

# **The Global Economic Context: The Nexus of Finance, Economics, Development and Climate**

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Introduction:

The world faces simultaneous set of challenges: the global financial crisis has precipitated a major global economic slowdown; governments face the challenge of stimulating economic growth while reducing carbon intensity ; over the longer term there will be an increase of global population from 6 billion in 2000 to 9 billion in 2050, with all of that population increase occurring in the developing world; and the international institutions do not reflect the new global realities in terms of representation and legitimacy and in terms of adequacy to address inter-related rather than sectoral global challenges. (On global governance, see companion paper, "The Gs and Global Challenges".)

The question is how to address the crises of the moment in a way that is consistent with the long term path toward sustainable global development.

## **I. The Global Financial Crisis: A Shift in the Market Model for Economic Growth**

For years, there has been an intensive debate about the whether the Anglo-Saxon model which reached its zenith in the Thatcher-Reagan years adequately explained dynamic economic growth and generated greater inequality as globalization increased its spread. Already, well before this financial crisis, there was doubt and suspicion in the rest of the world that globalization favored the rich over the poor. Now, irrespective of secular trends, the volatility imposed on the real economy by the financial crisis makes it clear that financial instability is the handmaiden of inequality. Since the early 1970s, when the U.S. delinked the

dollar from gold, the world economy has sequentially manifested a pattern of chronic instability from the oil shock in the 1970s to the interest rate shock of the 1980s to the capital flows shock of the 1990s to the financial crisis of the 2000s.

*The conclusion that is being drawn by most observers from the current financial crisis is that the hands-off capitalism is dangerous; the invisible hand is an insufficient guardian of the public interest; and laissez faire models for financial markets are passé. This is in fact a propitious shift in mind set. The ideology of market fundamentalism was indeed excessive. What policy makers are looking for now is a pragmatic approach to finding institutional innovations, policy interventions and other actions that will better protect the public interest in job growth, asset value preservation, and financial stability. This bodes well for developing a more balanced, integrated and sustainable economic path forward rather than over-relying on market signals, competition, and liberalization as the engines of growth.*

For years, development economists have been searching for mixed economy approaches which are both market-based and policy-based, that combine market incentives with policy inducements, and that mesh short-run policies with longer-term goals. *The financial crisis is bringing about a shift in perspective that opens up new possibilities for using policy and institutions to supplement, buttress and channel market forces rather than let them run rough shod over the public interest.* No where is this more clear than in the new discussion regarding the strengthening of processes, mechanisms, and institutions for increased oversight, supervision and regulation of financial markets that is going on now with all major economies and in the G20 summit preparations as well.

## **II. The Global Majority, Global Poverty and Energy Demand**

There is a new appreciation in the world that global poverty is a security issue not only because failed states tend to be hotbeds for violence and terrorists per se but that the glaring inequalities of income and wealth which seem to be associated with globalization reduce the legitimacy and credibility of the market model. With world population projected to increase from roughly 6 billion people in 2000 to 9 billion people by 2050, the global poverty issue vaults upward on the global agenda as a pressing political and security issue. Roughly half of the world's people today live on \$2 a day. A significant percentage of the poor live in emerging market economies that have dynamic growth, not just in small, low income economies. Advanced economies have not entirely solved their internal poverty problems either, even as they have increasingly addressed the poverty in developing countries. Poverty is indeed a global problem and a global challenge.

In recent years, there has been a paradigm shift in the international community's vision of the global poverty problem. With leadership from the United Kingdom under Lady Chalker, Claire Short, John Vereker, and Richard Manning and from the United States as well, the OECD Development Assistance Committee (DAC) promulgated a set of seven International Development Goals (IDGs) in May of 1996 based on UN summits in the 1990s. Despite some initial divergence between the development goals in the Millennium Declaration in 2000 and the IDGs, by the UNFFD conference in Monterrey in March of 2002 a consensus set of goals were agreed to by over 180 heads of state as the Millennium Development Goals (MDGs).

The MDGs now "frame" the development effort across the globe, among bilateral industrial country donors, among non-OECD new donors, multilateral agencies, private charities and NGOs and most importantly within the developing countries themselves. The MDGs represent a shift from a financialist, single discipline set of economic policy prescriptions embodied in the Washington Consensus to a multi-sectoral, multi-disciplinary, multi-ministerial and multi-institutional approach to poverty reduction. This was a shift from vertical to horizontal, from specialized to integrated, from single lense to multi-prismatic approaches to development. It was by any account a paradigm shift more consistent with the fundamental fact of 21<sup>st</sup> century global challenges as inter-related, inter-penetrated, and inter-dependent challenges as opposed to the 20<sup>th</sup> century understanding of problems as being specialized issues to be treated by experts operating out of intellectual and institutional silos.

This paradigm shift helps us embrace the new understanding of development as being a set of inter-connected challenges affecting the human condition holistically. The MDGs made it clear that progress on any one goal can not be achieved without progress on ALL goals. Education for all can not be achieved with out gender equality; health goals can not be achieved without education; environment goals are vital to health; and poverty reduction can not occur without simultaneous action across the entire range of MDG issues. Sound economic policies still matter but they are not perceived any longer as the necessary AND sufficient conditions for improving the human condition nor are they the sole drivers and focus for poverty reduction.

Electricity is vital to economic growth and poverty reduction. In 2000, in a world of 6 billion people, 2 billion still lacked access to electricity. Between now and 2050, the world needs to try to extend access to electricity to those 2 billion people currently without it AND create power generating capacity to reach the additional 3 billion people who will constitute the world of 9 billion people in 2050. To put it another way, to provide electricity to everyone by 2050, world power generation capacity would have to grow by more than all the cumulative capacity constructed in the last 100 years.

This implies an enormous investment in energy over the next forty years. *Eliciting that investment is a major global challenge.* On top of this, of course, is the issue of climate change which needs to be interwoven integrally into this next phase of gigantic investment in energy production. Add to this the huge infrastructure investments required in developing countries to provide potable water and access to sanitation to the more than 1 billion people without them and you have a need for a massive marshalling of investment in the coming years. *The question is how to incentivate that scale of investment?*

### **III. Global Energy Needs, Climate Change and Economic Growth**

The most important feature of the current moment is precisely that the global financial crisis has brought about a shift in the global mind-set on economic policy toward one of greater pragmatism and openness toward an enhanced role for policy in support of markets and for institutions for supervising them. That is the critical shift away from an ideological commitment to market fundamentalism which allows us to think more rationally about possible interventions in the market that can make markets generate outcomes that are socially and environmentally advantageous as well as profit-maximizing and GDP generating.

*One of the main mantras of market fundamentalism is "get prices right". What does that mean, "get prices right"? In market fundamentalist terms, it means let markets work, free of government intervention and they will generate competitive equilibrium prices which are "optimal", by which is meant efficient. Any deviation from competitive market prices requires more effort (labor, capital, inputs, etc) for the same output level than would be the case at the market-determined price. Hence, any deviation is less efficient and sub-optimal. Therefore, hands off the market.*

Today, we understand, thanks to Nick Stern and others, something different by the term "right prices". We now know that the market-determined oil price, for example, does not embody the future costs of carbon emissions on the atmosphere and on climate change. The market price for oil is a short-run price determined by today's global supply and demand. It is not what economists call a social price based on real scarcity and future costs discounted into the present.

The second problem is that the oil price is volatile. In January 2007 the price of oil in the United States was a little over \$40 per barrel; in July of 2008 it was almost \$140 per barrel; by November 2008 the price of oil was below \$40 per barrel. (See Chart I.) If you are an investor in energy production, what price parameter do you use to judge whether you should invest in carbon-based fuels or in alternative sources of energy which by and large are more costly? *What is*

*the real price of oil? The market price does not convey what the real social price of oil is. In addition, it is volatile, so that investors have no basis for predicting what the price will be in the future.*

The issue before us is whether we accept the sanctity of the market and accept its volatility and its failure to represent future costs to the planet of continued reliance on oil OR whether we realize that the human mind can intervene in the market place and correct the market price to make it both reflect the future costs of oil on the planet AND smooth out the trend of the oil price out into the future. We have to not only have confidence that our intellectual understanding of the forces at work are superior to what the market on any given day tells us about those forces AND we have to realize that taking public responsibility for pricing a vital commodity such as oil is better than abdicating that responsibility in the name of hands-off market fundamentalism.

Having said that, figuring out how to insert the human mind into the oil market is another story. Let me illustrate what might be possible. I have chosen the United States as an example but it could be the UK or any other major country.

#### **IV. Integrating Climate Change into Economic Growth: An Illustrative Example**

Let's say the world market oil price today is US\$40 per barrel = US\$2 per gallon of gasoline in the United States.

Let's say that we think the social price of oil, including future environmental costs, is \$100 pb of oil or \$3.50 per gallon of gasoline.

So, why not invent a price adjustment mechanism on the oil price that keeps the oil price at the social price on a daily basis?

A variable carbon surcharge could be phased in over 38 months at 4 cents per month between November 1, 2009 and December 31, 2012, to get the US price up from, say, a \$40pb/ \$2/gal oil/gas price on the world market in November up to the social price of \$100pb/\$3.50pgal by the end of 2012, which is to say the end of the Kyoto Treaty phase. This would give the US a realistic, stable social price for oil/gas at the cusp of the post-Kyoto phase beginning January 1, 2013.

Now, if, as surely will be the case, the world oil price fluctuates AND is above \$40pb/\$2pgal during 2009, 2010 and 2011, then we could either adjust the phase-in to keep the US on a steady path from \$40pb/\$2pgal at time zero (November 1, 2009) to the stable price goal of \$100 pb/ \$3.50 pgal at the end of

2012 [sometimes it would be less than 4 cents a month and sometimes more than 4 cents a month] OR put the 4 cent per month surcharge on cumulatively regardless of the world oil price so that by the end of 2012 the social price is in effect.

After the social price of oil is reached on January 1 2013, then it would have to be adjusted going forward in terms of the dollar exchange rate fluctuations and inflation rate so that the social price keeps its REAL value. It might be necessary to adjust the 2012 target social price over the 38 months for these reasons in any case, and adjust the surcharge accordingly.

The point of the exercise, of course, is not only to re-price carbon to induce energy investments in alternative sources , priced out of the market by an artificially deflated oil price, but to STABILIZE the price and give it predictability, so that investors, consumers and policy makers can take it as a given over time as a long-term planning parameter, which investors, especially, need.

Further, if this idea has any value at all as a realistic tool of policy, it has immeasurably greater value if other major countries were to adopt a similar price adjustment mechanism. Without that, there will be an artificiality about the US social price in relation to the world market price in other countries, and people on the borders would potentially drive to Canada and Mexico to fill up, and other arbitrage behaviors could arise.

*But the important points here are that without a price adjustment mechanism of this kind there is no way that the volume of energy investment required over the next forty years will be forthcoming, especially not in more expensive alternative sources of energy. Without it, there is no way that carbon will be priced into the market sufficiently to steer us away from the carbon-intensive growth path the world is currently on.*

Something has to be done to supplement market forces with a price adjusting mechanism, such as this one, which would realistically price the full social costs of carbon AND stabilize the market for oil so that investors have a credible price parameter to guide their investments over the long run and consumers are not subjected to gasoline prices doubling one month and dropping by half the next.

*And finally and importantly, the monthly phase-in proposed of 4 cents per month over 38 months, or 1 cent per week, illustrates a gentle, gradual insertion of a re-pricing of carbon into the economy which should not endanger the economic recovery and growth path of the country. In fact, any contractionary effects of a rising oil price would be expected to be compensated for in terms of*

economic growth by the increases in energy investment induced by the social price of oil.

*It is far better to have an investment driven recovery than a consumption driven one. Re-pricing carbon could provide positive incentives for shifting the dynamism of economic recovery from consumption to investment.*

In Chart II EIA we see that the U.S. has hit close to \$100 per barrel oil price in constant 2008 US\$ twice before, once in 1981 and once in July 2008. Note also in Chart III that the U.S. has hit a \$3.83 per gallon of gasoline price in the United State in today's dollars (1/12/09) and a \$3.18 per gallon gas price in March of 1981. *There is nothing unprecedented about a \$100pb / \$3.50 pgal social price for oil/gas.*

## **V. Conclusion: The Finance, Economic, Development and Climate Nexus**

The truth is that this is a propitious moment for integrating the strategies of financial reform, economic recovery, development and climate change into a comprehensive and consistent approach. The MDGs show us the salience of forming a multi-dimensional, integrated approach to development. The financial crisis has created doubt about the wisdom of hands-off free market economics and opened new options for thoughtful policies and institutional innovations that would make the market work for us rather than against us, both now and for the future. *What is at issue is whether we trust ourselves more than we trust the market.* The human mind is able to make pragmatic judgements and decisions not driven by ideological purity. We have an opportunity and an urgency now to rely on our wits rather than abdicate our responsibility.

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