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FOCUS

G20

In November 2010, France took over the presidency of the G20 for one year, with six official priorities. Three of them are a continuation of previous agendas (strengthening financial regulation, promoting development, rebalancing of the global economy), and three are new actions: reforming the international monetary system, combating commodity price volatility, improving global governance.

The rebalancing agenda is especially sensitive. At the Seoul summit in November 2010, each member of the G20 committed itself to implement policy measures to reduce balance-of-payment imbalances and boost global growth. But no agreement was reached on a common code of conduct (such as a limit on current-account imbalances, as suggested by the US Treasury Secretary). A working group was set up to work with the technical support of the International Monetary Fund on such guidelines.

The task is complex since development stages and demographic trends may justify large current account imbalances in some countries. However, it should be noticed that current-account standards are less controversial than exchange-rate norms. Actually, exchange rates stem from current-accounts added with a number of assumptions, including on domestic-demand policies).

One further advantage of focusing on current accounts rather than on exchange rates is to broaden the discussion potentially to any area of economic policy, safeguarding national economic-policy sovereignties, since many types of policies can ultimately affect the current account of a country. In fact, the risk of "currency wars" is related to the lack of policy instruments at the global level, compared to the large number of policy objectives. This is obvious for exchange-rate policies (with *N* currencies in the world, there are only *N-1* independent exchange rates). It also applies more generally to economic policies: policy trade-offs made at the country level will unlikely be consistent at the global level.

Hence, one task of the G20 could be to incentivize its members to raise the number of domestic policy instruments, for instance through active prudential policies and counter-cyclical macroeconomic policies.

At first sight, reforming the international monetary system could be viewed just as a way to achieve the rebalancing agenda: should the renminbi be allowed to appreciate against the US dollar, this would hopefully contribute to reducing the Chinese surplus and propensity to accumulated foreign-exchange reserves, while helping the People's Bank of China to fight domestic inflation. However, reforming the IMS would bring only part of the solution to global imbalances, since the evolution of real exchange rates will fundamentally depend on macroeconomic and structural policies rather than on the regime of the nominal exchange rate.

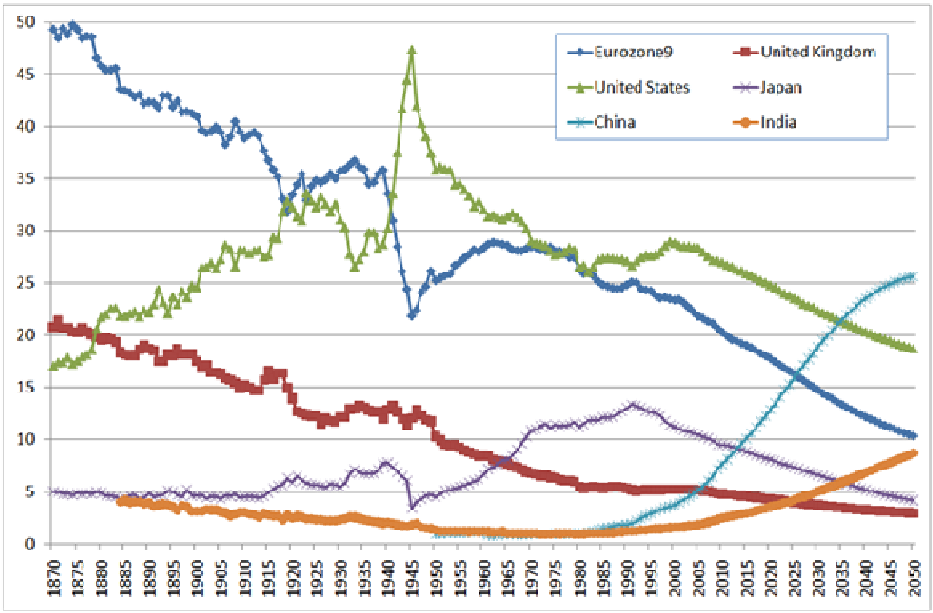
Another reason for attempting to reform the IMS is its malfunctioning in terms of exchange-rate misalignments, volatility of capital flows, excessive accumulation of foreign-exchange reserves, insufficient financial safety nets, lack of control on global liquidity, insufficient discipline and coordination of macroeconomic policies. However, it must be admitted here that the IMS has performed remarkably well during the crisis: the US dollar did not crash, and liquidity provision was efficiently extended to countries in need, not least thanks to the action by the Federal Reserve and other major central banks.

In fact, the needs for reform may be less acute than the necessity to accompany forthcoming changes. Although the renminbi is not yet fully convertible and the euro is experiencing a deep crisis, the IMS is likely to evolve towards multipolarity, just like the global economy itself (Figure 1). Country size is far from being the only determinant for the international status of a currency and the transition may take time. But there is little doubt that the renminbi will eventually become an international currency. The future of the

euro will very much depend on further European integration and more specifically on the possible launch of a unified government bond market in euro. Hence, the IMS may evolve towards a bipolar or tripolar system.

Figure 1: Percentage Shares in World GDP of Selected Areas 1870-2050

(in constant prices at 2005 exchange rates)



Source: Maddison and CEPII.

* Australia (up to 1900), New Zealand (up to 1939), India (up to 1946).

Such an evolution may mitigate some flaws of the present (non-) system, such as the rigidity of key exchange rates, the asymmetry of balance-of-payments adjustments or what remains of the Triffin dilemma. However it may exacerbate other problems, like short-run exchange rate volatility or the scope for "currency wars", while leaving key questions unsolved, such as the response to capital flows and a closer management of global liquidity provision. On the whole, a multipolar regime could bring more flexibillity in exchange-rate regimes around the world (or a regionalization of currency pegs) and some form of liquidity management at the global level.

It is not the duty of the international community to decide the number and the identity of international currencies. However the dollar may well no longer be the only prevailing key currency of the system, one or two decades ahead. The international community should put its short-term action within this longer perspective.

This suggests:

(i) to create a favourable environment for exchange-rate flexibility, which may involve common rules for the use of reserve accumulation and capital controls, in order to let national governments go for various instruments to curb "excess" exchange-rate volatility while firmly monitoring such policies;

(ii) to improve liquidity-provision schemes in case of emergency, giving priority to multilateral schemes;

(iii) to create a scheme for global liquidity management, which could be based on a cooperation between the central banks of the hard currencies included in the SDR;

(iv) to monitor the internationalization of the renminbi and, possibly, of the euro, so that demand and supply for these currencies expand at compatible paces.

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ON THE RESEARCH AGENDA

Carbon Price Drivers: Phase I *versus* Phase II Equilibrium?

The European Union Emission Trading Scheme (henceforth EU ETS) is the first large scale CO2 emission trading system in the world. The pilot phase of the system covered the period 2005-2007. Since January 2008, the scheme has entered Phase II which will end in 2012. The aim of the EU ETS is to help Member States reach their Kyoto target (over 2008-2012), and meet the European target of 20% greenhouse gas emission reduction in 2020 compared to 1990.

Much has been written so far on the EU ETS in Phase I, despite this first period was meant to be a learning process. Together with the environmental effectiveness and the cost-efficiency of the instrument, academics have investigated carbon price patterns in 2005-2007, and discussed either their determinants or the most suitable stochastic behaviors to forecast such patterns.

Very little is known, instead, about Phase II. Phase I and II of the EU-ETS differ in terms of market expertise, characteristics (liquidity and depth), and regulation. Given these differences, we would notably like to test the believe that results for Phase I can be extended to Phase II. More specifically, our aim is to shed some light on the determinants of carbon futures price in Phase II by testing whether the carbon price drivers identified so far by the economic literature—such as energy prices and indicators of economic activity—still hold for the EU ETS in Phase II and evolve toward a stable long-run relationship.

Anna Creti, Pierre-André Jouvet & Valérie Mignon

Product Market Regulation, Firm Size, Unemployment and Informality in Developing Economies

Informal activities are pervasive in both developed and developing economies. The size of the shadow economy as a percentage of GDP ranges from 25 to 60% in Latin America, from 13 to 50% in Asia, and is around 15% among OECD countries. Informal firms differ from formal ones in a number of measurable characteristics, and there is a growing literature trying to understand the causes of informality and its differences compared to formal businesses. In developing countries informality seems to be omnipresent in virtually all sectors of the economy. We take the view that, for those economies, informal firms should be taken as being subject to the same economic environment and they should face the same externalities as the formal ones. In this spirit, we propose a general framework where both formal and informal firms have monopoly power in the goods market, they are subject to matching frictions in the labor market, and wages are determined through bargaining between large firms and their workers. Our numerical simulation is successful in replicating the key characteristics of the Brazilian economy. We study the effects of changes in product market regulation and in labor market regulation on the main endogenous variables of the model. The informal sector is found to be endogenously more competitive than the formal one. We find that lower strictness of either product or labor market regulations lead to a simultaneous reduction in informality and unemployment. The difference between these two policy options lies on their effect on wages. Lessening product market strictness increases wages in both sector but also increases the formal sector wage premium. The opposite is true for labor market regulation.

Olivier Charlot, Franck Malherbet & Cristina Terra

Are High Quality Imports more Sensitive to Variations of Income?

Textbooks in microeconomics point out that an increase in consumers' income tends to enhance the consumption of luxury goods relative to necessities. Using micro data for the United-States, Bils and Klenow (2001) have provided evidence that as people get richer, they also consume better goods in terms of quality ("quality" Engel curve).

We test the hypothesis that variations in aggregate income of countries affect more the imports of goods from countries specialized in high quality, relative to imports from countries specialized in low quality. The empirical analysis is performed using the "tariff lines" data provided by the United Nations Statistical Division. This database reports bilateral trade value and quantity at a high level of disaggregation over the period 2000-2008. Both values and quantities are used to compute, for each individual trade flow, the unit value as a proxy for the trade price. This information allows to classify bilateral imports of a product from different countries into high and low quality groups, in reference to the average price observed on each market. An import equation is then estimated to measure the effect of GDP variations on imports from both quality groups.

Primary evidence confirms our hypothesis that imports of high quality varieties are more sensitive to changes in GDP than low quality varieties. This effect is also more important for product categories with a wider potential for product differentiation. This result suggests that countries specialized in high quality varieties of a good may be more affected by booms and busts along the business cycle.

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Antoine Berthou, & Charlotte Emlinger

The Performance of Ethical Funds

Does the inclusion of environmental, social and governance criteria in the investment decision-making process hurt risk-adjusted returns? Or does it lead to a "win-win opportunity"? More than fifty academic papers have already examined this issue and they quasi-unanimously show that Socially Responsible Investing (SRI) funds neither over-perform nor under-perform. Actually, this is not very surprising. Underlying the literature on SRI funds financial performance is the implicit hypothesis that those funds are homogeneous. Yet, SRI funds are very heterogeneous and the relevant question is not "does it pay to be good?", but "when does it pay to be good?".

In our research we assess the financial performances within SRI mutual funds. In particular, we examine whether the financial performances are related to the characteristics of the extra-financial screening process. First, we evaluate the risk-adjusted return of the French SRI mutual funds. Reinforcing previous studies, our results show that the French SRI mutual funds do not outperform the market, whatever the performance measure considered. Then, we examine the significance of the extra-financial screening process on the financial performance. Overall, we confirm empirically that the SRI screening process may have a cost: the financial performance of SRI funds is hurt by the exclusion of non-socially responsible stocks. In particular, we show that industrial screens (such as avoiding sin stocks) pull down financial performance, while transversal screens (commitment with UN Global Compact Principles, ILO/Rights at Work…) do not have any impact. To a lesser extent, we show that the impact of shareholder activism is not significant, as well as the quality of the SRI selection process, and it is not clear whether one of the Environmental, Social and Governance (ESG) factors influence more than the others the financial performance of SRI funds, but those issues need further analysis.

Gunther Capelle-Blancard & Stéphanie Monjon

Turkey: Strong and Weak Points of a Large Emerging Economy Close to Europe

Ranking 17th in world population and GDP (in current dollars), Turkey is today a member of the G20 and is among the 20 countries with the highest IMF quota shares. The country is also one of the largest emerging economies with at least a 1% share of world GDP.

Turkey experienced a deep recession in 2001 stopping short of a debt default. A daring economic policy along the lines of the IMF recommendations, and the constraints due to the European Union acquis communautaire allowed reforms to be triggered on a wide scale in a few years. Turkey could then get out of hyperinflation, cut its huge debt, run a budget surplus and experience a strong economic growth. The global crisis of 2008 has hit the Turkish economy very hard (-4.8% growth in 2009) on account of a steep drop in the external demand. Thanks to strong fundamentals, Turkey could boost internal demand by implementing a friendly fiscal policy, and shift trade towards North African and Middle Eastern countries, Russia and the other CIS countries. GDP has actually recovered its pre-crisis level, with an 8% growth in 2010. Debt and the public deficit rose to 45 and 5.6% of GDP respectively in 2009.

Today Turkey enjoys a beefier health than ten years ago and sounder macroeconomic fundamentals than many European countries. However, the snag lies in its current deficit record (-6% in 2010) driven by over consumption, that reveals a weak structural competitiveness. Turkey experiences, indeed, labour market shortcomings due to its large young population (43% are under 25) and next to half of the 15-19 years old cohort (61% of the girls) is out of school. The participation rate of the active population amounts to only 47% (70% for men, 25% for women). At last, informal employment takes up a lot of room (44% of total employment, 21% of which in agriculture).

This research aims at presenting the evolution of a large emerging economy with its strong and weak points, an economy that plays a great role in the immediate surround of Europe.

Deniz Ünal

DATABASES

BASELINE database

Long-run economic outlooks are very useful for policymakers and entrepreneurs, especially when it comes to dealing with sustainable development and energy constraints. In order to be able to address such issues, the CEPII released in December 2010 a growth scenario to 2050[1] leading to the publication of the BASELINE database.[2] The goal of this database, produced by the CEPII, is to provide a fully-documented long-run growth scenario, ready to use as an input for other works, for instance as a reference scenario in general equilibrium models like MIRAGE, developed at the CEPII. The database gives past and projected values for GDP, production factors and productivity, according to the methodology described in Fouré, Bénassy-Quéré and Fontagné (2010).

This long term scenario focuses on the macroeconomic determinants of growth – namely labor force, capital accumulation and energy consumption – and their dynamics, based on their historical values from 1980 to 2008. These production factors determine GDP levels through a constant elasticity of substitution production function and are associated with two different productivity factors:

- Energy productivity, representing how efficiently the energy is used in each country. Over the past, the values of this energy productivity result from the firms maximizing their profits subject to the prices of the different production factors.
- Total Factor Productivity (TFP) related to capital and labor force, computed as the Solow residual of the production function.

Contents of the BASELINE database are presented below, focusing on productivity and production factors, since GDP projections have already been discussed in a previous newsletter.[3]

In projection, both Energy productivity and TFP follow an estimated technology diffusion process, in which countries tend to catch-up with the technological frontier, that is the level of the world leaders – the USA for TFP; Japan, Germany, United-Kingdom and France for energy productivity. This means that the farer a country is from the productivity frontier, the faster its productivity grows. However, TFP growth rates are conditional to human capital (average years of education) while energy productivity growth is lowered by improvements in GDP per capita, in order to show that energy is more efficiently used both in agriculture (major economic activity in less developed countries) and services (high development) than in the industry (middle development). Figure 1 depicts past and projected values of energy productivity (1a) and TFP (1b) for the BRICs (Brazil, Russian Federation, India and China) and a selection of OECD countries.