Chapter 1

Overview: Globalisation and the role of international governance

Globalisation has become associated with difficulties for less-skilled workers, inequality and a general sense that it is not benefitting large sections of society, in both advanced and emerging economies. While there is much to be done with domestic policy to improve outcomes, there is also a strong need for better alignment of domestic and international policies and a more level playing field in the cross-border activities of businesses. This requires a commitment by countries participating in globalised markets to a common set of transparent principles that are consistent with mutually-beneficial competition, trade and international investment. This would reduce the problems left to be dealt with by domestic policy by improving resource allocation (promoting productivity growth) and reducing the extraction of rents (that harm consumers). Major factors that make for an uneven global playing field are examined in this Outlook. Empirical evidence is provided on their importance and rules that could help to improve outcomes for trade, innovation, investment and competition are discussed.

Perhaps the single most important issue in the outlook for business and finance is heightened political uncertainty resulting from the rebuff to globalisation which has been gaining traction. Recent major surprises in elections and referendums seem to have a common theme: discontent with globalisation that is perceived to be the cause of unemployment and/or the stagnation in absolute living standards for significant sections of society.[1] This year's *OECD Business and Finance Outlook* discusses some of the more important global (cross-border) factors that influence such outcomes. It makes the case for policies that promote greater "fairness" (in the sense of a level playing field in trade, investment and corporate behaviour) through the setting and better enforcement of global standards. Improving outcomes in this way would reduce the burden on domestic policy from the outset.

Globalisation is being tested

Evidence presented in this *Outlook* shows that globalisation, in particular growing trade and investment flows and the increased involvement of emerging markets in the world economy, has brought benefits to all countries. This is quite different from saying that the gains are also shared evenly. The great surges in income inequality post-WWII seem to have occurred after two significant globalisation movements and, in recent years, there is strong evidence of a hollowing out of the middle classes in advanced countries related to trade and technology. This suggests the need for a debate on the issue of globalisation and fairness in the distribution of gains from trade and international investment. This very complex issue needs to move beyond generalisations about "openness" towards providing more detailed ("granular") evidence on the diverse factors at work.

The extraordinary success some large emerging economies have had in pulling millions of people out of poverty in the past couple of decades is one of the most positive aspects of globalisation. This has also had many benefits for advanced economies, such as cheaper imported consumer goods and increased exports to these newly-industrialising nations. Evidence is also presented to show that in recent years the sheer scale of these successes, in conjunction with other related developments such as digitalisation, technology and innovation, is adversely affecting some less-skilled and middle-class jobs in advanced countries.

In a sense, the whole process of globalisation is being put to the test and raises questions about the balance between traditional domestic policies and the need for stronger global level-playing-field rules for cross-border activities.

On the domestic policy side, advanced economies have not done enough with respect to infrastructure investment, structural reforms, safety nets, worker retraining, education, and kick-start adjustment support for trade-exposed workers. These aspects at least have the advantage that sovereign governments can take decisions to do more. There is no such authority for the international governance of all cross-border activities of private companies and state-owned enterprises. Advanced and emerging economies have not done enough to promote a level playing field.

This *Outlook* focuses mainly on these cross-border issues, the combined effects of which have neither been adequately researched nor addressed in effective policy action.

Better global governance is urgently required

To set the scene for this discussion, two issues are addressed at the beginning of this *Outlook*: the impact of the greater role of emerging markets on world trade; and the effects of this and technological advances on labour markets and the "hollowing out" of the middle class. Firstly, with respect to trade, evidence shows that post-2001 there is a 15% to 18% rise on average of all bilateral exports (not just those with emerging markets) due to the increased overall size of the world market. Secondly, as economic theory would predict, wage growth and employment for less-skilled workers in advanced economies were affected as emerging-economy workforces began to be integrated into global value chains.[2] Labour market mobility in advanced countries in particular has been limited – with impacted workers not moving to new locations and industries. Those suffering from the "downside" of more trade openness and related technological change have been unable to adjust adequately to the new environment. Conventional economic wisdom has always called for active labour market policies and retraining. While some of these measures have been employed, they have tended to be piecemeal and inadequate to the task, so more needs to be done.[3]

However, in addition to improved domestic labour market adjustment and macro policies, what is needed is globalisation that operates according to a common set of rules and principles. This has been the relatively neglected area where not enough progress has been made. Without this, countries and companies acting in their own self-interest may use tactics and policies to distort the outcomes of greater openness in their favour. In so doing, they risk retaliation and this interferes with market-based economic adjustments, blocks the path of firms to improved productivity growth and exacerbates effects on trade- and technology-exposed workers. Thus, the net gains from openness will be smaller than they might have been and may not be shared according to productivity-based economic merit. Left unaddressed, the burden on domestic policy is unnecessarily increased.

Company insights on globalisation

The ability of the world to grow with stable and rising living standards for all depends on productivity growth which makes it possible for all participants in the economy to be better rewarded over time. Enabling factors at the macro level such as well-developed infrastructure are available to all players, but not all firms succeed in taking advantage of them to drive innovation and growth. The business and finance aspects of the current economic situation demand a closer look at companies. Why some firms succeed and others fail, and whether there are enough of the former and an appropriate exit of the latter, is critical for understanding the impact of globalisation on those most exposed to greater integration with the rest of the world.

Based on a large global sample of companies, this *Outlook* presents empirical research results which are consistent with the new firm-based trade and productivity theories. This is a process whereby the most successful (cash-flow-generative) firms invest more in technology (via research and development), attract higher-skilled labour and expand through increased foreign sales. This, in turn, generates further economies of scale and innovations. The evidence shows that it is precisely the companies that succeed the most in raising productivity through entry to foreign markets and innovation that are

associated with better returns, and rising value added and wages per worker. Companies that do not innovate and/or compete well globally see declining returns and falling average value added and wages for their workers. These pressures occur within industries, rather than between them. While all industries are affected in this way, evidence from the vast "Materials" and "Industrials" sectors is provided and shows them to be amongst the clearest examples of this phenomenon.

Openness promotes opportunities for business. But the governance of trade, international investment and competition has not advanced enough to foster better outcomes. The *Outlook* provides empirical evidence on how uneven elements of the playing field block economies of scale, misallocate resources and undermine fair competition. The global governance issues (the "rules" and "norms") that affect the "levelness" of the playing field are discussed in relation to eight contributing factors: *(i)* exchange rate and capital account management; *(ii)* financial regulation; *(iii)* subsidies for (and the governance of) state-owned enterprises; *(iv)* collusion in the form of cross-border cartels; *(v)* higher costs of underwriting new equity and bond financing resulting from the way fees are charged by global financial firms; *(vi)* barriers to trade in financial services that have unintended consequences preventing insurance and pension funds from doing an adequate job; *(vii)* responsible business conduct in global supply chains; and *(viii)* bribery and corruption in international investment.

The holistic discussion in Chapter 2 of the *Outlook* is followed by three more detailed chapters where further elaboration was felt to be necessary, particularly with respect to the OECD instruments that target better global governance.

Exchange rate and capital account management

The first set of issues concerns exchange rate targeting (whether by advanced or emerging economies) supported by capital account management, and/or the setting of traded goods prices for market share (with state support), that distort relative prices (discussed in section 2.3). These practices have the potential to block gains in foreign sales of firms from one country in favour of those of another, and therefore to block companies' paths to higher productivity via scale economies. Empirical evidence is presented on the extent of over- and under-valuation which suggests the issue is quite complex. Based on purchasing power parity, the real exchange rate is found to be overvalued for most advanced countries (above the level justified by real living standards) and more neutral for China following recent weakness (despite heavy intervention to resist appreciation in earlier years), while other emerging economies such as India appear undervalued. Given their level of development, countries may wish to resist moving into overvaluation territory (as advanced countries tried to do in early post-WWII years). The exchange rate effects in a gravity model of exports are found to be not that strong. Exchange rates may, however, be less important than a tradable-goods-pricing strategy focused on winning and maintaining market share. With government backing, profit margins of state-owned enterprises, for example, can be used to offset changes in costs and the exchange rate, and subsidies and other cost-reduction factors may also help in this regard.

The evidence from a gravity model of exports is much clearer for the capital account management policies that often accompany managed exchange rate regimes. Since 2001, when the vast Asian market became better integrated into expanding global value chains,

openness with respect to investment and the capital account has become more important in supporting bilateral trade. This evidence relates both to foreign direct investment (FDI) and banking and portfolio flows. In terms of better level-playing-field rules in this area, the OECD Codes of Liberalisation are designed to make capital account management policies more transparent and provide a framework for moving towards more openness in the longer run, while still allowing for different stages of economic development.

The level playing field in financial regulation is rolling risks into new areas

The second set of issues concerns inconsistent financial regulations (between countries and sectors) that are driving risks into new areas (section 2.4). There has been huge progress in improving the quality and quantity of bank capital, and new Basel regulations have helped to deal with liquidity and funding problems that emerged in the crisis. But two anomalies remain. One derives from differences in the role of banks versus capital markets in different jurisdictions that leads to competitiveness and considerations other than financial stability in writing regulatory rules in practice. The other is more technical in nature, and stems from persisting with the Basel II idea that it is permissible to allow banks to use internal risk models to calculate capital weightings. It is shown that the Basel risk-weighting system gives banks scope to have different leverage for the same capital rule in different banks and jurisdictions, in contradiction to the goal of a level playing field. On average, the ratio of risk-weighted assets to which the capital rule applies for global systemically important banks was driven down (i.e. leverage up) from 50% in 2003 to 34% by 2008. The aftermath of the crisis has seen deleveraging and a sharp pulling back of capital from cross-border activities in most advanced countries as re-regulation proceeds.

The attempts (by "shadow banks" and countries previously dependent on cross-border banking flows) to deal with the effects of regulatory reform and bank business model changes in advanced countries may increase contagion risk between sectors. For advanced countries, empirical evidence shows improvement in this regard only in the United States, with contagion risk between banks and shadow banks largely unchanged post-2008 in Europe and the United Kingdom, and some mixed evidence in Japan and Australia. Increased contagion is most extreme in emerging markets, where the use of off-balance sheet special purpose vehicles (particularly so-called wealth management products managed by banks) has contributed to the emergence of two-way contagion risk between the riskiness of banks and shadow banks (significant even at the 1% level). This was not statistically identifiable prior to 2008. Broad principles that would serve to level the regulatory playing field are discussed.

State-owned enterprises and excess capacity

The third set of issues, discussed in section 2.5, concerns distortions resulting from subsidies and other advantages accorded to state-owned enterprises (SOEs) which tend to be greater than for private companies. Unlike exchange management, this support, where present, is pointed to particular industries and enterprises of strategic interest. SOEs have grown as a share of key world industrial sectors and most are domiciled in Asia. Importantly, they include very large financial companies which play a key role in funding other SOEs across most business sectors, sometimes on favourable terms.[4] This and other forms of government support have raised concerns about unfair practices that make for an

un-level playing field and lead to excess capacity in some industries. This, in turn, exerts downward pressure on margins and the return on equity (ROE) versus the cost of capital (COK) more generally. In advanced countries, ROE versus the COK for a large selection of private and state-owned enterprises moves in line, but has declined from the 8% to 10% range in 2005 to 4% to 6% more recently. ROE minus the COK for emerging-economy companies on the same basis has fallen from 4% to 6% to -1% to 1%.

Where excess capacity has emerged, concerns also arise about the difficulty of reducing production potential and facilitating the exit of inefficient firms in the SOE sector. Company data show the high levels of debt of emerging economy SOEs. Since fixed costs are high, this indebtedness gives rise to incentives to produce and export more in order to reduce variable costs. Section 2.5 also provides evidence on the exporting of excess capacity. Industrial policies based on infant-industry protection and state aid need to be carefully calibrated if they aim to correct market failures; otherwise they will undermine competitive neutrality and weaken incentives for the entry of more productive firms and the exit of inefficient ones. Such policies result in trade and investment tensions, including barriers to cross-border FDI flows, when unfair support is suspected. Rules to ensure a level playing field for competition between private and state-owned enterprises remain necessary. The OECD has published several guidelines for SOE governance and ownership best practices which are designed to deal directly with many of these issues.

Cross-border cartels

The fourth set of issues relates to the treatment of consumers (section 2.6). Competition between multinational enterprises drives out inefficiencies and creates economies of scale. This helps to reduce prices and pass on the benefits of globalisation to consumers. However, collusion through cross-border cartels can deny consumers these benefits and pass them instead, through higher prices, to profits and ultimately to the owners of shares. This overcharging hurts consumers and hits low-income families hardest in what they pay for necessities (including banking, pharmaceuticals, retail services, transport, white goods, etc.). This is no small matter. Two hundred and forty cross-border cartels were detected and fined between 1990 and 2015, affecting USD 7.5 trillion in sales. Average overcharging amounted to 20% of sales, and was at times much higher in some key commodities, such as pharmaceuticals.

In a sense, the import competition-exposed worker is hit twice: via lower employment and wage remuneration while paying higher prices for essential goods and services. The need to address the issue of cross-border cartels and overcharging goes hand in hand with other considerations bearing on the level playing field – consumers as well as companies need to be treated fairly. The cross-border activities of SOEs also fall into the competition policy domain, intersecting with the corporate governance issues noted above, if competitive neutrality is to be maintained. OECD instruments on bid rigging, dealing with hard core cartels and the way to enhance co-operation between competition agencies are all designed to deal with these issues.

High costs in underwriting and the cost of capital

A fifth set of issues on the activities of some global firms that adversely affects the ability of others to grow illustrates that it is not only government support that undermines competitive outcomes (section 2.7). Equity finance is well-suited to long-term risk taking on investment projects (where a failure does not leave a firm with an unsupported debt burden), and yet, since the crisis, corporate debt issuance has been enormous (particularly from emerging markets) and equity initial public offerings (IPOs) have fallen off. This has been associated with US, UK and European banks losing market share in their investment banking activities to China and other parts of Asia. While the one lead underwriter model has given way to consortiums of banks and more cross-border involvement in underwriting for corporate issuance, high levels of fees and parallel pricing appear to have increased. The median underwriting fee for US IPOs is 7%, and this has risen to 8% in Japan and China (doubling in the case of the latter). These high fees, which constitute more than 60% of the total cost, are a neglected aspect of the explanation for falling IPO issuance. In the case of IPOs of less than USD 100 million, the average cost is 9% to 11% of the transaction. This means that for every 10 IPOs, the market value on an entire new company accrues to fees. This increases the cost of equity and works against long-term productive investment. Reinforcing competitive conditions in these markets could lead to better outcomes.

Cross-border barriers to trade in financial services

Direct barriers to trade in financial services will (like other trade restrictions) work against a well-functioning global economy. Three examples are provided in section 2.8. First, the benefits of international reinsurance in terms of being able to absorb the burden of large-scale catastrophe losses may not be realised where (unwarranted) regulatory impediments are placed on insurance companies' ability to transfer these risks within international markets. This is because global pooling is critical to reinsurance. Examples from the Great East Japan Earthquake and Superstorm Sandy are provided. Second, domestic rules and regulations for pension funds that encourage them towards a home-country bias increase the difficulty of achieving funding targets and reduce diversification benefits. Finally, with respect to Brexit, the City of London is an agglomeration that serves the global financial system from which economies of scale and scope (internal to the location) are derived. Commitments under the OECD Codes of Liberalisation provide room for a pragmatic approach to the United Kingdom's exit from the European Union.

Responsible business conduct and due diligence in global supply chains

Section 2.9 discusses issues relating to responsible business conduct (RBC). While most of the previous sections focus on distortions to pricing or inconsistent regulations that raise "fairness" issues, RBC pertains to global business outcomes in the context of sustainability of supply chains. Gains from trade and international investment apply to all points (upstream and downstream) in the supply chain, and sustainability of these cross-border linkages is important for long-term growth. Supply chains may be disrupted when

human rights issues, damage to the local environment, and over-exploitation of resources result in disputes with local communities, strikes, government interventions and legal processes. It is important not to focus on short-term profits at the expense of supply-chain sustainability and longer-term financial performance for investors.

Sustainable supply chains and better company financial performance can go hand in hand – a "win-win" outcome. Evidence is presented which shows (after allowing for other control factors) that a rise in the social score component of the Thomson Reuters Economic, Social and Governance (ESG) index improves company financial outcomes. A rise of 0.5 in the ESG score (a normalised Z-score between 0 and 1.0 that is based on a survey of 6 000 global companies) increases, on average, the return on equity for companies in the sample by around 2.5 percentage points. Numerous academic studies also support the positive impact on company results. Thus, pursuing due-diligence strategies in supply chain management could have a strong potential to improve trust and reduce social and environmental disruptions to trade and international investment flows which block firm-level paths to better productivity and sustainable growth. OECD instruments relating to the behaviour of multinational enterprises and supply chain due diligence are well suited to this task.

Bribery and corruption

The final level playing field issue, discussed in section 2.10, concerns the bribery of foreign officials. These activities distort the allocation of resources and undermine the benefits of globalisation. Rent-seeking behaviour through bribery and corruption is estimated by the World Bank to be 2% to 3% of world GDP (equivalent to the size of the French economy). This wastes resources. Thus less dynamic firms can win contracts in countries with weak bribery laws and/or poor enforcement at the expense of more productive ones. Bribery and corruption cause economic rents to be diverted to private benefits (including to dictators and military leaders) rather than being invested in technology, education and training, and quality infrastructure in the host country. Such investment would enhance productivity growth and allow real incomes to support demand in emerging economies. An empirical study presented in that section shows that strong bribery laws consistent with the OECD Anti-Bribery Convention cause adherent countries to invest less in corrupt regimes and more in countries with sound property rights and accountability. A one point rise in the World Bank corruption index in the host country (within a 0-10 range) will see FDI from countries that have ratified the OECD Anti-Bribery Convention fall by between 4% and 9%. Corrupt countries therefore forego the benefits of more investment (and hence better productivity growth) from the OECD countries that are amongst the largest FDI investors.

This section also takes a first look at bribes paid by financial intermediaries that play a key role in the allocation of resources. The perception that high-level managers of financial firms from wealthy countries bribe officials from poor countries (most often inside SOEs) appears to be correct. This contributes to creating an investment climate whereby globalisation does not benefit large parts of the population. Greater adherence to, and enforcement of, the OECD Anti-Bribery Convention would help to increase the universe of less corrupt foreign investment destinations, thereby helping to level the playing field and promote sustainable growth. Stricter enforcement could help to improve the face of globalisation in the world economy.

Conclusions

The 2017 *OECD Business and Finance Outlook* provides detailed evidence that suggests the problems (such as inequality, the hollowing out of the middle class and employment of less-skilled workers in advanced countries) often associated with globalisation do not originate from economic "openness" as such. Instead, while recognising that not enough has been done with respect to domestic structural adjustment policy, the *Outlook* shows that the absence of a level playing field in a number of cross-border areas that affect trade, investment and competition outcomes is also playing an important role. This evidence warrants policy action. Levelling the playing field would help to reduce the extent of the problems to be dealt with by domestic policy. OECD standards can play a leading role in shaping this conversation, and promoting globalisation on a level playing field. This requires a commitment by countries participating in globalised markets to a common set of transparent principles that are consistent with mutually beneficial competition, trade and international investment.

Notes

1. For example, Pew research found in a survey of the US adult population that among the factors that hurt American workers most are outsourcing (80%) and imports (77%). Pew Research Center (2016), Social and Demographic Trends, 6 October, www.pewsocialtrends.org/2016/10/06/the-state-of-american-jobs/.
2. The generalised Stolper-Samuelson theorem predicts that for real factor returns increased trade will see the return to the scarce factor go down while that for the abundant factor go up. In advanced countries, capital is more abundant and unskilled labour relatively scarce and the reverse is true in emerging economies. Increased trade will reduce the return for unskilled labour in advanced countries and vice versa in emerging economies. Separately, if unskilled wages are sticky in advanced countries and cannot fall sharply enough to increase attractiveness relative to capital, then unemployment of unskilled workers would rise .
3. While not the focus of this study, it should be noted that other macro policy settings also affect labour market flexibility in unintended ways. For example, very low interest rates can stimulate house price inflation in more prosperous regions which may, in turn, influence the ability of workers to move from declining trade-affected areas (with low house prices) to more prosperous regions with more expensive housing. Macro prudential measures to dampen regional house-price bubbles could also be useful alongside traditional labour market policies.
4. The other SOEs are smaller than the banks as state industrial policy is often organised on a regional basis. Chapter 2.4 discusses some issues about the activities of these banks from a financial stability perspective.

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