money was defined in terms of their gold content; hence the exchange rate between national currencies was determined automatically. The gold standard was a symmetric system: no single country issued the international key currency. However, because of the predominant position of the City of London financial market, the British pound obtained special status and was largely used as a reserve currency along with gold. In the period between the two world wars, the British economy faded, the US emerged as the new international economic power and the dollar was increasingly used both for trade and reserves. The dollar replaced sterling as the leading international currency after World War II, when the Bretton Woods conference introduced an exchange rate system based on the convertibility of the dollar into gold along with fixed exchange rates between the dollar and other currencies. The Bretton Woods monetary system was a gold exchange standard system, with the dollar functioning as the international key currency. According to Triffin (1960), the dollar overtook sterling very slowly. In the interwar period, both were used as international reserve currencies. Triffin estimates that in 1928, sterling had an 80 per cent share of total foreign exchange reserves, falling to 70 per cent in the following ten years. In 1938, the international role of sterling was still substantial. Other authors such as Aliber (1966) and Chinn and Frankel (2009) confirm Triffin's findings, while Eichengreen and Flandreau (2008) argue that the dollar overtook sterling in the 1920s only to fall behind again after dollar devaluation in 1933. These studies demonstrate that it is possible to have more than one leading international currency. Changes in the economic ranking of a country do not automatically translate into a new ranking for its currency in the foreign exchange market; a currency may continue to dominate after the country has lost its economic supremacy, as explained by network externalities and hysteresis: when a currency has gained international status and is widely used in international transactions as well as being accepted as a reserve currency, it is convenient to continue using the currency despite the decline in the economic and political support of the currency because it is less expensive to use a

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currency everybody else is using rather than switch to another promising currency traded in a more limited number of transactions. In other words, the persistent dominance of a currency in the foreign exchange market is a product of inertia in international payment technology and represents a case of the advantage of the incumbent. In this regard, other political and institutional elements may affect the international status of a currency. For example, after the fall of the USSR, the fact that the US was the sole military superpower and the hub of a network of international military and strategic alliances, had a positive impact on the international role of the dollar. Partner countries may decide to support the international role of an incumbent currency for political rather than purely economic reasons. The emergence and persistence of key currencies in the world monetary system depend on market forces and on political action and the geopolitical strategies of partner countries (Helleiner and Kirshner, 2009).

What are the economic characteristics of a key reserve currency? As national currencies, any international currency has three main functions: to facilitate trade and investments (medium of exchange function); to denominate prices (unit of account function); and to maintain value through time (store of value function). In a world monetary system based on national currencies, one currency may achieve worldwide importance only if it simultaneously carries out all these three functions in international markets. An international currency is used for trade invoicing and settlements, is a vehicle currency[7] and is used in central bank intervention in foreign exchange markets; it is used for pricing most international commodities and goods, is held for safe private investments and is hoarded in official international reserves. Currently, the dollar meets all these conditions; the euro does so in a more limited manner and the renmimbi still falls short in all areas. However, the trend toward a multipolar world economy is likely to change this static picture.

Not every country can issue a key reserve currency because the international spread and acceptance of a currency requires the economy to be large enough, trade and financial links with other countries to be extensive and domestic financial markets to be liquid, deep and sophisticated (Jayakumar and Weiss, 2011: 97). The frequency with which a currency is used worldwide positively correlates with the intensity of trade and financial flows with foreign partners. Furthermore, it is only when it is widely exchanged in international markets that it can be used to set international prices. Trust in the solidity and solvency of the domestic financial market is essential for the currency to be held as an international reserve abroad. In turn, low inflation, 'sound' economic policies and a market-friendly environment are necessary ingredients for creating and maintaining trust in the currency.

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In these terms, how do the dollar, euro and renmimbi compare? Starting from the incumbent, the dollar, notwithstanding the anticipated loss of share in world GDP, the size of the US economy will continue to provide the dollar with a key position in the future. The broad international use of the dollar is shown by the fact that about 65 per cent of all US banknotes circulate outside the US and in 2007, 96 countries followed exchange rate policies that either linked their exchange rate to the dollar through dollarization (seven countries) or pegged exchange rates regimes (Goldberg, 2010). In finance, despite the ongoing crisis, US financial markets remain the deepest and most liquid in the world, and dollar-denominated assets are still in demand and held abroad. IMF data on the composition of global international reserves reveals that the dollar continues to be the major component of allocated reserves,[8] although in the 2000s the share of the US currency declined by roughly 1 per cent each year, falling from 71 to 62 per cent (see Figure 4.5). At the same time, the euro rose from 18 per cent in 2000 to 28 per cent in 2009. In 2010, the euro lost ground, its share falling by two percentage points to 26 per cent. Uncertainty about the prospects of the US recovery, along with the persistent trade deficit and rise in public debt, largely held abroad, suggest that the pattern of imbalances contributing to the crisis persists and the weakness of the US economy is likely to reinforce multipolarity in international finance. As hysteresis and network externalities in the foreign exchange market show, the dollar will continue to have an important role in the international economy unless creditor countries withdraw their support and switch the composition of their financial investments to other currencies. This appears unlikely, because a sudden withdrawal of foreign investments from the US would produce a sharp depreciation of the dollar, which in turn would strongly reduce the value of dollar assets held abroad, causing a dramatic shock in financial markets the world over. More likely is the slow and gradual diversification of the currency composition of international investments and reserves.

For the euro, economic fundamentals such as GDP and trade flows are favourable to the expansion of its international role. The euro is currently the second major currency held in international reserves (Figure 4.5) and is widely used as a medium of exchange in transactions outside the EU. According to the ECB (2011: 10), in 2010, on average, countries belonging to the EMU area invoiced and settled about 68 per cent of their exports and around 53 per cent of imports in euros (EU countries outside the EMU included). Considering only trade with extra-EU countries, these figures fall to 55 and 41 per cent. The ability to use a domestic currency in international transactions is a good index of the international status of the currency. From this point of view, the euro has been a success; its use in international trade has increased constantly since 2000. The areas where

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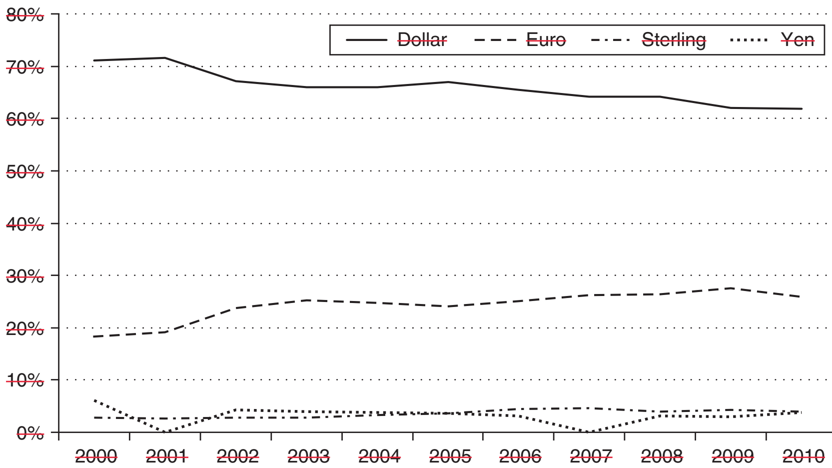

Source: IMF COFER database

Figure 4.5 Currency composition of international reserves (2000 – 2010)

the euro is most commonly used are Africa, Eastern Europe and central Asia, while transactions involving the dollar are predominant in North and South America, the Middle East, and the Asian-Pacific area. As far as international financial markets are concerned, at the end of 2010, euro-denominated securities represented 27.4 per cent of the market, dollar securities had a share of 48.7 per cent and yen securities 6.3 per cent (ECB, 2011: 19). In the same year, in daily foreign exchange market turnover the euro accounted for 19.5 per cent, the dollar 42.4 per cent and the yen 9.5 per cent of global currency transactions (ECB, 2011: 26). Another indication of the degree of internationalization of a currency is how many foreign countries follow exchange rate policies based upon it. In the case of the euro, an array of policies exist, including unilateral euroisation, currency boards, pegs and managed exchange rates based entirely on the euro or including the euro in a basket of major international currencies. The countries that adopt these exchange rate policies are in EU-neighbouring regions. The major obstacles to the expansion of the euro in the world monetary system are related to the institutional structure of the EMU and, in particular, to the fact that fiscal policy coordination in the EU is insufficient because of the absence of a European federal fiscal authority. A single Europe-wide market for government bonds is also lacking; this has contributed to the European sovereign debt crisis allowing speculators to bet against single countries. If the national sovereign debt markets of

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Europe were consolidated into a single continental market, as in the Blue Bond proposal (Delpla and von Weizsacker, 2010), its dimension would be comparable to that of the US and profitable speculation would be more difficult.

For the renmimbi, the rapid expansion of Chinese GDP and foreign trade is the major driver behind a broader use of the Chinese currency in international transactions. However, inconvertibility is a major obstacle. The renmimbi exchange rate is currently not market determined and the Chinese government keeps strict controls over capital flows. The export-led growth strategy followed in recent years by the Chinese government has led to the pegging of the renmimbi to the dollar. Furthermore, the desire to avoid a currency crisis, such as occurred in Asia at the end of the 1990s, partly explains the reluctance of the Chinese authorities to liberalize capital flows and ease state control of the exchange rate. However, unless the Chinese authorities take these steps, no further progress in the direction of internationalization is possible. As far as the use of the renmimbi in international trade is concerned, the Chinese government has promoted its use in bilateral swap agreements with Asian and other emerging countries, such as Argentina, Hong Kong, Malaysia, and South Korea. In 2009, China and Brazil also signed an agreement according to which China's import from Brazil are in renmimbi, while Brazil's import from China are paid in real (Kelly, 2009: 2; World Bank, 2011: 141). The aim of these agreements is to reduce these countries' dependence on the dollar in international trade. The renmimbi may also gradually gain ground in the pricing of commodities. Through rapid industrialization, China is the world's largest consumer of metals such as copper, nickel, aluminium and zinc; the need to ensure a stable supply of these materials is the reason for the growing flow of Chinese FDI in Africa. Should this continue, it is reasonable to think that the renmimbi might be used to set the price of such commodities, excluding oil since Chinese demand is unlikely to top that of the US and EU for several years (Kelly, 2009: 9).

China is taking steady steps in the direction of internationalizing the renmimbi; in the long term, the country will have a fundamental role in every aspect of the world economy, including via the renmimbi (Dobson and Masson, 2009). The road is very long, however, and requires sweeping reforms in the still state-controlled Chinese financial sector. Controls over capital flows can only be withdrawn in the presence of a well-regulated, modern, private domestic financial system. In 1997–1998, the weakness of the domestic banking sector contributed to the crisis in Asian countries which had opened their capital accounts to foreign investments (Corsetti et al, 2005). The Chinese authorities have learned this lesson, putting

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the modernization of the financial side of their economy on the agenda (Barth et al, 2009; Cham et al, 2007; Huang, 2007). Even after this goal is achieved, the use of the renmimbi as a global reserve currency is still not assured, however, because the reputation associated with a reserve currency can only be built up over time, as the history of the dollar and sterling shows. Nonetheless, the renmimbi is likely to replace the yen as the leading currency in the Asian region. In the 1980s, due to its strong economic expansion, technological progress and the efficiency of its production, Japan was set to become the third pole in the international economy, alongside the US and EU, but after 20 years of stagnation, and over ten years of unprecedented Chinese growth, Japan can no longer aspire to this role, nor can the yen remain the only key Asian currency. The growing network of industrial and financial links between China and its Asian neighbour will give the renmimbi a crucial role in economic relations in Asia, as the euro has in Europe and Africa. The spontaneous evolution of the world monetary system will see the continuing central role of the dollar and the formation of two large regional areas dominated by the euro and the renmimbi. The final relative strength among the three currencies in the world monetary system will depend not only on economic variables, but on the ability of the US, the EU and China to face up to political and institutional challenges. In the US the aftermath of the financial crisis led to a huge expansion of public debt, creating new problems and threatening economic recovery, as well as sparking harsh debate between Republicans and Democrats, unable to agree on the solution. In Europe, the survival of the EMU depends on the will of European governments to move toward closer fiscal coordination and true fiscal union. Finally, the Chinese government has the duty to switch the current export-led growth model toward higher domestic demand, simultaneously reforming the financial system along with easing state controls over capital flows and the exchange rate.

Should each currency area be successful, the resulting world economy would nonetheless benefit from a new supranational currency and supranational institutions, because the flaws and asymmetries of an international monetary system based on national currencies would persist in a three-currency world.

NOTES

1. In terms of per-capita GDP, China is still a poor country.
2. The IMF includes the following 34 countries in the Advanced Country group: Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan,

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Korea, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and the United States.

3. Emerging countries FDI in advanced countries mainly have the form of mergers and acquisitions of existing companies (brownfield investments) rather than investments in newly established companies (greenfield investments).
4. The gravity theory of international trade draws on Newton's well-known gravity equation using trade flows between two countries as the gravity force between two objects. In this view, international trade flows between two countries *i* and *j* are positively related to the countries' economic size, typically measured by GDP (Y_i, Y_j), and inversely related to geographical distance *D*. A typical standard gravity equation is therefore: $T_{ij} = A \cdot Y_i^a \cdot Y_j^b / D^c$ where *a*, *b*, *c* are the weights to be estimated.
5. The GATT promoted the development of international trade adopting a multilateral discussion strategy that was implemented in nine 'discussion rounds' named after the location or the promoter of each round. In sequence, the rounds were: the Geneva Round (1947–1948), the Annecy Round (1949), the Torquay Round (1950–1951), the Geneva Round (1956), the Dillon Round (1960–1962), the Kennedy Round (1963–1967), The Tokyo Round (1973–1979), the Uruguay Round (1986–1993), the Doha Round (2001. . .). The first seven rounds focused on trade in goods and tariff reductions. The Uruguay Round extended discussions to trade-related issues, such as patents and phytosanitary measures, and led to the creation of the WTO. As of today, the Doha Round has not produced any new treaty because of harsh disagreements between advanced and emerging countries on the opening of US and EU agricultural markets.
6. The EU clearly inspired the African Union whose institutions comprise a Commission, an Executive Council and a Pan-African Parliament.
7. A vehicle currency facilitates the exchange between two minor currencies. Currencies with little international supply and demand are more easily exchanged using the vehicle currency in an intermediate step. In the first step 'currency one' is exchanged for the vehicle currency, which is readily available and accepted worldwide. In the second step, the vehicle currency is exchanged for the other minor 'currency two'.
8. The data presented in Figure 4.5 do not offer a complete picture of the currency composition of international reserves due to the lack of information from many countries.

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