2008/2009

TOP 10

GLOBAL ECONOMIC CHALLENGES FACING AMERICA'S 44TH PRESIDENT

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THE TOP 10 GLOBAL ECONOMIC CHALLENGES FACING AMERICA'S 44TH PRESIDENT

By Lael Brainard

THE 2008/2009 TOP 10 GLOBAL ECONOMIC CHALLENGES
Edited by Lael Brainard

With America's next president taking office at a moment of consequential global challenges that even the most powerful nations cannot resolve on their own, there is a clear need for leadership. But with U.S. financial turmoil reverberating against the backdrop of a profound global shift in economic power, America's capacity and will to provide that leadership are less clear. Nonetheless, given America's enormous stakes in a strong and resilient global economy, it will be critical for America to lead on the main challenges we face today.

THE GLOBAL CONTEXT

The "made in the USA" financial crisis comes at the same time economic policymakers are confronting the emergence of a group of rising powers, from China and India to the Gulf states and Russia. We are now living in a rapidly shifting economic environment. Following 35 years of strong economic output by the Group of Seven economies, during which they commanded approximately 65 percent of the global output and the so-called "BRIC"—Brazil, Russia, India, China—economies accounted for about 7 percent, we have seen the Group of Seven's share falling to 58 percent over the past five years and the BRIC's share rising to more than 11 percent. By 2030, according to Brookings expert Homi Kharas, the two groups are expected to converge towards parity, with each accounting for about one-third of world output. The BRICs and other emerging economies are booming, integrating into the global economy, and learning to assert their interests more forcefully.

This revolution in national income shares is emblematic of a broader global dispersion of wealth and economic dynamism. In contrast to the shift of the world's financial epicenter from the City of London to Wall Street in the interwar period, stock markets and commodity exchanges are now proliferating in multiple financial centers; thus, in 2006, 18 of the 20 largest initial public offerings took place outside the U.S. and were spread out among 11 stock exchanges. Indian and Brazilian multinationals have made major acquisitions of flagship European and North American brands. And in 2007, a new breed of sovereign wealth funds injected more capital into shaky U.S. and European financial institutions than the International Monetary Fund provided to Asian economies at the height of their financial instability in 1997.

THE CHALLENGE

The rapid growth of the rising powers is creating enormous opportunities but also putting considerable strain on resources from food to water to energy, contributing to global inflationary pressures, just as humanity is waking up to the urgent need to wean the world's economy from its centuries-long dependence on carbon. Growing global integration also creates growing interdependence and mutual vulnerability—most visibly to financial turmoil—but also to food and energy shortages, pandemics, and vortexes of conflict and poverty.

The size, complexity, and opacity of financial transactions in the context of an outdated regulatory structure have shredded the traditional U.S. financial policy playbook. The recent actions by the U.S. Treasury and the Federal Reserve to intervene in the U.S. financial system through unconventional means on an unprecedented scale have added to foreign skepticism over Washington's conventional liberalization agenda. It will be many years before U.S. policymakers will be able to make the case for the full liberalization of capital flows in emerging markets. To many audiences in emerging markets, China's heterodox growth model, in particular, has gained considerably greater allure.

Growing integration on the real side of the global economy is similarly complex. Though trade ministers sign all types of bilateral and mini-lateral trade agreements, and global trade flows are going gangbusters, multilateral and major regional trade negotiations are going bust.

Although polarization has grown on trade, there is growing convergence on the critical importance of global development. While the U.S. public has rallied around grassroots efforts to raise spending on HIV/AIDS and provide debt relief, U.S. military and foreign policy circles have come to recognize the fight against global poverty as a fight of necessity—not only because personal morality demands it but also because U.S. national security does as well. These two converging strands have helped provide the biggest boost to U.S. foreign assistance in decades, along with a proliferation of uncoordinated institutional arrangements to administer it.

In the next few years, every one of these challenges will be further complicated by the belated and patchwork attempts to mitigate and adapt to a changing global climate. A fundamental transformation of the world's economic paradigm away from the carbon foundations of the past nearly two centuries will require vast global flows of technology and capital.

AMERICA'S OPPORTUNITY

The top 10 global economic challenges awaiting the next President defy easy solutions but are vital to the prosperity and stability of America and the world:

1. **Restoring financial stability:** With our financial troubles at the center of the current global vortex, the U.S. has important obligations to strengthen the global financial system, including by strengthening our own financial regulation and diminishing our reliance on foreign credit. The next U.S. president should work with the international community to develop a common agenda for managing capital flows, including increasing flexibility in exchange rates to facilitate the adjustment of persistent imbalances, developing global codes for improved transparency of new players such as sovereign wealth funds, and updating the mission and governance of the international financial institutions to address today's challenges and engage today's players.

2. **Setting the right green agenda:** It is past time to muster the political will to act on climate change at the national level while also working to forge international agreement so that markets and regulatory policy will provide a consistent set of incentives to wean the economy from carbon foundations. It will require a delicate balance of persuasion and pressure to induce the fastest growing

emitters of greenhouse gases to take action in the face of concerns about growth. It will require much assistance and financing to help the most vulnerable nations adapt. And it will inevitably risk trade frictions as competitiveness concerns come to the fore if America takes on obligations ahead of its trade partners.

3. **Exercising smart power:** Investing in the education, health, livelihoods, and the security of the world's poorest not only makes Americans feel good about themselves but also makes the world feel good about America. It is critical to capitalize on the upsurge of support for global development among the U.S. public evidenced in increased advocacy, service, and individual giving to make sustained investments in lifting up the lives of the poor. It is critical to increase not only resources but also the impact of each dollar spent.

4. **Reimagining global trade:** Americans feel most secure about global engagement when they are well equipped to compete and have insurance against economic risks. This requires vigorously enforcing the trade rules and investing in economic competitiveness—lifelong learning, innovation, infrastructure—to widen the circle of winners, while at the same time developing effective and portable insurance systems for unemployment, health, pension, and earnings to provide economic security in the face of job dislocation.

5. **Navigating China's rise:** America will need to engage intensively bilaterally, regionally and multilaterally to shape China's continued integration with the international system of rules. On issues such as climate change, enforcement of trade rules and exchange rate adjustment, where the stakes are simply too high to ignore, America should look for cooperative mechanisms to advance its goals where possible but continue to press bilaterally and better deploy regional and international mechanisms where necessary.

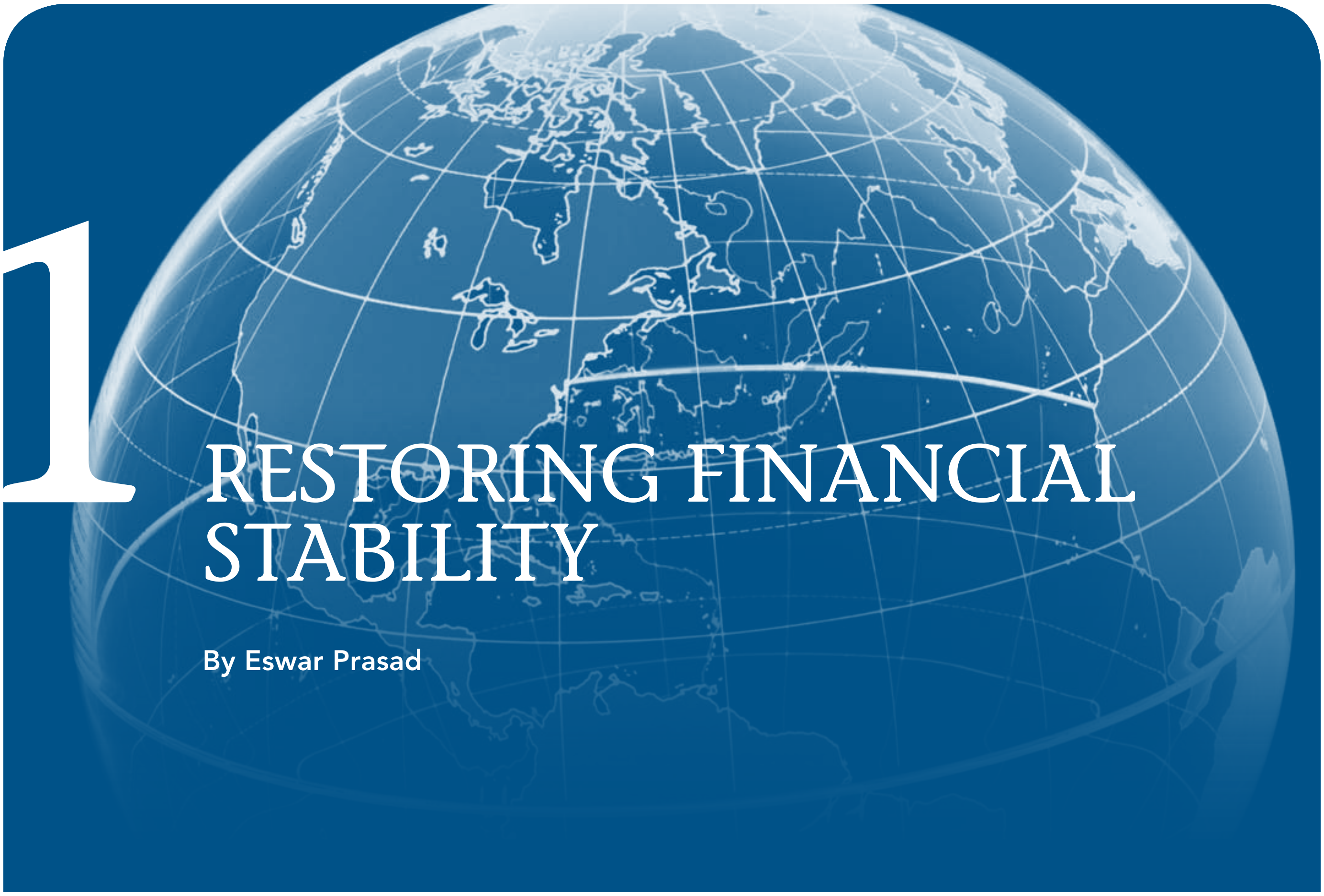
6. **Deciphering "Russia, Inc.":** Difficult as it may be to accomplish, America nonetheless has significant interests in alternately coaxing and goading a resurgent, resource nationalist Russia toward international norms and cooperation on energy, trade, financial integration and security more broadly.

7. **Engaging an emerging India:** America has enormous interests in India's successful integration into the global economy as the world's most populous democracy engages in the task of lifting hundreds of millions out of poverty. Yet India poses challenges in areas ranging from integrating global agricultural markets to combating climate change, and the country's success in global high value services markets has complicated America's internal debate on trade. America must look for areas of cooperation where possible and deepen bilateral engagement broadly in order to make progress on its agenda.

8. **Revitalizing ties to Latin America:** The United States has deep and abiding interests in vibrant economic relations with the nations of the Western hemisphere and a growing population with roots in the region—which are not matched by the quality of its engagement. America must become a stronger partner to its neighbors and engage on issues of mutual concern, including on energy, environmental protection, economic competitiveness and social policies.

9. **Supporting Africa's growth turnaround:** Many African nations have experienced dramatic, sustained growth during the past decade due in part to improved policy frameworks and increasing global demand for their products. America can become a stronger and steadier partner to Africa as it navigates economic challenges by supporting global standards for natural resource management, opening markets to African products, supporting vibrant private enterprises, supporting African efforts to enhance regional security and build resilience to climate change, and both increasing and improving the quality of development assistance.

10. **Pursuing a positive agenda for the Middle East:** Though America's leaders view the Middle East through the prism of Islamic radicalism, many of the region's leaders see their own core challenge as providing educational and economic opportunities for their burgeoning youth populations. America can build partnerships in the region based on trust and mutual respect if it aligns its agenda on economic and political reform with the aspirations of the majority of the region's people: the young who are striving for opportunity and global integration.



1 RESTORING FINANCIAL STABILITY

By Eswar Prasad

During the fall of 2008, the U.S. financial system careened on the edge of a meltdown, with the U.S. government effectively becoming the guarantor, lender and even investor of last resort. Whatever the final outcome of the ongoing turmoil on Wall Street, one thing is certain: The rest of the world will no longer be as enthusiastic about adopting the free market principles that have guided U.S. financial development. And current massive U.S. government interventions will also make it difficult to convince other nations that the state should stay out of the workings of the financial system.

THE GLOBAL CONTEXT

For years, credit in the U.S. has been easy and regulation has been light, with a resulting explosion of questionable lending practices and novel, poorly understood financial instruments. The famous "ninja"—no income, no job and no assets—mortgage loans were as clear a sign of regulatory negligence as any. But these obvious signs of malfeasance were all too easily ignored when times were good and the policy culture was hostile toward regulation.

Clearly, financial innovation without effective regulation does not work well. In the new world of more sophisticated financial markets, dangers lurk in hidden places. Central bankers and policymakers from Brazil to China have so far been spared the worst. Having resisted these lightly regulated financial innovations to some degree, they can now be grateful that their economies have not yet been pummeled by the unfolding crisis as much as America's has been.

In this decade, the emerging markets have become major players in international finance, not only receiving large inflows of private capital but also exporting large amounts of capital. Indeed, since 2000, industrial countries as a group have been running a current account deficit, which has been financed by the emerging market countries and, according to the International Monetary Fund, has reached more than $450 billion annually. Meanwhile, the proliferation of new financial instruments and the rising prominence of new players—sovereign wealth funds, hedge funds and institutional investors such as pension funds—have also changed the landscape, raising a number of challenges as the world becomes more financially integrated.

One thing the U.S. financial crisis proves is that fraud, corruption and government interference can eat away at the foundations of even the deepest financial systems, especially when these problems are compounded by a regulatory system that is too narrow and rule-bound in its outlook and that, at times, turns a blind eye to obvious rot in the system. As they embark on their own financial sector reform agendas, emerging markets such as China and India will learn much from the lessons of the painful U.S. experience.

THE CHALLENGE

In this context, the next U.S. president faces a challenge with several dimensions:

> **Lessons from the financial crisis:** The U.S. financial crisis confirms that some types of government involvement in financial markets—especially through the implicit backing of ostensibly "private" institutions—generates bad outcomes that inevitably end up with taxpayers footing the bill. The real lessons from the Fannie Mae and Freddie Mac debacle should be about the dangers of implicit government guarantees coupled with moral hazard and weak regulation, and the risks that lurk even in advanced financial systems.

> **New players:** The proliferation of hedge funds and mutual funds, and the amounts of money now controlled by them, have created concerns about the higher volatility of capital flows. Indeed, the increasing integration of international financial markets has, if anything, increased the risk of herding behavior, where capital flows are driven more by sentiment than by fundamentals. At the same time, it is equally plausible that institutional investors such as pension funds have a longer-term investment horizon and can add stability to the markets.

> **Political agendas:** Certain new players—such as sovereign wealth funds, which collectively control more than $3 trillion, by some estimates—are raising concerns about countries using these institutions to further their own political agendas. This has also generated worries in countries such as the U.S. that allowing domestic assets (firms, real estate) to be taken over by SWFs could create a threat to national security and broader national interests. Thus, the increasing size of SWFs and their attempts to make investments in some of the "crown jewels" of countries such as the U.S. makes investment protectionism a politically combustible issue, especially in view of their lack of transparency.

> **Currency issues:** A number of emerging market economies, while ostensibly moving toward more flexible exchange rates, seem to have a "fear of floating." This is evident in intensive management of the nominal exchange rate through intervention in the foreign exchange market. This results in the rapid accumulation of foreign exchange reserves when countries are trying to manage currency appreciation. Not only do these countries deprive themselves of a shock absorber; they also create ground for instabilities in international capital markets.

> **Common platforms:** It goes without saying that the traditional international financial institutions, such as the International Monetary Fund and the World Bank, still have a potentially important role to play in the smooth functioning of the international financial system. However, these institutions have been enervated by their small capital base relative to the volume of international capital flows. Moreover, the relatively modest share of total voting rights that emerging markets and developing countries have in these institutions has further undermined their effectiveness because these countries do not see these institutions as being advocates for their own interests.

AMERICA'S OPPORTUNITY

The next U.S. president should work with the international community to develop a common agenda for managing capital flows. Though each group of countries, depending on their level of development and openness to international financial flows, will have a different perspective on the agenda, joint action can be based on themes of common interest. As the largest economy in the world and one of the key players in international financial markets, the U.S. also has its own obligations to keep the system working well. The current U.S. financial crisis indicates that a set of rigid rules allows resourceful financial institutions to mask riskiness in their portfolios or shift things around to make standard risk metrics appear better than they really are. Instead of a regulatory framework that accounts for every specific financial instrument and institution, it would be preferable to develop a "principles-based" framework that can adapt to the evolution of financial markets and can adopt a broader approach to managing systemic risks. This framework should address several issues:

> **The U.S. fiscal problem:** One of the factors behind the large U.S. current account deficit and the vulnerability of the dollar to a sharp fall in value is the high level of the U.S. budget deficit. The U.S. current account deficit also creates the risk of a disorderly adjustment in world exchange rates; this turmoil could be especially harmful to emerging markets. Getting its own house in order will be important for the U.S. to be able to exercise an effective leadership role.

- **Managing capital flows:** The U.S. administration should encourage initiatives, for instance those undertaken by the International Monetary Fund, to create a set of standard operating procedures for SWFs. This would allow them to be better monitored, in exchange for fewer restrictions on the investment opportunities made available to them. Mechanisms for managing official capital flows in a more transparent way would be useful. For its own part, the U.S. needs to think about more efficient ways of delivering foreign aid that boost growth, minimize resource loss in the process of making aid transfers and do not create aid dependence in recipient countries.

- **Currency issues:** Countries like China should be encouraged to allow greater flexibility in their exchange rates. There is a case to be made that prolonged intervention in currency markets creates instabilities in international financial markets, which could ultimately hurt the very countries that are trying to forestall currency fluctuations. Moreover, many Asian countries as well as Gulf states that have tied their currencies to the dollar are facing complications in domestic macroeconomic management, particularly the control of domestic inflation. More important, exchange rate flexibility can play a key role in advancing countries' own reform priorities, including financial sector reforms and monetary policy frameworks that can respond more nimbly to domestic needs.

- **Global governance:** The U.S. should support further changes to the governance structure of international financial institutions such as the International Monetary Fund and the World Bank. To maintain the relevance of these institutions, emerging market and poor countries must be given a more prominent say in running them and institutions may make them more effective, it will also be necessary for the U.S. to support steps to increase their capital bases to enable them to respond more effectively to instances of global financial turmoil.

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2 SETTING THE RIGHT GREEN AGENDA

By Warwick McKibbin, Adele Morris and Peter Wilcoxen

Climate and energy issues will be some of the most urgent challenges facing the next U.S. president. These issues will need immediate attention to create a policy framework that will enable timely reductions in greenhouse gas emissions while minimizing the economic burden on American working families.

Much of the potential for effective U.S. government action depends on the ability of the next president to develop a coherent executive branch strategy, deftly navigate a complex congressional landscape, and ensure that American priorities help shape the post-Kyoto Protocol international climate agreement, despite weakened U.S. credibility. Implementing an effective and efficient domestic cap-and-trade program will require strong leadership and intense focus, not only to make complex trade-offs across potential legislative features but also to withstand the onslaught of pressures for special provisions that has plagued recent bills in the U.S. Senate.

Given the enormous economic implications of transforming the U.S. energy system and the environmental necessity for reducing greenhouse gas emissions, the new administration should pursue a climate protection strategy that cuts emissions while protecting the American economy—no easy balance. What follows is a sketch of one approach that would minimize the economic burden while spurring new technologies and adaptation, as well as setting a course for a stabilized atmosphere.

THE GLOBAL CONTEXT

At the heart of the international debate on climate policy lie two key tensions. First is the tension between the worldwide need to avoid damaging disruption to the Earth's climate and the critical importance of reducing global poverty. Analysts agree that the world's already-heavy dependence on fossil fuels is only likely to worsen if developing countries continue to stoke their rapid economic growth in traditional carbon-intensive ways. The second tension is over the distribution of costs and the competitive implications of mitigating greenhouse gas emissions. China and India argue not only that they cannot reduce emissions without technology and financing from rich countries but also that developed countries should act first because they are responsible for the buildup of greenhouse gases in the atmosphere. And though the members of the European Union and most other developed countries are unlikely to meet their targets, they have tried to take action by ratifying the Kyoto Protocol and taking steps to implement it. In sharp contrast, the U.S. rejected Kyoto and has taken no regulatory action at the federal level. As a result, the U.S. lacks credibility in international negotiations and will find it difficult to prevail until it makes a serious domestic commitment to action.

Therefore, despite dramatic recent growth in greenhouse gas emissions by developing countries and projections for more, the spotlight will be on the next president of the United States to reengage in the United Nations Framework Convention on Climate Change process and push for serious domestic emissions reductions. Clearly, the next president will need to act; the question is how.

THE CHALLENGE

Both major-party candidates for U.S. president have promised a cap-and-trade system for the control of greenhouse gas emissions with an eye toward reductions by 2050 of 60 to 80 percent relative to 1990 levels. Long-run objectives notwithstanding, the new president will need to focus more on getting the broad structure of the cap-and-trade system right and less on aggressive reductions that would undermine support for it. The next president will need to proceed judiciously to establish sound institutions, create incentives for new technology and build an effort that can endure for generations. Here's how to do it:

AMERICA'S OPPORTUNITY

> **Use the cap-and-trade program to set a modest but growing price on carbon and other greenhouse gases.** Moving to a low-carbon economy will require large long-term investments by all sectors of the economy. To encourage those investments, the government should provide clear, predictable long-term payoffs for them through a modest but credibly increasing price for emitting greenhouse gases. The price incentive can efficiently shift the economy to a low-greenhouse gas future. Starting modestly will reduce costs by allowing new technologies to develop before steep emissions cuts kick in.

> **Keep it simple.** Though it would be tempting to offer a "comprehensive energy plan," favor certain sectors and technologies, introduce goals other than climate protection and create new institutions, the simpler the better—both now and in the long run. Policies such as low carbon fuel standards, biofuel mandates, and renewable portfolio standards significantly raise costs by dictating how the cap must be met. They can also introduce unintended consequences such as deforestation and higher food prices. Giving free allowances for certain kinds of reductions (such as carbon capture and storage) or preferred sectors also raises costs by distorting investment away from least-cost solutions and forgoing revenue recycling. The key goal must be to create a clean, clear price signal with minimal bureaucracy.

> **Create incentives to sustain the program.** Firms will only invest in new technologies if they think the price on greenhouse gas emissions will endure and grow, so strong long-run incentives to keep the program intact are important. A variety of mechanisms could be used, ranging from creating multiple-year emissions allowances to auctioning allowances that won't be valid until future years. In either case, creating future emissions rights that can be traded (but not used) today will create a constituency of permit owners with a strong financial interest in continued climate protection, and could bring in extra revenue early on to fund research.

> **Control the risk of inadvertent stringency and laxity in the cap.** Chances are good that the trading price of allowances won't be exactly what lawmakers expect when they set the cap. If the allowances price is too high, consumers and the economy could suffer enough that the policy would be repealed. If it's too low, investors would have little incentive to look for cost-effective reductions and could miss greenhouse gas emissions targets. This could be avoided by establishing an annual preset allowance price range that would allow firms to buy extra allowances at the ceiling price. The best means to impose a price floor would depend on how the program sells or otherwise allocates allowances. Alternatives, such as a committee that can intervene at its discretion, could do more harm than good by increasing uncertainty in the allowance market.

> **Sell allowances and recycle the revenue.** Pricing carbon raises the prices of goods and services more broadly, effectively reducing the value of working families' wages, which are already subject to payroll and income taxes. The cost of this important "tax interaction effect" to the economy could be even higher than the direct cost of abating greenhouse gas emissions. The good news is that using revenue from allowances sales to lower other taxes (or the federal deficit) can offset the burden significantly.

> **Make serious investments in basic science and in technology research and development.** Higher carbon prices will provide strong incentives for private companies to accelerate development technologies that are nearly ready for the market. However, basic research on the underlying science and engineering will also be needed and will not be undertaken by the private sector alone. Funding that research should be a top priority for the

federal government. Priority research areas should include low-greenhouse-gas technology; large-scale carbon capture and sequestration; better means to adapt, such as improved crops and water management; and basic climate science to reduce uncertainty around the problem. In addition, much more research is needed on geoengineering, which could be needed if the climate begins to change rapidly.

> **Protect the poor.** All households will gradually feel the pinch of the carbon price, but the poor will be hit the hardest and soonest. The government should use some of the proceeds from allowance sales to benefit the poor, for example with lump-sum rebates, but it will need to recognize that every dollar used for redistribution will raise the total cost of the program by forgoing the benefits of revenue recycling.

> **Use domestic action to promote binding commitments by major developing countries.** Initially, the U.S. should introduce its domestic cap-and-trade program unconditionally. As the U.S. carbon price ramps up, the U.S. should parlay its domestic efforts into commitments by all major economies to reduce their greenhouse gas emissions, even relative to baseline projections. Although the competitiveness of U.S. industry vis-à-vis China is a potent political issue, domestic climate policies would have little effect on most industries that are exposed to international competition. Apart from a few sectors, such as aluminum refining, energy accounts for only a small share of the cost of most manufactured goods. Indeed, most energy is used for nontraded goods and services, such as local transportation and electric power generation. Introducing tariffs or border adjustments on imported goods to compensate for differences in climate policies among trade partners would be far more trouble than it would be worth. It would be administratively complex and impede trade, while producing very little protection for domestic industries and having little effect on the so-called leakage of emissions reductions to countries with low energy costs.

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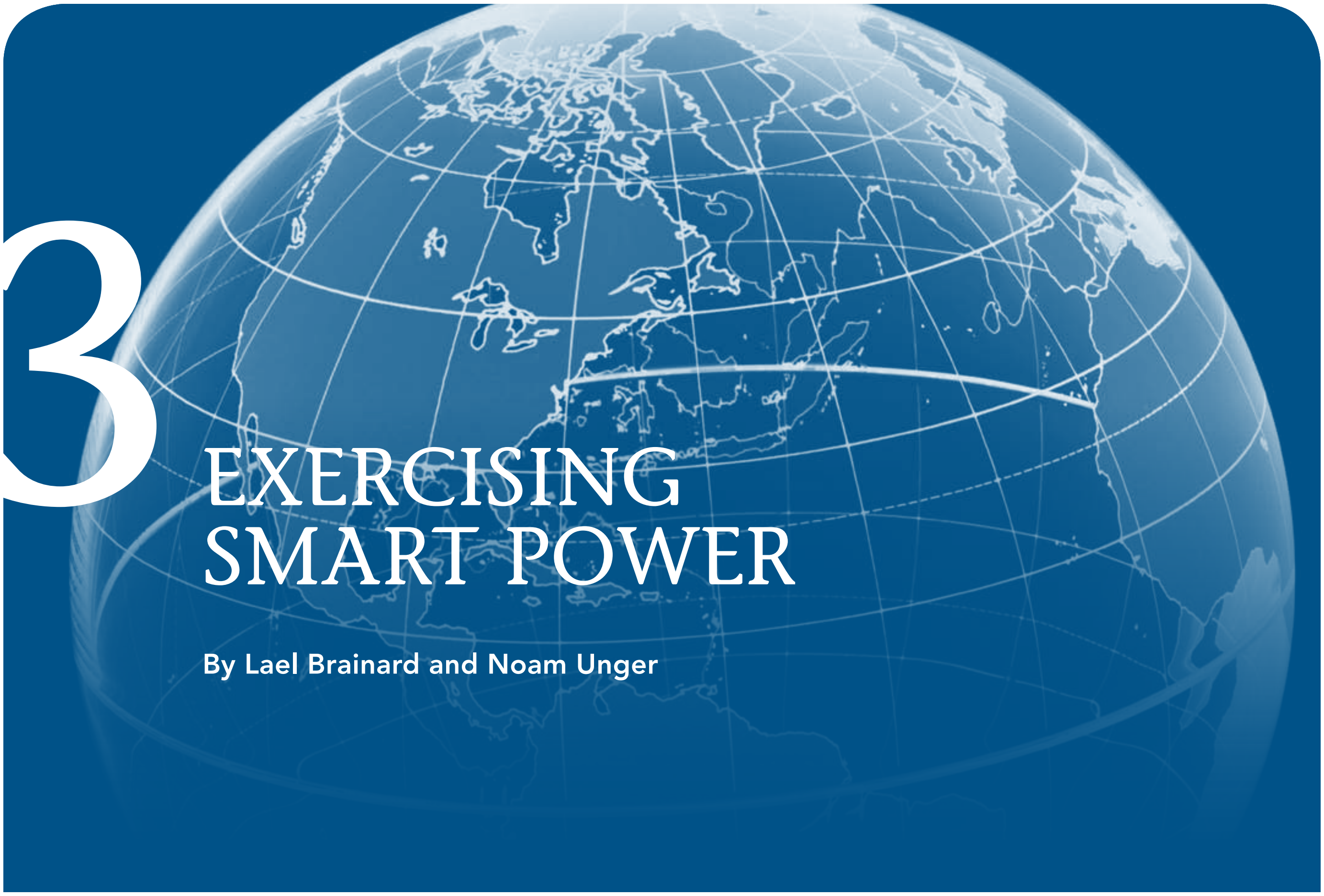

3 EXERCISING SMART POWER

By Lael Brainard and Noam Unger

The spectacular failure of the U.S. financial regulatory system is just the latest in a series of blows to America's standing in the world over the past eight years—which are particularly troubling against the backdrop of the emergence of new powers, notably China and India as well as resource-rich Russia and Brazil. As the new U.S. administration faces the critical challenge of restoring American leadership, it has a unique opportunity to readjust how America projects its global power. Friends and allies are more important than ever on today's interconnected globe, particularly as it faces sustained threats from climate change, poverty and pandemics as much as from terrorism. To strengthen its global influence, America must present a different face to the world, one that burnishes the country's smart power through more effective aid and stronger civilian, volunteer and private sector engagement.

THE GLOBAL CONTEXT

In a world where remote threats can rapidly metastasize into emergencies, the fight against global poverty has become a fight of necessity—because national security demands it no less than American morality. The U.S and the international community can and should do more to address key challenges—including fighting HIV/AIDS and other key infectious diseases while strengthening public health systems; boosting productivity in food production; and, more generally, improving the accessibility and quality of education, especially for girls; targeting poorly governed and conflict-prone states; and helping to mitigate and build resilience to climate change. From the world stage where leaders adopted the UN Millennium Development Goals to the local stage where individuals send text messages to the ONE campaign in support of antipoverty programs, the basic goal is clearly understood: to help the poor lift up their lives and with them the sustainability and stability of the planet.

America's engagement in the fight against global poverty harkens back to the best traditions of the Marshall Plan, the founding of the Bretton Woods institutions and John F. Kennedy's Alliance for Progress. But it also appeals to the best instincts of a new generation of Americans who are engaged in the fight against global poverty as never before. Individual donations from the U.S. to the developing world have surged to roughly $26 billion a year, exceeding official development assistance, and more than 50,000 Americans volunteer their time overseas each year. Americans' consciences, hearts and faith demand that the U.S. tackle deprivation because it is the right thing to do. But helping the poor gain access to shelter, medicine, sustenance, education and opportunity does more than make Americans feel good; it also makes the world feel good about America. When America leads in helping the poor lift up their lives, it enhances its own influence and authority in the world community—building support for its interests in other areas.

THE CHALLENGE

America's aspirations and aid dollars will surely exceed its impact on the ground unless and until it refocuses its foreign assistance strategy, modernizes its aid apparatus and builds its civilian capability. The urgent demands of postconflict reconstruction in Iraq and Afghanistan and humanitarian disasters have led to a faster rate of expansion of foreign assistance dollars in the last seven years than at any point since the Cold War. But instead of modernizing the U.S. aid infrastructure left from the Cold War era, the George W. Bush administration responded to each new global challenge by creating new ad hoc institutional arrangements alongside the old ones, such as the President's Emergency Plan for AIDS Relief, the President's Malaria Initiative, the Millennium Challenge Corporation, and the State Department's Office of the Director of Foreign Assistance. Meanwhile, by default rather than design, the Defense Department has been taking on a growing role, and it now accounts for one-fifth of U.S. official development assistance.

With all this recent U.S. institution building, the federal government's executive branch now has 50 separate units that share responsibility for aid planning and delivery, with a dizzying array of 50 objectives ranging from narcotics eradication to biodiversity preservation. Different agencies pursue overlapping objectives with poor communication and coordination. At best, this lack of integration means that the United States is failing to take advantage of potential synergies; at worst, these disparate efforts are working at cross-purposes. Meanwhile, at a time when aid dollars have grown rapidly, the number of civilians with the training and experience to effectively implement assistance programs has diminished sharply. As a result, the impact of American foreign assistance is falling short of the value of the aid dollars expended—which remains unmatched among bilateral donors.

Internationally, as Brookings expert Homi Kharas has shown, the average number of donors per country is growing, while the average project size appears to be shrinking, implying a growing fragmentation of aid and underscoring the need to improve global, as well as U.S., systems.

Making U.S. aid efforts not just bigger but also smarter—through better coordination, planning and aid administration—should be a primary objective for the next administration as it addresses global poverty.

AMERICA'S OPPORTUNITY

The next U.S. president will have the opportunity to:

> **Elevate development assistance to equal stature and independent standing alongside defense and diplomacy by aligning resources and capabilities with goals.** A Cabinet-level voice for development would serve as a bold commitment to ensure against the subordination of long-term investments in democratization, development and poverty alleviation to short-term political objectives. Instead of the 50 units currently managing its aid programs, the U.S. should have one operationally capable, integrated agency. Instead of the 50-odd objectives these units pursue, the U.S. should have no more than five strategic aid priorities: fighting poverty; supporting capable, accountable states that advance human development and security; and countering security, humanitarian and transnational threats. This focus is critical for maintaining broad support for expanded assistance. Instead of stove-piped trade, aid and debt policies, the U.S. should have a high-level policy coordinator in the White House and integrated task forces in the field.

> **Strengthen U.S. civilian capabilities** to assist weak and failing states by bolstering civilian capacity for conflict prevention, stabilization and reconstruction both inside the government and in reserve; increase the seniority of White House coordination; and ensure linkages between interagency planning and foreign assistance operations.

> **Showcase the spirit of American generosity by doubling the number of Americans who volunteer overseas by 2010.** The U.S. should do this by revitalizing and expanding its established programs that encourage volunteer service abroad. Also, with a small investment and by engaging key players outside government, the U.S can and must create innovative new approaches that support the myriad global service, cultural and educational exchange opportunities provided by America's vibrant faith-based and private volunteer organizations, universities and businesses. Finally, efforts supported by the U.S. government that are related to international service and volunteering should be drawn together under a Corporation for International Study and

Service, a globally oriented analog to the existing domestic Corporation for National and Community Service.

> **Adapt to and leverage the new ecosystem of global development players**—including multinational corporations, major individual philanthropists, high-profile advocates and especially the vocal and energized public working through grassroots and faith-based networks—that are fundamentally redefining the international development community. The next administration should create platforms and flexible funding mechanisms within the U.S. foreign assistance agency to systematically, proactively encourage multistakeholder collaboration; replicate and scale up successful innovations; and adopt common mechanisms for evaluating results and enhancing accountability.

> **Help developing countries fully integrate their climate adaptation activities into their broader national programs for reducing poverty and creating wealth.** The next U.S. administration can both redirect bilateral and multilateral funding to projects that are carbon neutral and help align development outcomes with climate resilience to minimize the threat of promoting climate maladaptation that inadvertently impedes human development or development programs that result in greater vulnerability to climate change.

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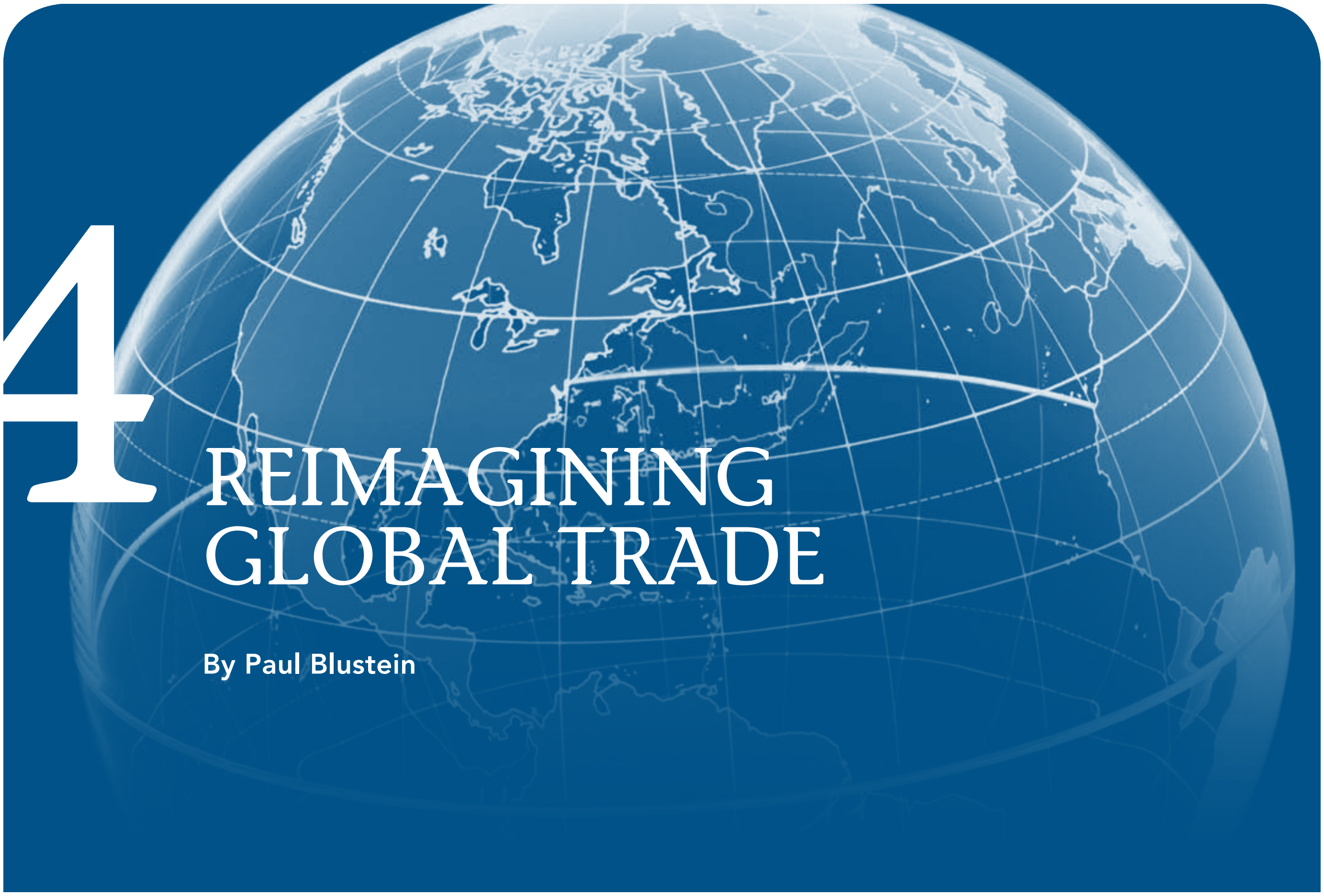

4 REIMAGINING GLOBAL TRADE

By Paul Blustein

By some measures, U.S. trade policy has been a blizzard of activity and achievement during George W. Bush's administration. In 2001, the United States played a crucial role in launching the Doha Round of global trade talks. In 2002, the White House won congressional authority to negotiate new trade agreements. And in subsequent years, Washington has secured bilateral free trade accords with numerous countries, including Chile, Singapore, Jordan, Australia, Morocco, Oman, Bahrain, five Central American nations and the Dominican Republic. Negotiations for free trade agreements with three other countries—Colombia, South Korea and Panama—have been completed by the administration but are tied up in Congress. However, these initiatives have produced very limited benefits, and they have left the global trading system in an increasingly parlous state for the next president and his trade representative.

Since the collapse in July 2008 of the latest effort to reach a Doha Round agreement, there have seemed scant prospects that a deal will materialize anytime soon—and certainly not one that fulfills the initial promise of providing massive trade advantages for developing countries. Another cherished goal of the Bush White House, the creation of a Free Trade Area of the Americas, has been stalled since 2003. As for the bilaterals, the countries with which the Bush team struck agreements are relatively paltry markets for U.S. exports. Taken together, the nations with completed deals account for less than 7 percent of total U.S. goods exported; if the pending accords with Colombia, South Korea and Panama are included, the figure is still only about 11 percent of all exports. (And that's just a sliver of the total economy; exports accounted for less than 8 percent of U.S. GDP in 2007.)

Moreover, although the administration's strategy was to use bilaterals as building blocks to regional and ultimately global trade accords, this approach, known as "competitive liberalization," has failed. Meanwhile, the administration's authority to negotiate new pacts expired in June 2007, and amid continued division in Congress over how trade deals should be structured, that authority is unlikely to be restored in the near future. The campaign vows by Sens. Barack Obama and Hillary Clinton to renegotiate NAFTA were emblematic of the antitrade mood in the American body politic.

THE GLOBAL CONTEXT

In the midst of this global situation, U.S. trade has not flagged in monetary terms. On the contrary, imports have played a crucial role in recent years in keeping inflation low, and exports have been a major factor in preventing the U.S. economy from falling into recession.

But the system that undergirds global commerce will be imperiled if its troubles are not addressed. In particular, the woes of the Doha Round raise profound concerns about the World Trade Organization's ability to continue as the main rule writer for global trade. For all its flaws, the WTO is a crucial lynchpin of stability—its rules keep a lid on member countries' import barriers; and by adjudicating trade disputes among member nations, it helps keep those disputes from flaring into trade wars.

The WTO's centrality was already in some doubt because of the proliferation in recent years of bilateral and regional trade agreements (fueled partly by Washington's enthusiasm); more than 200 of these accords are currently in force. To be sure, the WTO is hardly going to disintegrate overnight. But the more dysfunctional and irrelevant the WTO appears, the greater the danger that its authority will atrophy to the point that its member nations start to flout their commitments and ignore its tribunals' rulings.

THE CHALLENGE

The nations of the world have an enormous collective interest in ensuring that the multilateral trade system remains vibrant, and the best way to do that is to forge a credible, ambitious Doha Round agreement. The possibility of an accord on the main elements of the round before the end of 2008 cannot be ruled out, because a number of key leaders and trade policymakers—President Bush foremost among them—would love to burnish their legacies with such an accord. But the chances for a quick deal are remote, given the vast differences between key players—the U.S., China and India in particular—over the central issues of how much to liberalize trade in agriculture (that is, cutting both tariffs and subsidies). Overcoming these differences, and facing down powerful interests, will be a daunting task, especially for democratic governments.

Beyond the gaps in position among big powers, the Doha Round is suffering from the staleness of its agenda. Its ambition has already been whittled away. The deal on the table in July wouldn't have appreciably reduced current trade barriers; it would have mainly required member countries to lower their "bound" tariffs—that is, their legal maximums—to levels that are still above the "applied," or actual, rates. More important, the round in its current form would do almost nothing about several major trade-related issues that have arisen in recent years. One of these is the food crisis, which has prompted many nations to impose limits on crop exports. Another is climate change; some countries are moving toward imposing "green tariffs" based on the carbon content of imported goods, which may provoke challenges in WTO tribunals.

AMERICA'S OPPORTUNITY

The new U.S. administration should make it clear from the outset that its trade policy will be multilateral in focus; this can—and should—be coupled with a shift away from bilateralism:

- **Shoring up support for trade:** Perhaps most important of all, the new president must shore up support for trade, both in Congress and in the public at large; otherwise, no new trade agreements of any kind may be possible. This will entail bridging gaps on Capitol Hill over the key issue of whether trade agreements must contain enforceable standards for workers' rights and environmental protection. But much stronger steps will also be required on the domestic front, to expand the social safety net and health care. Mitigating Americans' legitimate worries about the disastrous impact of job losses is essential to turn the debate away from NAFTA's revision and toward enhancing the system that has underpinned the expansion of global trade for the past 60 years.

- **Breathing new life into the Doha Round:** The new president will have a historic opportunity to breathe new life into the Doha Round by proposing to broaden the negotiating agenda to include issues such as the food crisis and climate change. It is conceivable, of course, that such an approach will encounter such stiff opposition from other nations that it will prove impractical; if so, the administration should not turn to bilaterals and regional deals as an alternative but instead should pursue agreements in particular sectors (such as services) under WTO auspices with countries that are willing to liberalize.

- **Proposing a moratorium on bilateral trade agreements:** In addition, the president could propose a moratorium on bilateral trade agreements, a step that would be welcomed by many poor countries, which fear being marginalized in an increasingly splintered world of trade.

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5 NAVIGATING CHINA'S RISE

By Wing Thye Woo

China is growing rapidly through its outward orientation and engagement with the world economy. Its growth has provoked anxiety in the United States and concerns about its perceived unfair trade practices. The next U.S. president should enact policies that reduce the sources of anxiety, address trade practices, strengthen U.S. competitiveness, and develop a sustained strategy for working with China on international economic issues.

THE GLOBAL CONTEXT

China is pursuing a classic export-led growth strategy, hinging on two features: foreign demand to fuel output growth and foreign direct investment to upgrade its technology and expand its export capacity. Because of the massive scale of China's economy, this outward-oriented growth is generating tsunami-like waves affecting the farthest reaches of the global economy.

China's key growth mechanisms have been extensive investments in export-oriented enclaves and a massive redeployment of workers from low-productivity agriculture to higher-productivity, labor-intensive manufacturing. About half the country's exports are produced by non-Chinese firms and joint ventures located in these enclaves; and wages have grown unevenly and much more slowly than productivity in many areas, reflecting China's enormous amount of surplus labor from rural areas.

As China's economy has grown, so has its engagement with and integration into the Asia-Pacific region through its "smile diplomacy"—it has settled regional territorial disputes, abjured the use of force in Southeast Asia, and actively promoted and supported regional cooperation. A growing network of regional political agreements and arrangements place China at the center—ranging from the ASEAN + 3 agreement at the head-of-state level (the three additional participants being China, Japan, and South Korea) to a dizzying array of regional and bilateral trade and monetary arrangements.

On the international scene, Chinese officials have pursued deft economic diplomacy, winning over potential adversaries. Despite some stark differences in the Doha Round negotiations for the World Trade Organization relative to developing countries like India, China has worked with other rising powers to shape these negotiations' agenda. Though the chronically large balance-of-payments surpluses of China indicate an undervalued exchange rate, it has managed to deflect serious interference by the International Monetary Fund.

However, in light of the experience of dealing with Japan's trade surpluses in the 1980s, it must be recognized that the adjustment of the bilateral U.S.-China exchange rate alone is not a silver bullet that would eliminate U.S. external imbalances. A huge appreciation of the renminbi—unaccompanied by a large, generalized appreciation of other Asian currencies—would significantly reduce only the bilateral U.S.-China trade imbalance but not the U.S. overall trade deficit because imports from third countries would replace imports from China. A drastic decline in the U.S. overall trade deficit would require policy actions on a broad front in both China and the U.S.—for example, budget deficit reduction in the U.S. and financial sector restructuring in China.

China's sustained rapid growth, along with that of India, has contributed to a big jump in commodity prices. The higher costs of inputs have two negative effects: reducing profits and hence lowering the supply of the final goods; and causing the prices of final goods to rise, thus preventing profits from absorbing the entire cost increase. This stagflationary (inflation-amid-contraction) situation has confronted the central banks in Europe and the U.S. with the difficult choice of contracting credit to blunt higher inflation or of expanding credit to offset reduced production. This dilemma is now complicating efforts to meet the new challenge of creating additional liquidity to calm the financial turmoil that started with the bursting of the U.S. subprime mortgage bubble in February 2007.

Inevitably, weakened demand in the U.S. and Europe is being transmitted to suppliers in Asia and elsewhere, in turn slowing down their growth, and hence moderating the commodity price boom. The lesson is that economic globalization has created such complex interdependence and new powerful actors that the guardianship of global prosperity has become a multilateral enterprise, in which widening cooperation (for example, in trade deregulation, financial flows and environmental commons) is paramount for avoiding unintended negative side effects.

THE CHALLENGE

China's growth has been accompanied by growing anxiety in the United States. While U.S.-based multinationals rush to establish a foothold in China's growing market and U.S. consumers stock up on "made in China" merchandise, American manufacturing workers, small business owners and politicians have become anxious about this latest wave of globalization. Though fears of a permanent loss of U.S. comparative advantage are overblown, concerns about an unequal distribution of the benefits and pains are not.

The adjustment pains reflect not only the integration of China but also that of India. Together, these two huge nations are adding 1.2 billion lower-wage workers to the global economy. With lagged adjustment of "capital," this puts downward pressure on the wages of similarly skilled workers elsewhere—while increasing corporate profits and the earnings of other complementary inputs.

At the same time, the large U.S. trade deficit and China's rapid rise have sparked accusations that China's economic strategy is unfair. The U.S. goal in promoting China's accession to the WTO in 2001 was to bind China to increasing responsibility in the international arena. Yet China has often failed to live up to its WTO commitments and rules on intellectual property, export subsidies and import deterrents. The U.S. Department of Homeland Security reports that nearly 70 percent of products seized for infringing on intellectual property rights originate in China. Chinese firms that meet specified export performance targets are eligible for tax rebates. And firms that choose Chinese-made equipment over imported equipment also qualify for tax rebates.

China's growing influence in the Asia-Pacific region has been matched by America's neglect of its important regional allies. The U.S. has neglected the 21-nation Asia-Pacific Economic Cooperation forum's economic agenda; as a result, regional policymakers have learned to bypass the United States in favor of Asia-only forums. And while the U.S. has devoted its energies to negotiating bilateral free trade agreements with selected East Asian countries, it has neglected the ASEAN + 3 approach that increasingly dominates the region's economic architecture.

China has now overtaken the U.S. as the biggest emitter of carbon dioxide in the world. And China's greenhouse gas emissions will continue to grow faster than U.S. emissions because of China's continuing industrialization and growing use of coal as a fuel. Any international agreement on controlling emissions would fail without the full participation of China and India. Because China is responsible for only a tiny part of the stock of atmospheric carbon dioxide, and its per capita emissions are only a quarter of America's, the notion of "common but differentiated responsibility" has to be the guiding principle in the U.S. bargaining stance in global negotiations on climate change.

AMERICA'S OPPORTUNITY

The next U.S. president will have the opportunity to:

> **Enact policies that address domestic anxiety about how American workers will fare in an increasingly globalized economy.** The president should prioritize national investments in key areas that foster American innovation and competitiveness that have been neglected

in recent years—science and technology infrastructure, and education and training programs. The president should update the social insurance system to reduce the pain of increased worker dislocation. The U.S. should provide protections for health insurance and pensions, improve the unemployment insurance system and implement a wage insurance program to minimize the burden on workers facing job transitions.

> **End the chronic external imbalances of the U.S. and China.** Because there would be considerable disagreement on how to encourage a change in China's policy of undervalued currency and on the degree of misalignment, the U.S. should use coordinated multilateral pressure through the International Monetary Fund and the Group of Seven—along with bilateral engagement—far more effectively. The U.S. should also engage on a technical level with China to support efforts to accelerate the development of nonstate financial institutions to fully intermediate savings into domestic investments, and to reduce the excessively high savings rate—both of which would reduce China's external surplus. Because trade imbalances reflect economic conditions in both countries, it is fundamental to recognize that improving the competitiveness of the U.S. economy and putting the U.S. fiscal house in order are fundamental to restoring U.S. growth and its trade balance. Mutual recriminations (China bashing) and the obsession with a single silver bullet (exchange rate adjustment) would only accentuate the tensions over trade imbalances. Instead, the optimum solution will be based on mutual actions on multiple fronts.

> **Emphasize China's obligations to enforce WTO rules on the protection of intellectual property and on the creation of a level economic playing field.** The next administration will need to employ a multipronged approach, combining engagement and technical assistance with the use of dispute resolution mechanisms to enforce rights in a handful of consequential cases.

> **Pursue a concerted strategy of shaping international structures and arrangements to handle China's rise.** The U.S. should woo its natural allies in the Asia-Pacific region with parallel interests, rather than abandoning the field to China's smile diplomacy, as in the past five years. The next president should mount a concerted diplomatic effort to accelerate and deepen involvement in broader regional integration initiatives, such as those centered on the Asia-Pacific Economic Cooperation forum and ASEAN + 3.

> **Take a leadership role—given U.S. membership in the International Monetary Fund—in brokering expanded IMF "chairs and shares" for China and other countries commensurate with their economic heft in return for a more muscular surveillance capacity that might lead to meaningful currency realignment.** The U.S. should also actively sustain a high-level multiagency mechanism as a vehicle for bilateral engagement across a range of issues.

> **Understand that one key to avoiding a clash with China over how to prevent an environmental Armageddon is to devise win-win technological solutions to the challenge of climate change.** The U.S. should take the lead in establishing an international clean energy research consortium to create synergy among the national efforts to accelerate the emergence of renewable energy and clean coal technology. This consortium would coordinate and fund experiments on new clean energy technologies in China because China, on its own, would have little incentive to develop these new technologies, which can be easily appropriated by other countries. Because China is building one power plant each week to sustain its high rate of economic growth, it is the ideal location for these experiments on how to harness alternative fuels, burn coal cleanly, and scale up prototype green power plants.

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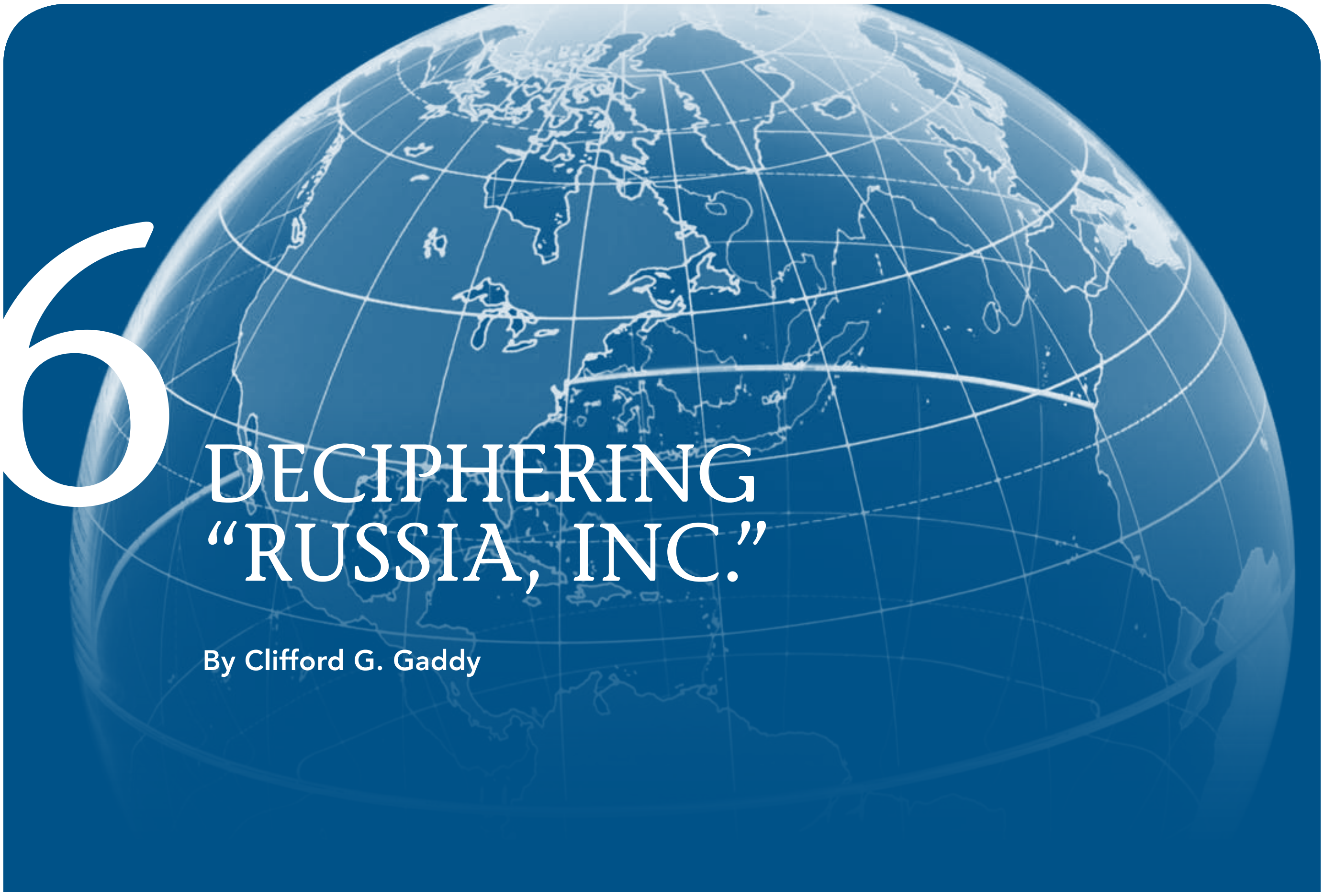

6 DECIPHERING "RUSSIA, INC."

By Clifford G. Gaddy

For more than eight years Russia, has benefited from the global commodities boom as have few other countries in the world. Prudent management of its oil and gas windfall has resulted in large fiscal and financial surpluses. At home, welfare and public and private wealth have risen dramatically. For the world, Russia has emerged as a major market for consumer and investment goods. As 2008 draws to a close, however, the outlook for Russia has begun to dim. Oil and gas output growth has slowed and even contracted. The Russian stock market has suffered from the combined drop in oil prices and the global credit crunch. Geopolitical tension since Russia's invasion of neighboring Georgia in early August 2008 has led to calls to exclude Russia from the global economy. All these developments threaten Russia's potential contributions to the global economy.

THE GLOBAL CONTEXT

Seventeen years into its transition from central planning to a free market economy, Russia presents a conflicting picture. It has the second-largest number of *Forbes* billionaires after the U.S. At the same time, the structure of its economy continues to bear a strong imprint from its Soviet past. The production structure—the type and size of factories and the location of entire cities—is highly unnatural from a market standpoint. Its management model is also distinct: a combination of companies operated by private owners but under the watchful eye of the closed inner circle of the country's political leadership. The description of the Russian economy as "Russia, Inc." is apt.

As a potential market, as an energy supplier and as a major financial power, Russia now occupies a prominent place in the global economy. Eight years of annual GDP growth exceeding 7 percent have made Russia's 140 million consumers, still with pent-up demand from decades of shortages under communism, one of the world's most attractive markets. And as the world's biggest producer of oil and natural gas, Russia plays a crucial role in global energy security. Finally, Russia now holds the world's third-largest foreign currency reserves.

THE CHALLENGE

The challenge for the next U.S. president and U.S. policymakers is to ensure that Russia can realize its potential as a market, that it can continue to supply oil and gas to the world economy and that it will remain committed to global economic integration. This is especially difficult in the wake of the global financial crisis and the geopolitical tensions stemming from the Georgia invasion. The U.S. challenge has several dimensions:

> **The market challenge:** The U.S. share of the Russian market has traditionally been small. The potential for growth is vast, but companies doing business in Russia face a difficult business climate permeated by corruption and overregulation.

> **The energy supply challenge:** The strong growth of Russian oil production in the past decade was an important moderating force on oil prices globally. Russia's current decline is therefore a cause of general concern for consumers worldwide. Russian oil is high-cost oil, and thus all investment in future supply is subject to great risk from price volatility. Russia is likely to continue to underinvest unless the West can help solve the fundamental problem for the Russians: large risk.

> **The financial challenge:** Russia is third only to China and Japan as a foreign holder of Western—mainly U.S.—government securities. These massive funds represent a transfer from Western consumers to Russia's state coffers. America would be better off if these funds were recycled back into its economy in the form of equity investments.

> **The geopolitical challenge:** In the desire to punish Russia for its invasion of Georgia in August 2008, some Western policymakers have proposed using economic levers such as blocking Russian accession to the World Trade Organization or restricting trade and investment flows. Such an approach could damage the global system itself.

AMERICA'S OPPORTUNITY

Russia's economy operates according to a model that remains distinctively different from that of other leading nations. It is not only in Russia's but also our own interest that its economy evolve toward the international norm. The most realistic approach to achieve that goal is to promote the further integration of Russia into the global economy. Direct influence on Russian economic policymaking is out of the question. In the 1990s, there was no shortage of bold American interventionist plans and programs to reform the Russian economy. Today, American policymakers must think primarily of how to interact with, not act upon, the Russian economy. A few guidelines in that effort might include:

> **Support Russia's full role in the global economy:** To show that it is serious about supporting Russia's equal participation in the global economy, the U.S. should repeal the Jackson-Vanik Amendment, a piece of Cold War legislation that denies most-favored-nation trade status to countries with nonmarket economies that restrict emigration rights.

> **Insist that Russia play by the rules:** While the U.S. encourages Russia to integrate into the global economy, it must at the same time insist that Russia play by the rules. But America needs to be scrupulous in applying all rules fairly; they should not be applied in a discriminatory fashion as a political lever.

> **Encourage U.S. investment in and trade with Russia:** The U.S. government should strongly encourage American firms to invest in and sell to Russia, despite the current difficult investment climate. But the U.S. will have to make it clear that it can do little as a government to directly change that climate. Ultimately, the burden rests with the businesses.

> **Deal seriously with Russia on the energy issue:** This urgent challenge will require sustained attention at the highest level on the U.S. side. It is an illusion to think that Russians will "need" to turn to the outside world for help simply because their output of oil and gas is stagnating or declining. There is a real danger that the enormous costs and risks of massive new energy investment will cause the Russians to postpone critical decisions for too long. The U.S. administration must work with the Russians and the Europeans to find risk-sharing mechanisms. Political distrust will only raise the West's risk premium.

The new U.S. administration must resist the temptation to use integration with the global economy as a carrot that can then be withdrawn as a stick—this would undermine the very premise that greater mutual economic dependency promotes both prosperity and security. Thus, it would be counterproductive to try to make Russia pay for political behavior by blocking its accession to the WTO, expelling it from the Group of Eight or restricting its trade and investment flows with West. It would hurt America more than the Russians, and it would risk leaving the U.S. with a Russia that is more, not less, difficult to deal with. The West has two choices for Russia: Keep it out or bring it in. If it is pushed out and kept out, it will have no stake. Nothing good will happen inside Russia as a result of less interaction with the outside world.

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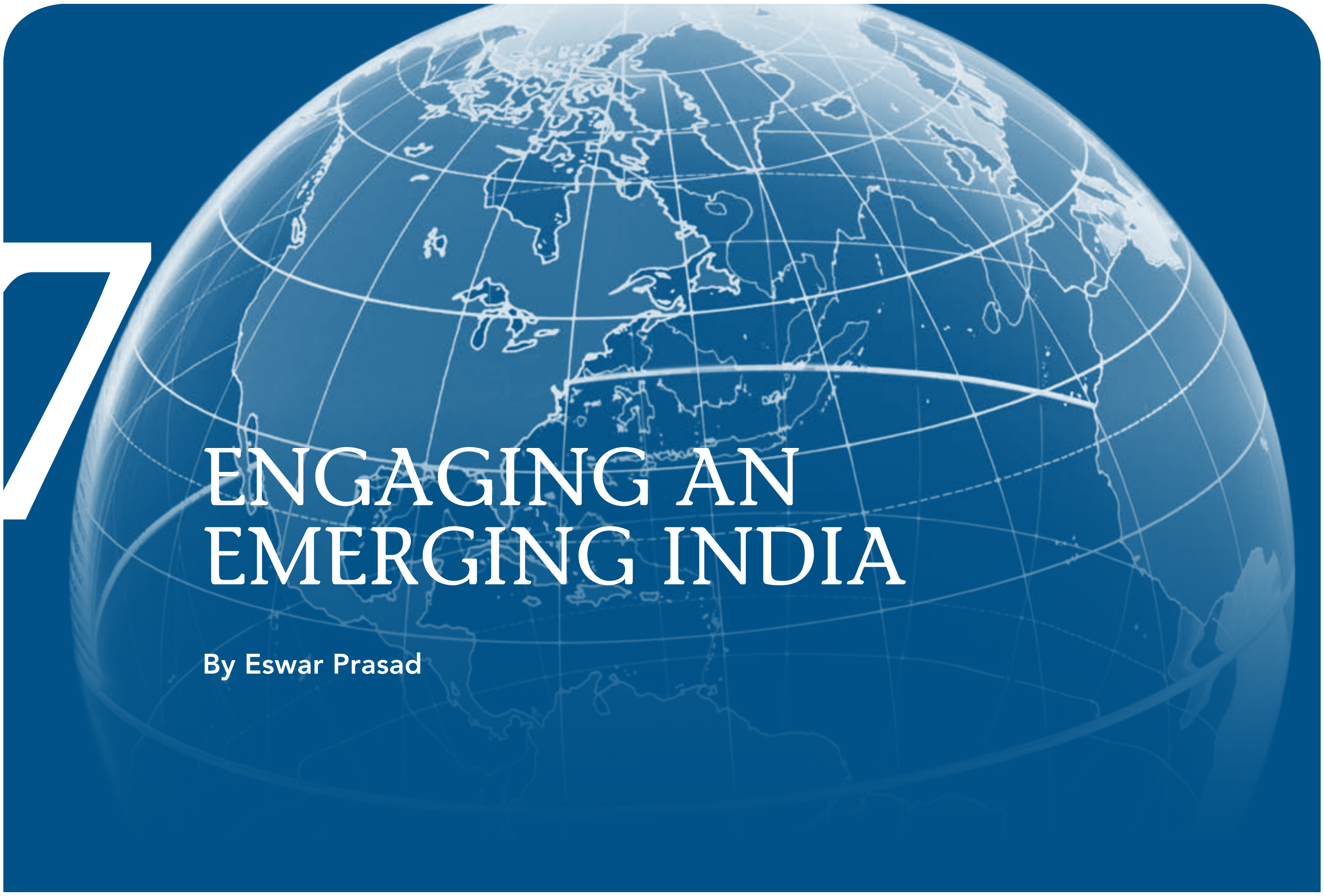

7

ENGAGING AN EMERGING INDIA

By Eswar Prasad

India's sustained growth surge since the beginning of this decade has put the country at the center of the world economic stage, along with China, as one of major success stories of recent years. With a burgeoning middle class and a large pool of educated workers, India seems poised to remain on a trajectory of rapid growth for many years to come. But this is far from certain. There are many challenges on the domestic front—including weaknesses in the physical infrastructure and educational system, poor public governance, high fiscal deficits, rising income inequality, and domestic macroeconomic management issues that have arisen through India's integration into the world economy. America must deepen engagement with India to advance our common interests on energy and climate, services and trade and global governance.

THE GLOBAL CONTEXT

India boasts a large pool of educated labor, a young workforce, a booming service sector, and a growing manufacturing sector. Yet the country's economic dynamism masks the fact that it has a weak manufacturing base and that a substantial proportion of its workforce is still engaged in low-productivity activities in the agricultural sector. The recent growth in the manufacturing sector is promising, but this sector remains hampered by restrictive labor market regulations that, for instance, make it difficult for medium-sized and large industrial firms to layoff workers even in economic downturns. This has resulted in a prevalence of smaller enterprises in the manufacturing sector that are not able to reap the benefits of economies of scale, making this sector a lot less dynamic and a less effective source of job creation than it could be. And though the boom in services has boosted GDP growth, it has failed to create large numbers of jobs relative to the rate of population growth. Therefore, India's economic policy will need to focus both on maintaining the service boom and on finding ways to bring more people into higher-productivity sectors like manufacturing.

THE CHALLENGE

India and the United States are economic and political partners that share a desire for open, transparent and dynamic global markets. India's rising economic clout has been accompanied by its increasingly assertive role in international institutions and discussions of cross-border issues (both bilateral and multilateral), including trade and climate change. India's relationship with the U.S. has also matured, and there are now significant two-way flows of trade, finance and human capital. If this relationship is well managed, it could foster a productive, mutually beneficial relationship that could help both countries make progress toward their many common objectives. Indeed, India's rising prominence as a spokesperson for the entire group of emerging markets on many issues, including the Doha Round of trade multilateral negotiations, means that this relationship between the U.S. and India has assumed even greater importance.

The new U.S. administration will need to consider several key issues:

> **Energy and climate change:** In the past 15 years, India's carbon dioxide emissions per capita and as a share of world emissions have increased by about half. The country's new push into manufacturing will surely speed up this trend. But India is worried more about procuring sufficient oil to fuel its economic boom than using energy efficiently and reducing emissions. Its climate change policy so far has been based on the quest for technological solutions, and it has not been willing to sign on to emissions reductions or carbon trading—or pricing—schemes. This technology-based approach leaves it out of global climate agreements, reflecting a view it shares with China that developed countries should take the lead in implementing any climate change agreement. The ratification of the Kyoto Protocol foundered in the United States on the lack of inclusion of developing countries. Together, the U.S. and India face steep challenges on climate change and energy policies and should work together to develop international policies and processes.

> **Trade and the Doha Round:** In the Doha Round of World Trade Organization negotiations, India has played a leading role among the Group of 77, the largest intergovernmental organization of developing states in the United Nations, in pushing for reductions in agricultural subsidies in developed countries. However, fears over losing domestic manufacturing share to exports from China have led to a breakdown in negotiations. In response, India has begun to pursue free trade agreements with the European Union and the United States. These bilateral agreements could be corrosive to the cohesion of the world trading system.

> **Domestic capital markets:** India has undertaken a significant liberalization of its financial sector and has also opened up to capital flows from abroad. Its stock markets, in particular, have become sophisticated and relatively deep, partly due to the influx of foreign funds. However, its overall level of financial depth—a measure of the prominence of its financial system relative to the size of its economy—remains low by international standards. Its financial system still has a number of weaknesses that are preventing it from creating a significant number of jobs and that could hinder overall growth. For instance, the government bond market remains relatively torpid and the corporate bond market is very small. The banking system has a very low ratio of nonperforming loans, but this is at the cost of a high level of passiveness in lending, which has resulted in India having one of the lowest ratios of bank lending to GDP among emerging markets. These outcomes are partly the result of restrictive government policies and also the consequence of the government using banks, especially state-owned ones, as a source of deficit financing (by getting them to buy government bonds) and as a redistributive mechanism.

> **Outsourcing:** Growth in the service industry has been the bright spot in the Indian economy, with the service sector as a whole now accounting for more than half of GDP. Even though the high-end services sector (including business processing) accounts for just about 1 percent of India's GDP, this sector has received a lot of attention and is seen in the U.S. as threatening domestic jobs.

AMERICA'S OPPORTUNITY

Given the commonality of interests between the two countries, it will be important for the next U.S. president to build and maintain a constructive partnership with India. Actions in several areas could particularly help build momentum for a deeper, more enduring relationship:

> **Energy and climate change:** The United States should encourage India to adopt sustainable growth strategies and engage with the international community on climate change. Given India's existing stock of inefficient state-owned manufacturing firms and the potential growth of a more dynamic manufacturing sector, the country has an opportunity to opt for more sustainable and efficient technology.

> **Trade and the Doha Round:** The United States should continue to actively engage India in the Doha Round negotiations. For the U.S. to enter a free trade agreement with India would be an unfortunate turn of events for the

world trading system. Although positions have hardened on both sides, there is a lot at stake, and continued dialogue will be essential to not leave the negotiations completely stalled.

> **Domestic capital markets:** The Government of India has in the last couple of years appointed committees to look into specific aspects of financial system reform and to lay out a broader blueprint for reforms in this sector. The United States should encourage the Reserve Bank of India to take the recommendations of these committees seriously. As the recent financial crisis in the United States has made clear, no country has the luxury of not needing to constantly update financial regulation in a way that keeps financial innovation under control without stifling it.

> **Financial flows:** The United States should work with India to increase flows of foreign direct investment to expand the Indian manufacturing sector, and also work to reduce restrictions on foreign investors' participation in India's government and corporate bond markets. Such steps, in addition to increasing financial depth, could also make it easier for India to obtain financing for its massive infrastructure needs.

> **Outsourcing:** The new U.S. administration should proactively ensure the benefits of free trade are broadly spread. Of course, it is important to strengthen the U.S. social safety net and social insurance for those displaced by competition from abroad.

> **Global governance:** The U.S. should support permanent seats at the table for India at the United Nations Security Council, the Group of Eight Summit and other multilateral forums.

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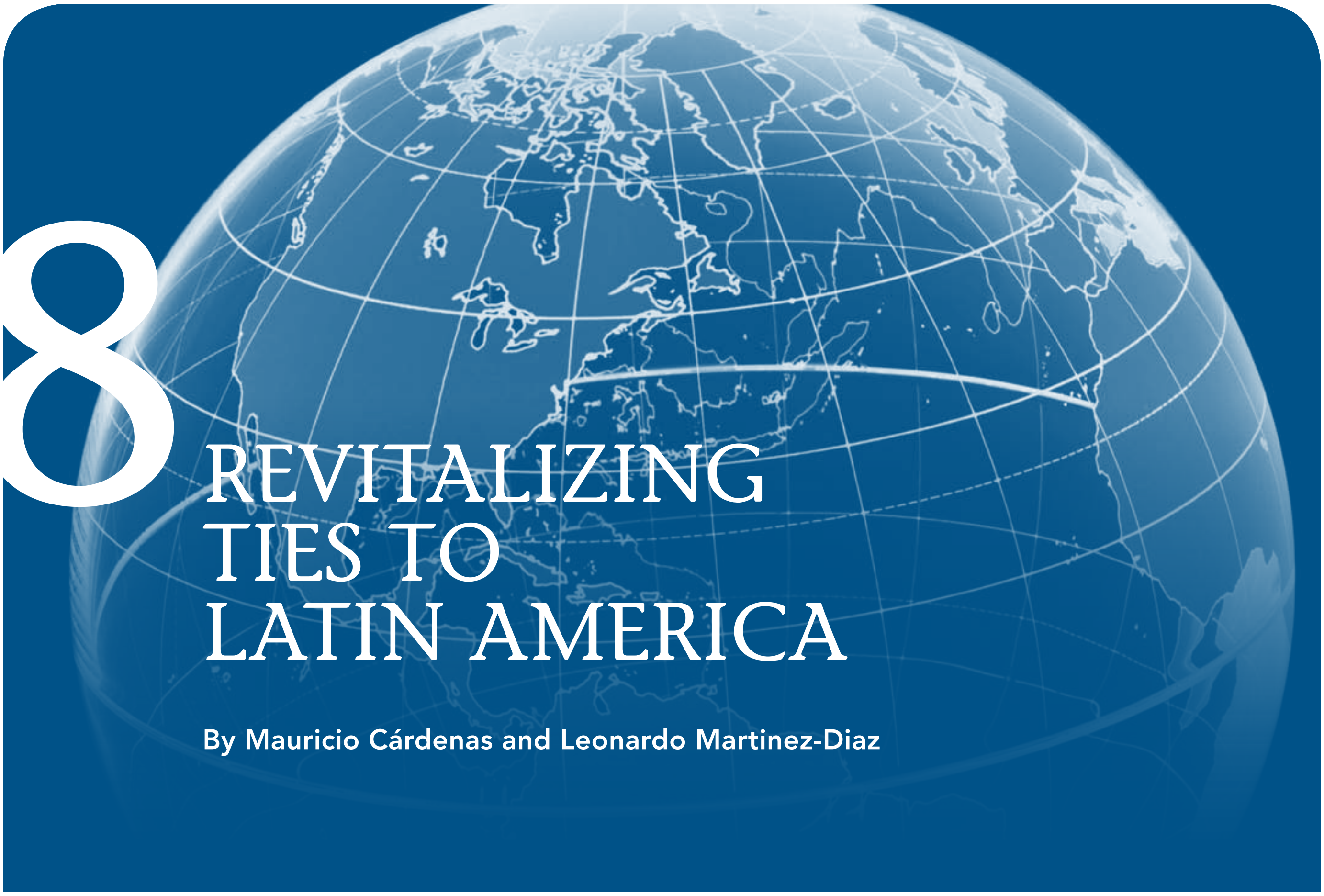

8 REVITALIZING TIES TO LATIN AMERICA

By Mauricio Cárdenas and Leonardo Martinez-Diaz

Relations between the United States and the 33 countries that make up the Latin American and Caribbean region have fallen into a state of neglect in recent years. Washington's policy focus has been consumed by terrorism and the wars in Afghanistan and Iraq. In the process, Latin America and the Caribbean countries have dropped off the U.S. political radar screen.

THE GLOBAL CONTEXT

While the United States has been focused elsewhere, important trends have swept the Latin American and Caribbean region. The region's countries have begun to diversify their economic and political relations. Brazil, in particular, emboldened by strong economic growth, has been pursuing a more active regional and global role. Democratic institutions have been strengthened in most countries in the region. Fiscal and monetary discipline have become a cornerstone of economic policy. The region has also suffered from its share of financial crises, and relatively feeble rates of growth and job creation have frustrated the expectations of the middle classes and the poor. Poverty, violence and inequality remain major—and in some countries growing—challenges.

Meanwhile, the region's residents have grown increasingly alienated from the United States. In a 2007 Zogby poll of Latin American elites, only 14 percent of decisionmakers from the region described Washington's handling of relations with Latin America as "good" (13 percent) or "excellent" (1 percent). The remaining 86 percent thought U.S. policy was "fair" or "poor." But 27 percent of Latin American elites described China as the country they believe is most important to their region's future—a close second after the United States (30 percent).

Neglect of Latin America and the Caribbean and alienation from its leadership are proving costly to the United States because no other region has a greater impact on the daily lives of Americans. Through their impact on flows of natural resources, goods and investment, shifts in the region can affect the health of U.S. firms and the U.S. economy. In addition, shifts in migration patterns can have an impact on U.S. labor markets, politics and society. The United States has a large stake in the future of Latin America and the Caribbean, but unless it reengages with the region, its ability to influence transformative trends will continue to decline.

THE CHALLENGE

For the United States, the challenge is how to design a constructive agenda with the countries of Latin America and the Caribbean and to forge partnerships that can help it advance its short- and long-term strategic interests. With the exception of Europe, Latin America and the Caribbean is the region that most closely shares U.S. political and economic values and institutions; rehabilitating the United States' image in this region should be easier than elsewhere in the world. Key U.S. interests in the region include not only pursuing the traditional counternarcotics and investment- and trade-promotion agendas but also promoting energy security, managing migration flows, strengthening democracy and the rule of law, combating criminal networks and supporting efforts to build more cohesive and equitable societies in the region.

There are a number of obstacles on the road to constructive reengagement. First is the powerful pull of more urgent challenges in the Middle East and Asia, which divert high-level attention and resources from Latin American and Caribbean issues. Second is a strong temptation to treat the region as a single entity, though it has a number of very different political and economic structures. What is needed is a creative mix of bilateral, subregional, and hemispheric institutions and initiatives.

Third, some leaders in the region (especially Hugo Chávez, Evo Morales, and Fidel Castro) have exerted too strong an adversarial hold on Washington's attention, often pushing it into costly, counterproductive confrontations. Instead, U.S. policymakers should focus on understanding these leaders' interests and the configuration of economic and political forces that keep them in power. A fourth obstacle is that U.S. policy tends to alternate between neglect and obsessive attention to a few issues that affect Americans directly, such as drug trafficking and migration. What is needed is more consistent, sustained attention on a wider scope of issues, including those that Latin American and Caribbean governments see as shared challenges, and those issues in which hemispheric cooperation is essential for progress.

AMERICA'S OPPORTUNITY

The next U.S. president needs to pursue several opportunities in relating to the Latin American and Caribbean countries:

> **Relaunch relations:** The first step of the next U.S. administration should be a symbolic relaunching of relations with Latin America, starting with a reference to the region in the president's inaugural speech and a series of visits by senior officials to the region.

> **Diversify the agenda for the region:** U.S. policymakers should diversify the high-level agenda for the region beyond counternarcotics, immigration, and trade to include energy cooperation and integration, water management, financial regulation, environmental protection and competitiveness. Energy, in particular, is an area of high potential for hemispheric cooperation—to liberalize trade in ethanol, promote the integration of power grids, build stronger safeguards for the peaceful development of nuclear energy and sponsor research to develop cellulosic ethanol and other renewable energy sources.

> **Address U.S. fears and concerns:** On the hard issues of trade and immigration, the next administration will make no progress unless it first directly addresses the American public's fears and concerns. Without expanding and strengthening Trade Adjustment Assistance and investing in U.S. competitiveness, there will be no domestic constituency for expanded trade with Latin American and Caribbean (or other) countries. In addition, the U.S. government would be well advised to renew its efforts to pursue a hemispheric agreement rather than rely exclusively on bilateral trade deals, which cause trade diversion and create regulatory confusion. Finally, without a system that ensures the safe, legal and temporary movement of the region's workers into the sectors of the U.S. economy that need them most, progress on immigration will remain elusive.

> **Strengthen regional institutions:** The weakened Organization of American States could serve as a useful forum for promoting regional security cooperation and democratic institutions. But first, the OAS needs to be strengthened financially and institutionally. Another institution ripe for improvement is the North American Development Bank, set up to finance environmental protection projects in the U.S.-Mexico border region. An informal steering committee, modeled on the Group of Seven and composed of heads of state from the region's most important countries, could help guide the work of regional institutions and strengthen cooperation.

- **Contribute to the region's social agenda:** U.S. policymakers need to identify opportunities for the United States to contribute to the social agenda in Latin American and Caribbean countries. This means rethinking U.S. aid policy toward the region, improving aid coordination with other donors and directing aid to those sectors where the impact will be greatest per dollar spent. U.S. aid agencies should also be more transparent about the purposes of their aid to the region's countries (poverty reduction, counternarcotics, security) and should evaluate that aid's effectiveness only on the basis of its intended purpose.

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9 SUPPORTING AFRICA'S GROWTH TURNAROUND

By John Page

After three decades of low and volatile growth, Africa's economic performance has markedly improved in recent years. Since 1994, its average economic growth has been close to 5 percent a year. Today Africa's per capita income is rising in tandem with that of the rest of the world.

THE GLOBAL CONTEXT

What explains this dramatic turnaround? Africa's long-run growth masks a striking pattern of offsetting booms and busts. Between 1975 and 2005, the average African economy grew more than 3.5 percent a year a quarter of the time but contracted by about 2.5 percent another quarter of the time. This pattern changed in 1995, when the booms began to be more frequent and the busts became much rarer, thanks to two factors: good luck—resource-driven growth booms—and fewer mistakes—avoiding busts.

High export prices for virtually all of Africa's commodities have meant that the continent's resource-rich economies have had significantly more growth booms in the past 10 years than their non-resource-rich neighbors. But good policy has also played a part. Macroeconomic management has been strengthened. Fiscal deficits and inflation have declined dramatically since 1995. Exchange rates have become more flexible and competitive. Political and economic institutions have also improved, and the number of conflicts has declined. These changes have contributed significantly to a sharp fall in growth collapses for the resource rich and resource poor alike.

THE CHALLENGE

The issue now is to sustain growth. Though there is no single prescription for success, Africa's leaders are likely to face five major challenges to varying degrees:

> **Using natural resources well.** If the history of the resource-rich countries in Africa is any guide, rather than bringing prosperity, oil and other minerals may well leave a legacy of weak public institutions, boom-to-bust macroeconomic management, economic stagnation and inefficient public expenditures. Strengthening the institutional foundations of natural resource revenue management—in particular checks and balances on revenue contracts and public

expenditures—is critical for turning natural resource wealth into sustained growth.

- **Creating an export push.** For economies without substantial natural resources, the rapid growth of nontraditional exports offers an important way to boost growth. African exports, however, particularly nonoil exports, are growing slowly and are highly concentrated in a few products. To generate new dynamism in nontraditional exports, Africa will need an "export push," supported by appropriate trade and exchange rate policies, by effective export promotion institutions and by efficient, trade-related infrastructure.

- **Strengthening the private sector.** Private investment in Africa is low, and except for foreign direct investment in resource-rich countries, it has not increased since 1995. Despite recent reforms, Africa remains a high-cost, high-risk place to do business. It is essential to improve Africa's investment climate by reducing excessive regulation and corruption, building up its essential business services and closing its infrastructure gap with the rest of the world.

- **Building new skills.** Africa has scored a major success in primary education; the gross primary school enrollment rate stood at 92 percent in 2004. But there have been no comparable increases in secondary and tertiary school enrollments. The lack of expanded access to and improved quality in postprimary education has serious implications for long-term growth. Africa needs new skills to compete and new approaches to postprimary education.

- **Enhancing resilience.** Africa will perhaps suffer the most from climate change because of its size, large impoverished populations and stage of development. Without integrating climate risks into development planning, Africa risks undermining its growth. For example, in some African countries agricultural yields could drop as much as 50 percent by 2020. For a region heavily reliant on agriculture for overall growth, these projections make a compelling case for the need to climate-proof vulnerable cities, populations and sectors.

AMERICA'S OPPORTUNITY

Africa's long-run success ultimately rests on the actions of its people and their leaders, but the United States has an important role to play in supporting their efforts. The new U.S. administration can take a number of steps to support Africa's growth turnaround:

- **Supporting global standards for natural resource management:** Given how central the effective use of natural resources is to Africa's prosperity, the next administration should support developing international standards and codes of conduct to promote transparency and accountability covering issues such as mineral rights, tax regimes, fiscal rules and public investment. International norms can both support reformers in the resource-rich economies and encourage responsible behavior on the part of extractive industries.

- **Confronting rising protectionism:** International trade is fundamental to sustaining growth in Africa. An export push needs market access. Yet according to a recent *Wall Street Journal* / NBC News poll, 60 percent of voters nationwide agreed that "foreign trade has been bad for the U.S. economy." In the face of such adverse public opinion, it will be difficult but imperative for the new administration to strengthen the Africa Growth Opportunities Act. Imparting new energy to the Doha Round of multilateral trade talks is also critical; many of Africa's most promising trade partners are newly industrializing members of the World Trade Organization.

- **Supporting the private sector:** The United States can help empower the private sector to do business in Africa. The U.S. Overseas Private Investment Corporation can help U.S. businesses invest in Africa by mitigating risk. The Millennium Challenge Corporation can foster stronger linkages with the African private sector. America can also take the lead in forging a consensus in the international donor community to support building up skills for competitiveness.

- **Promoting peace and security:** Poverty is both a cause of insecurity and a consequence of it. Fragile states can explode into violence or implode into collapse, imperiling their citizens, regional neighbors and the wider world as livelihoods are crushed, investors flee and ungoverned territories become a spawning ground for global threats like terrorism, trafficking, environmental devastation and disease. The new administration should intensify efforts to support effective collective solutions—through the African Union and the United Nations—to conflict across the region. There is also a role for unilateral efforts. The U.S. Africa Command created in 2007 should continue to strengthen the capacity of its African counterparts but at the same time avoid expanding its mandate into the realm of humanitarian assistance.

- **Redefining the aid agenda:** The new administration will have an important opportunity to change the priorities for U.S. assistance to Africa. Aid volumes to Africa have increased, but the bulk of the United States' $4.6 billion in aid to Africa in 2005 has gone to technical assistance and emergency relief. The highest priority should instead be to meet the Group of Eight's Gleneagles commitment to double aid to Africa by providing more assistance directly to projects and programs that support long-term growth and human development. Funding priorities should target projects that are carbon neutral and build resilience to the adverse effects of climate change. The new administration should also challenge the rest of its G8 partners to make similar outcome-based aid commitments.

- **Building bridges to new donors:** China is building a hefty bilateral development assistance program in Africa: providing $5 billion in preferential loans and export credits in the next three years; doubling aid from 2006 levels by 2009; and establishing a $5 billion China-Africa Development Fund to encourage Chinese direct investment. And China is not the only new donor. India, a number of other Asian countries, and several large foundations are also involved in Africa. To date, these new donors have been reluctant to coordinate their efforts with Africa's traditional development partners. The U.S. can help improve the effectiveness of all aid to Africa by leading efforts to build greater communication, collaboration and coordination among all development partners and African governments.

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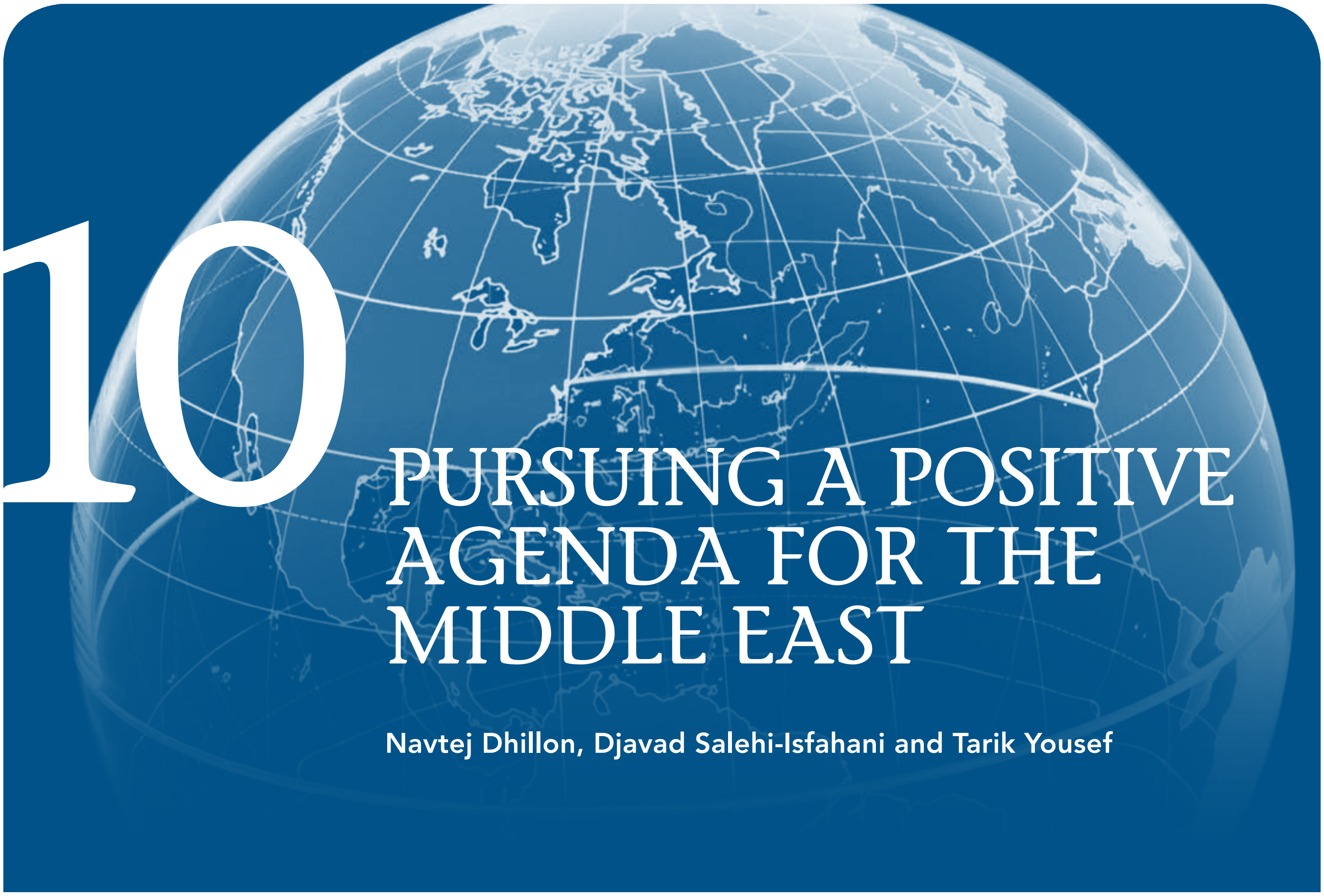

10 PURSUING A POSITIVE AGENDA FOR THE MIDDLE EAST

Navtej Dhillon, Djavad Salehi-Isfahani and Tarik Yousef

The Middle East is currently experiencing a double dividend: an unprecedented oil boom, with global prices hovering at or near $100 a barrel, and a demographic gift in the form of a large youth population. Though high oil prices and a large unemployed youth population are frequently viewed as contributing to economic volatility and social instability, with the right policies these twin dividends could yield greater global prosperity and security.

THE GLOBAL CONTEXT

Among all the world's regions, the Middle East contains the highest proportion of youth, who make up almost a third of its total population. With two working-age people (15 to 64 years of age) living in the region for every one non-working-age person (under 14 or over 65), it faces a historic opportunity to harness its own economic tiger by increasing incomes per capita, bolstering savings and improving social welfare.

Yet this Middle Eastern demographic asset is vastly underrecognized and underutilized. Though the transition to adulthood is an inherently difficult period, Middle Eastern youth face greater challenges than their peers in Latin America or East Asia. In the Middle East, youth unemployment rates are nearly twice the world average (25 vs. 14 percent), and the time required to wait for a first job is measured in years rather than months. Education, which in other regions is a way for youth to ease their transition to employment, fails to do the same in the Middle East. Furthermore, a large majority of youth must live with their parents well into their 20s and delay marriage, despite greater social taboos for relationships outside marriage.

The Middle East pays a high cost for the economic exclusion of youth; our recent research shows that estimates are as high as $53 billion in Egypt (17 percent of GDP) and $1.5 billion in Jordan (7 percent). While the youth bulge is itself a source of economic growth, it can also provide the social and political impetus for lasting institutional change. This is because many of the problems youth face—skill mismatches, unemployment, lack of access to credit—are the result of the institutional infrastructure that governs education, employment, housing and other key markets. These state-dominated institutions, when first established, were designed with strong social justice objectives; but today, in a much more competitive global economy, they hinder economic development. Thus the Middle East's increased stability and prosperity hinge on making economic reforms before the region's demographic window of opportunity closes and its societies begin to age.

THE CHALLENGE

The next U.S. president faces obvious tough questions about how to reengage in the Middle East without antagonizing the region's policymakers and people. Given suspicions about current U.S. policies and objectives in the region, how can the next administration help encourage critical economic and political reforms there while fostering more favorable views of the U.S.? The key lies in shifting the political and policy discourse from the fight against Islamic radicalism to how to build a future for the majority—from using hard power to boosting smart power.

A recent Gallup poll of Muslim countries revealed that when asked what the West can do for Muslims, the number one response was to "reduce unemployment and improve the economic infrastructure." When asked to describe their dream for the future, the majority of Muslims cited getting a better job. The same survey also revealed that respondents believe that the United States can improve relations with the Arab world by demonstrating more respect and not underestimating the status of Arab countries. The message is loud and clear: U.S. rhetoric should affirm respect and inspire local ownership, and the best U.S. efforts should be focused on economic development.

Yet many youth in the Middle East have witnessed the reverse. Most of these youth have had their perceptions of America shaped by the events of the past eight years: the 9/11 terrorist attacks, the U.S. war on terrorism and Islamic extremism, the stalemate in the Arab-Israeli conflict, the wars in Iraq and Lebanon. Young people find themselves portrayed in the West as in the grip of fundamentalist ideology and a source of security threats. Where public U.S. diplomacy has made overtures, it has often been out of sync with local realities.

Paradoxically, the chasm in U.S.–Middle East relations has emerged amid greater convergence in ideas and aspirations. Triggered by a large youth cohort, the Middle East is undergoing change where it is aligning with the fundamental drivers of globalization. The region has embraced the ideas of a market economy; it values education and civic participation is on the rise. Middle Eastern youth subscribe to the fundamental progrowth norms of behavior such as hard work and high investment in children, including girls.

These are all areas where the United States is a leader. As the country with the world's best record in harnessing the energy of youth, the U.S. can offer much to the Middle East. The challenge is how the U.S. can build on its strengths and be seen as genuinely interested in reform, not just in curbing radicalism. The next American president must recast the U.S.–Middle East relationship on broader terms—seeking to move beyond security to comprehensive engagement. Promoting reforms in the name of youth is the only workable template for exercising soft power that can encourage the best impulses of the Middle East.

AMERICA'S OPPORTUNITY

Given this challenge, the next U.S. president will have the opportunity to:

> **Change U.S. discourse to focus on youth-focused economic development in the Middle East:** Addressing the Middle East through the prism of Islamic extremism, however well intended, ends up alienating the majority of moderate citizens. It undercuts the government reformers who should be supported and contracts the space in which U.S. and Middle Eastern civil society, private sector and public institutions can build partnerships based on trust and mutual respect. The new discourse on economic and political reform should be aligned with the aspirations of the majority of the people in the Middle East: the young who are striving for global integration.

> **Make greater investments in supporting Middle Eastern youth:** Most development programs targeting youth focus on improving education, training those who are unemployed or providing them with credit without understanding the linkages between these diverse sectors or addressing the root causes of youth outcomes. The result is a missed opportunity to use youth programs to create incentives and institutional changes, and to generate success stories for reform-minded leaders seeking to shape policy. The United States can play a critical role by amending the Foreign Assistance Act and exporting soft technology, as noted next.

> **Amend the Foreign Assistance Act to provide resources for youth in developed countries.** Currently, the Foreign Assistance Act only funds a few youth activities in countries experiencing conflict or crisis. Thus, the legislation and programs are rewarding the bad behavior of these countries, a form of moral hazard in foreign policy. The act's language should be changed to overcome this policy flaw. Youth development should be given priority, particularly in countries experiencing youth bulges and high rates of youth unemployment.

- **Export soft technology for institutional reform of education.** Youth in the United States have a relatively smooth transition to adulthood compared with those in most advanced countries. Transitions to adulthood in the United States are facilitated because of the close integration between the education system and the labor market. U.S. institutions may not fit the Middle East perfectly, but as with all exports, soft technology exports can be adapted to fit local conditions. The U.S. educational system has already provided the region with excellent institutions of higher education—the American University in Beirut and the American University in Cairo—which have produced many of the region's leaders. The U.S. can extend assistance on a broader scale, encompassing curricular reform for high schools, the transition from high school to college (through reforms of admission practices), and the transition from school to work.

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> **The road out of poverty**
> **The rise of new economic powers**

The program is directed by Lael Brainard, vice president and holder of the Bernard L. Schwartz Chair in International Economics.

The program also houses the Wolfensohn Center for Development, a major effort to improve the effectiveness of national and international development efforts.

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