The 1987 Per Jacobsson Lecture

Vulnerability and Opportunity

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Interdependence

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Sylvia Ostry

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Foreword

The 1987 Per Jacobsson Lecture, entitled "Interdependence: Vulnerability and Opportunity," was delivered by Sylvia Ostry, at the Dorothy Betts Marvin Theatre of the George Washington University in Washington, D.C., on Sunday, September 27, 1987. Mrs. Ostry is the Ambassador for Multilateral Trade Negotiations for Canada and the Prime Minister's Personal Representative for the Economic Summit.

On behalf of William McChesney Martin, Chairman of the Per Jacobsson Foundation, Frank A. Southard, Jr., President of the Foundation, presided over the meeting, the proceedings of which are presented in this publication. At the meeting, announcement was made of the resignations of Mr. Martin and Mr. Southard and the appointments of Sir Jeremy Morse as Chairman and Jacques J. Polak as President. Closing remarks were presented by Sir Jeremy Morse.

The Per Jacobsson Lectures are sponsored by the Per Jacobsson Foundation and are held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

Frank A. Southard, Jr.

Ladies and gentlemen: Mr. Martin, who continues as Chairman of the Per Jacobsson Foundation for a little while longer, has asked me to preside over today's meeting. He is here, and you will have an opportunity to meet him at the reception, which will take place in this building after the lecture.

We are pleased, indeed, that so many of you who are long-standing friends of this small Foundation have come again to hear this lecture.

The Foundation is approaching its twenty-fifth anniversary, and we are planning, in conjunction with the Bank for International Settlements (BIS), to hold a symposium on June 12 of next year in Basle at the time of the annual meeting of the BIS. We thought that such a symposium would be very appropriate since Per Jacobsson spent the greater part of his career at the BIS. He was for many years the chief economist of the BIS as well as the main author of the institution's annual reports.

While probably the audience at the symposium will primarily consist of people who will be attending the annual meeting of the BIS, any of you who might think that you would be in Basle at that time might make a note of it and might want to come to the symposium.

At this time there is to be a change in the leadership of the Foundation. Mr. Martin, as Chairman, and I, as President, have resigned, and our resignations will become effective at the end of this lecture. Our positions will be taken by Sir Jeremy Morse as Chairman and Mr. Jacques Polak as President.

The Board believes that these two appointments are most fitting. They both knew Per Jacobsson well. And they are both in the mainstream of the chief area of interest of this Foundation. Jacques Polak, in particular, was the Economic Counsellor and the Director of the Research Department of the Fund and served in these positions virtually throughout Per Jacobsson's tenure as Managing Director of the Fund.

Each year, when we think ahead to prepare for the lecture—and we need to plan for eight or nine months ahead to arrange this lecture—we try to think of a theme that would be both current and important at the time of the meeting. I think, on the whole, we can say that we have been fairly successful in our efforts.

This year, back in late fall and early winter, when we were again thinking of a speaker and a subject, we felt that this was the time when the subject of trade and the interrelationships among countries was important. We were sure that at the time of this meeting the subject would become even more important because of the possibility of a drift toward more and more protectionism. We felt that a discussion of that drift would be a lively topic.

So we thought hard as to who might give such a talk and we were advised by many that the right person to deal with this topic was the lady who is sitting on the platform today, Ambassador Sylvia Ostry of Canada.

Mrs. Ostry has had a brilliant career in what I could call "applied economics," as well as in theoretical economics. She has been extremely active in the United Kingdom and in Canada. As you will see from her biography, she has had very wide recognition. She has made important contributions to such events as the twenty-fifth anniversary of the Organization for Economic Cooperation and Development and, more recently, the Venice Summit. We were more than satisfied that she was a very good choice.

I will introduce Mrs. Ostry in a moment. I only want to mention that in keeping with our usual practice, you will find at the back of your program a card for writing questions. If any questions come to your minds while Mrs. Ostry is speaking, you may want to jot them down. She will respond to questions after the lecture.

I now introduce Mrs. Sylvia Ostry.

Interdependence: Vulnerability and Opportunity

Sylvia Ostry*

Mr. Chairman, distinguished guests, ladies and gentlemen:

It is a great honor and privilege for me to deliver the 1987 Per Jacobsson Lecture. The letter of invitation suggested that I might say something about the multilateral trading system so that is what I intend to do. Looking at the list of lectures since 1964, I realized that this was the first time this topic had been the focus of discourse. That omission may be interpreted in many different ways—which I leave to the audience—but for me it is another welcome sign of growing awareness of interdependence, the theme of my lecture.

The word interdependence has been overworked in recent years but that is because it captures such an insistent aspect of our reality.

Interdependence has two separate but related aspects: the increasing economic *linkage* among countries through trade and financial flows and, at the same time, a slightly different concept, that is, the complex *interrelationships* between major influences on the world economic system, present and foreseeable. What interdependence entails is amplified risk, and—since knowledge usually lags behind complex change—amplified uncertainty. More profoundly, interdependence means that opportunities for joint gains are enhanced but vulnerability is also greatly magnified.

I want to elaborate on the notions of linkage and of interrelationship as they occur in the multilateral trading system and, more specifically, in aspects of the Uruguay Round, the most important negotiations since the formation of the General Agreement on Tariffs and Trade (GATT) and, without doubt a watershed. But before I do that, I must recall the background for you.

The Declaration of September 1986 at Punta del Este, which launched the Uruguay Round, took interdependence for granted when it stressed the need for "concurrent action" to make the international monetary system work better and increase the flow of resources to developing countries. To put it baldly, the Uruguay Round on its own cannot preserve the multilateral trading system.

*The views expressed in this lecture are those of the author and do not necessarily represent the policies of the Government of Canada.

In the absence of necessary overall changes in policy, the abuse of trade policy will only worsen the imbalances and the disorder in exchange markets. Trade policy is no substitute for macro-policy. This audience is well aware of the effects, especially during the 1980s, of the exchange rate system on trading patterns and protectionist pressures. Further, the debt of the middle-income countries, whose imports shrank by one quarter over the 1981–86 period, contributed significantly to the U.S. trade deficit. If the multilateral trading system is to be rebuilt and strengthened, progress in multilateral surveillance and coordination of policy among major industrial nations is necessary; so is the growth-with-adjustment strategy to address Third World debt problems. But these conditions, though necessary, will not be sufficient in themselves. I do not intend to deal with such issues on their own since they have been well rehearsed by my predecessors and in many other places.

Yet—and I fear this is *not* well understood by those who focus mainly on macro-conditions and macro-policies—the "not sufficient" is as important as the "necessary." Indeed, the wellspring of protectionist pressures in member countries of the Organization for Economic Cooperation and Development (OECD) and the rise of the new "protectionism" since the early 1970s have been mainly "micro" in origin. The new protectionism reflects incapacity or unwillingness to adjust to ongoing structural change. It is aggravated by supply shocks and by a hostile and turbulent macro-environment.

Even without further supply shocks the pressures for adjustment will not abate. What is more, as I shall argue, the world economy faces an unprecedented conjuncture of forces for structural change which capture the two aspects of interdependence: vulnerability and opportunity. Before I go into that I should like to take a brief look at the new protectionism.

The New Protectionism

It sounds like the title of a magazine article—the new feminism; the new lifestyle; the new skirt-length. But this time it really is new. The new protectionism, because it takes the form of domestic or border nontariff measures, has been difficult to quantify. There have been plausible estimates of the impact of border measures such as quantitative restrictions, voluntary export restraints, orderly market arrangements (often illegal under the GATT). They suggest that as much as one fifth of OECD manufacturing imports were affected by 1980, a quadrupling over the 1970s. In addition, over the same period, the OECD notes a marked increase in domestic industrial subsidies in member countries—a doubling, in fact, in the share of such transfers in the operating surplus of the manufacturing firms affected. In agriculture, the ballooning of domestic transfers in the industrial countries has reached monstrous proportions, thus achieving for this sector a dubious distinction as *the* cautionary tale of political short-termism and economic myopia.

Since 1980, the move to managed trade has not abated. Indeed, despite the so-called porousness of many of the nontariff measures, during the 1980s the most rapidly increasing protectionist actions have been that subset of nontariff measures most likely to have the most restrictive effects. There has also been a rise in what is called U.S. "process protectionism," that is, the increasing use of quasi-judicial mechanisms to discourage imports or provoke export restraint. Further, the *scope* of managed trade has expanded in terms of both industry and country coverage. The protectionist measures applied by the OECD countries after 1980 were mainly directed against exports from each other and from the newly industrialized countries. In absolute terms, however, nontariff measures are significantly more prevalent on imports from developing countries. This is mainly because of the importance of agricultural products and textiles and clothing in the exports of the developing countries.

The new protectionist measures have a number of characteristics that make them particularly threatening to the system. They create a political constituency for their maintenance in both the importing and exporting countries through the generation of scarcity "rents." By fostering trade diversion, both geographic and product-oriented, they build in a dynamic for extension. Often designed to provide a breathing space for adjustment, they are seldom successful.

The effects on the *system* are even more damaging. Precisely because they are less transparent and less easily comprehended than are tariffs they evoke little public reaction as the system is slowly transformed. But the new protectionism, by violating the basic principles of the GATT, weakens external counterpressure to domestic protectionist demands. GATT itself loses authority. In sum, there is little in the history or analytics of managed trade that promises *self-correction*. There is thus no escaping the need to deal with the political economy of structural adjustment, both at home and internationally, if we are to halt and reverse the erosion of the multilateral trading system. This is especially true in view of the powerful structural changes now overtaking the world economy.

Sources of Structural Change

The strong pressures for adjustment in the OECD countries since the 1970s came from several sources: the rise of the newly industrialized countries and the increasing challenge from Japan; continuing technological change, especially in information technology; severe commodity and oil shocks; and the breakdown of the Bretton Woods system of fixed exchange rates. The process of structural adaptation, difficult under the best of circumstances, was impeded by a number of government actions. Imposed mainly during the 1960s and early 1970s, these measures had the unintended effect of impairing the capacity to adjust. The degree of impairment, it is true, varied significantly from country to country, being more acute in Europe than in the United States or Japan. Slower growth in the 1970s and the deep recession of the 1980s also inhibited mobility and adaptability. In the earlier postwar decades, when a major industrial transformation took place, the unprecedented surge in real growth made the process of structural adaptation appear almost effortless, much of the reallocation of resources coming out of the growth margin rather than out of someone else's hide. The virtuous circle of the golden decades is familiar: the dismantling of protectionist barriers in goods and capital markets both fed and was nourished by increasing investment, technology transfer, and productivity. The consequent robust and sustained rise in growth both facilitated and was enhanced by structural adaptation through improved market signals from the international economy. Since the new protectionism functions to inhibit the flexible response of markets to price signals, the growth of economies is also checked. Slower growth begets slower growth.

The rise of the new protectionism and other symptoms of malaise such as high levels of structural unemployment reflect the "unfinished business" of adaptation to the structural changes of the 1970s and early 1980s. Unfortunately, the world will not stand still while we tidy up.

Indeed, that other inheritance from the past—the gross external imbalance in the OECD countries and the debt of the developing countries—while macro in origin will require more than macro-policy changes in the industrialized world and in the newly industrialized countries. It will also require unprecedented structural adaptation in both the OECD and the developing countries. Such structural adaptation is essential if world growth is to be sustained and the multilateral trading system preserved. The required switch in resources within the U.S. economy from domestic absorption into the export and import-competing sector will entail massive sectoral and regional reallocation of the labor force. It will also demand historically unique levels of investment both from domestic and foreign sources. (It is worth noting that in the course of these adjustments investment flows may well dwarf trade flows yet no multilateral disciplines exist to improve predictability and resolve disputes.)

The opposite structural changes are needed in the surplus countries, Japan and the Federal Republic of Germany, and also from the newly industrialized countries. Because of ever-closer linkage, the effect on the non-OECD world of these changes in external balances will also be very significant. The reason is clear: by mid-decade the United States was absorbing over half of Latin American and one third of East Asian exports. Protectionist pressures will shift with changing current account positions. The riddle of the 1990s will be: deficit, deficit, who wants the deficit? Let us hope Lord Lever is wrong in remarking: "It used to be said that when America caught a cold the rest of the world got pneumonia. The way we are going, when America gets well the rest of us will get influenza."

How structural adaptation is to be achieved in confronting global imbalance over the coming years has been widely debated by finance and trade ministers and their policy advisors. Less noted and certainly less integrated in that policy debate has been another development. Since the late 1970s, the pace and nature of change in information technology has evolved into a new technological revolution, one of Schumpeter's "creative gales of destruction." This type of pervasive change in technology does not occur often, perhaps two or three times in the past 150 years. As in each instance of transformation to a new "techno-economic paradigm," it will impose far-reaching change in the structure of industrial output and skills, the organization of production as well as the international division of labor.

It is indeed this unique *conjuncture* of circumstances—the major imbalances in the world economy and the onset of a new technological revolution—which represents the double aspect of interdependence, the magnification of vulnerability and opportunity. The opportunity is that the information-technology revolution creates the potential for a quantum leap in overall productivity and growth that could ease the transition to a more sustainable pattern of external balances and global debt. This could be the way back to the longed-for virtuous circle. But it is contingent on the structural change necessary for its diffusion both at home and internationally. And therein lies the vulnerability. For the risks of impeding adjustment are magnified by this technological transformation. The information revolution, again uniquely, entails a trend to ever-greater international integration of production, services, and markets. In this way it provokes further resistance to changes in the international division of labor. As we shall see, this was a major consideration in the launch of the Uruguay Round to which I now turn.

The Uruguay Round

The Uruguay Round was, as I have said, launched in Punta del Este in September 1986. The event was rightly greeted as new evidence of the improved international economic cooperation which had begun a year earlier at the Plaza Hotel in New York. The Plaza meeting was followed by the Annual Meetings of the World Bank and the International Monetary Fund in Seoul, with its unveiling of the Baker initiative on debt, and the blessing of multilateral surveillance at the Tokyo Summit in May. These welcome events improved the atmosphere for the Uruguay launch but it must be admitted that a powerful spur to action in Punta del Este was fear. Coleridge's aphorism is apt: "Fear gives sudden instincts of skill." It was not only the steady, largely invisible, systemic erosion of the GATT that moved the assembled trade ministers to begin the negotiations. It was also the very visible and growing external imbalances, with the accompanying protectionist fury of the U.S. Congress, and nightmare visions of "hard landings," which concentrated minds early that morning.

A serious flaw in decisions inspired by crisis is that delay as the crisis builds may allow time for obstructions to a genuine solution. A multilateral trade negotiation has been a traditional remedy, by and large successful, for diverting or deferring protectionist claims in all countries. The United States had been trying to launch a new round since the end of 1982. As we have seen, over the ensuing years, protectionist pressures and actions had flared up, sapping the credibility of the GATT and thereby weakening the potential countervailing force of the negotiation. Thus the reasons for the delay in the launch are important to understand in assessing prospects for the Round itself.

The ostensible reason for delay was the opposition of the so-called Group of Ten,[1] a small group of developing countries led by Brazil and India which, largely on legal grounds, opposed the inclusion of the so-called new issues of trade in services, intellectual property, and investment. I shall discuss this shortly. But opposition by the Group of Ten developing countries could probably not have prevented a launch had the three major trading powers—the United States, Japan, and the European Community—been able to agree on timing. The apparent disagreement between the United States and the European Community largely stemmed from the political and institutional complexity of the trade policy formulation process of the Community. The process is inevitably cautious and lengthy, especially when important policy differences exist among member states as they do in agriculture.

There is nothing new about the impact of domestic policy formulation processes on strategic aspects of international decision making. The troubled birth of the GATT itself reflects the hostility of the U.S. Congress in the late 1940s to the Charter of the International Trade Organization (ITO). But the *significance* of this phenomenon is very different today, in a world that lacks an undisputed hegemon. Professor Kindleberger points to the heart of the matter when he argues that international public goods—in this instance, the liberal multilateral

[1]Not to be confused with the Group of Ten—the forum of finance ministers and central bank governors of the major industrial countries participating in the Fund's General Arrangements to Borrow.

trading system—will tend to be underproduced in the absence of world leadership. And, as I hope to show before I have done, it is also the core issue and key challenge of the Uruguay Round.

Returning to the major hitch in launching the talks, that is, conflict over the inclusion of the "new issues," especially services, it seemed to me that though the debate was couched in legalistic and procedural terms, the real issues were of a most basic economic and political nature. These issues should be understood not only because of their intrinsic importance but also because they illustrate the interrelationship of trade, debt, and development. For the sake of brevity let us focus on trade in services. The question is worth a diversion.

Trade in Services

Behind the clash over discussing trade in services were two basic concerns. One had to do with fear of a trade-off between goods and services, that is, fear that the developed countries would not open (indeed might further protect) their markets for Brazilian and Indian goods without demanding in return some service penetration into the Brazilian and Indian markets. The Punta del Este compromise was: negotiations inside the GATT for goods, outside the GATT for services, but under one overall negotiating committee and within the same time frame. The formula reflects an unresolved conflict.

The notion of "no trade-off" is understandable in political terms in view of the new protectionism in goods markets and the marked deterioration in agriculture. It is more puzzling in economic terms. It implies a static concept of economic development that would be unique to this sector and would therefore be unlikely. Even now, the potential in certain service industries of the newly industrialized countries of East Asia and of Brazil and India themselves is clear enough. Fear of trade-off also presupposes a watertight compartmentalization of sectors—resources, goods, services—which does not exist today and will rapidly vanish in the future as industrial and sectoral boundaries blur. In all sectors services are key inputs to production and essential complements to trade. Commingling rather than compartmentalization is the more appropriate image.

The second concern of the Group of Ten developing countries about trade in services is more important. It originates in a fundamental tenet about the respective roles of governments and markets in the development process. In the judgment of the spokesmen of the Group of Ten developing countries, certain key service industries—telecommunications or financial services, for example—represent the "commanding heights" of future growth and development and therefore must be guided by government. This view of the critical importance of government control gained force from the consideration that establishing a multilateral discipline on services would inevitably involve confronting the equally sensitive issues of investment and protection of intellectual property. (It will also involve consideration of the temporary movement of labor where political sensitivities are exposed on the side of many *developed* countries.)

This development aspect of the clash over trade in services should be assessed not simply in GATT terms, but in the much broader context of the growth-with-adjustment debt strategy. Thus, for example, a prime structural impediment to the restoration of creditworthiness and growth in many of the heavily indebted countries are shallow and inefficient capital markets. Among economists and in Fund/Bank circles there is widespread agreement that improved financial markets are essential for mobilizing domestic savings, improving the efficiency of domestic investment, securing new equity capital and the repatriation of flight capital, and facilitating debt-equity swaps and other financial options. Indeed, the older model of development economists—that effective financial intermediation was a *consequence* of development—has been turned upside down, now stressing that it is a *prerequisite* of development. Yet no trace of this analytical framework surfaced during the prolonged debate on services among trade officials at the GATT. Nor, on the other hand, is there a coordinated strategy of financial market reform in developing countries, involving the GATT in cooperation with the Fund and the Bank, in utilizing opportunities offered by the Uruguay Round negotiations on services. But more of this later.

The example of financial markets is too narrow to illustrate fully the breadth of interrelationship inherent in the services issue. For the most part the growth of service trade to its present share of more than one fifth of total world trade has reflected the expansion of trade in goods and the growth of international investment and financial markets as a whole.

But if we look to the future, services should be considered in the radically different context of the information revolution. The revolution began in the manufacturing sector in a cluster of technological advances (micro-electronics, fiber optics, communications, and computer technology). But the main trend of the transformation is rapidly turning to services, as the shift from "hard" to "soft" technologies accelerates. Moreover, the trend to increasing international integration that is inherent in the information revolution is likely, at least for a time, to enhance the role of the multinational enterprise as a carrier of leading-edge technology. Access to this new generic technology and the flows of capital by which it will in considerable part be transferred will become a prime determinant of growth and development around the world. For this reason an "infant industry" approach to strategic service industries will prove increasingly costly and inappropriate. This point is especially important for developing countries since the new technology is labor-energy- and materials-saving. Developing countries, which in previous Rounds have not played a major role, have suffered to some extent as a consequence. Hence it is vital that they participate actively in the present negotiation. Otherwise they are likely to suffer again.

Finally, it must not be assumed that the contentiousness of the services issue is confined to developing countries. Services are subject everywhere to varying degrees of government regulation. They impinge directly on sensitive issues of national sovereignty and differences of opinion about the role of government. Such issues and differences will have to be taken into account in negotiating multilateral disciplines. In the end, more effective international cooperation is the only way in which constraints on national action imposed by interdependence can be compensated.

Now, after this rather lengthy detour on the rocky road to Punta del Este, I want to conclude with some thoughts on a few core issues of the Round, those relating to strengthening the GATT system.

Strengthening the GATT System

Despite—or perhaps because of—the unpropitious economic and political *mise-en-scène* for the Punta del Este meeting, the agenda for the Uruguay Round is the most comprehensive and ambitious in the history of the GATT. The negotiating groups that were established in January 1987 cover the full range of items necessary to improve market access. They deal with agriculture as a central concern for the first time in 40 years. They cover multilateral disciplines for trade-related intellectual property rights, trade-related investment measures, and international trade in services. They will update and strengthen GATT trading rules and GATT itself as an institution. In addition, they provide for a mechanism to resist new protectionist measures and phase out existing ones over the course of the Round.

All these agenda items are important. A major round of liberalization would provide a welcome stimulus to world growth. An improvement in the trading rules governing temporary import protection or "unfair" trade practices would greatly enhance predictability and hence improve the investment climate. A successful negotiation in agriculture would reduce the grotesque distortions in trade that exact such a heavy toll from consumers and producers around the world. This is essential for heavily indebted countries such as Argentina whose export earnings have been devastated by the subsidy war. And so on, down the list.

But I want to concentrate on the key systemic aspects of the Round. In the Punta del Este Declaration these aspects are titled "Functioning of the GATT System" (and, inevitably, the negotiating group is called FOGS, an unattractive and, one hopes, inappropriate acronym). If the GATT system is not fundamentally strengthened there is a high probability that, over the long haul, it will continue to crumble and the gains in liberalization and growth from the Uruguay Round prove transitory. So these are the international public goods issues: there is no reciprocity involved. These public goods will either be provided by governments in active cooperation or not at all. In effect, this aspect of the Uruguay Round provides a real life experiment testing the hypothesis, now widely asserted, that international public goods will not be provided in a world without an undisputed leader.

The two vital components of GATT reform and renewal that I want to describe are first, strengthened relationships with the Bretton Woods institutions and, second, surveillance of trade policies.

Relationship with the Fund and the World Bank

The drafters of the GATT fully recognized the need for policy coordination between the Fund and the ITO which was to replace the General Agreement. When the third leg of the tripod of postwar multilateral institutions collapsed, the extensive provisions for coordination lapsed with it. There was only one exception: the exemption provided for use of quantitative restrictions to deal with balance of payments problems requires consultations with the Fund. This exception in fact exemplifies the need for reform. The balance of payments articles reflect a world of fixed exchange rates, and views of the external adjustment process long since abandoned by economists and by the Fund itself.

There is a major and timely opportunity in the Uruguay Round to spell out new provisions for effective coordination with the Bretton Woods institutions. In recent years, in response to the debt crisis, there has been an evolution in the process of coordination between the Fund and the World Bank and this process should be extended to the GATT.

Thus, for example, trade policy reform is a key component of the growth-with-adjustment approach to debt, and some means of ensuring the continuing participation of the GATT should be developed. (More immediately, such reform could be encouraged by providing "credit" in the Round for measures adopted in conjunction with a Fund or World Bank program.)

But this is only half the story. Emphasizing structural adjustment policies in the developing countries requires a symmetrical approach in the developed countries. There is no regular surveillance of adjustment or micro-policies in either developed or developing countries that complements the Fund's surveillance activities. If trade policy surveillance is implemented as a result of the Uruguay Round (a proposal I will discuss shortly) this, too, would call for more effective coordination among the three institutions that together constitute the present regime for managing interdependence.

Finally, strengthened coordination between the GATT and the financial institutions is not only desirable in itself. It should also help reinforce the process of consultation *within* countries between trade and finance ministers. The need for institutional change in the policymaking process both at home and internationally is perhaps nowhere so acute as in trade policy. This is an important consideration in the other key component of FOGS, trade policy surveillance.

Surveillance

The birth defects of GATT account for the attenuation of institutional capacity. It is these defects which largely explain the absence of regular analytical and evaluative reviews of a member country's trade policies: a micro-policy counterpart, in effect, to the Fund's macro-mandate. Inadequate secretariat resources and the absence of a designated policy forum at both official and ministerial level are symptoms of the flawed and ambiguous "constitution."

Yet the old saying "where there's a will there's a way" is not without substance. As the new protectionism increased, violating the basic principles of the original agreement, that is, nondiscrimination and use of the price mechanism or tariff, no country had a strong incentive to expose its trade-related domestic or border policies to regular scrutiny and discussion. This reluctance may have been increased by the legal nature of the GATT and the difficulty of ensuring that frank policy discussions did not result in invoking the legal obligations of the Contracting Party.

The components of an effective policy-based surveillance mechanism would have to include an enhanced analytic capacity in the Secretariat; a designated policy forum at both the official and ministerial levels; a link with the rules-based surveillance of the dispute settlement procedure and, desirably, improved transparency of domestic trade policymaking procedures in member countries.

The issue of structural change and structural adjustment should be the theme of the reviews in their analytic and policy evaluative content. I need hardly remind you of the contentiousness of this approach in, for example, defining the policy scope to be surveyed.

The purpose of surveillance would be to exert peer group pressure, at the senior official and ministerial levels, for policy adjustment and adaptation. It would do this by highlighting the impact of trade-related policies on the country's domestic performance, on other countries' trade opportunities, and on the system as a whole.

Peer group pressure may seem a weak reed to cope with the forces for structural change in the world trading system but, in effect, it is a counterpart of multilateral surveillance in the Fund or the OECD or the Group of Seven industrial countries. There is no neat set of rules that may be found to guarantee "automaticity" in any of these places. And just as the breakdown of the postwar consensus *macro*-paradigm of how the macro-economy works has made policy coordination more difficult since the 1970s so, today, the new "strategic trade policy" is providing a theoretical rationale for sophisticated forms of protectionism. This weakening of the consensus *micro*-paradigm will doubtlessly make trade policy discussion more ambivalent and inconclusive—but also much more realistic than the stirring trade pledges of yesteryear.

A valuable complement to effective trade policy surveillance in the GATT would be reform of domestic policymaking in member countries. Because losses from structural change are highly concentrated and benefits widely diffused, improving public understanding of the full economic effects of protectionist measures, that is, greater openness, could mobilize counterpressure.

Thus, the report of the group of "wise men" commissioned by GATT Director General Arthur Dunkel recommends a "protection balance sheet" designed to inform the public of the costs and benefits of trade policy actions. A recent study group chaired by Olivier Long, under the auspices of the Trade Policy Research Centre, proposes that domestic institutional reform, to increase transparency and reduce fragmentation of decision making along sectoral lines, be included in the Uruguay Round. This could be achieved, for example, by negotiating the broad objectives for these institutions whose focus would be the domestic economy-wide impact of all forms of industrial assistance.

The relationship would have to be spelled out between policy-based surveillance and the rules-based surveillance linked to the dispute settlement function of the GATT. Improvement of the process for settling disputes in the GATT is in itself a high priority for the Round. It is essential to improve predictability for business decisions and also for reasons of fairness. Effective machinery to settle disputes is the best guarantee for middle-sized and smaller countries against unilateral or collusive action among the major trading powers.

The two forms of surveillance should reinforce each other. As I suggested, in order to encourage frank and broadly based discussions, policy surveillance must be distanced from the legal mechanisms of the GATT. But distance does not mean isolation. Quite the contrary. Effective policy surveillance might be able to anticipate serious trade friction and perhaps help prevent it. For example, over many years the steadily growing number of disputes centered on agriculture clearly signaled the need for basic reform. Or, let me cite a more recent example: the Japanese-U.S. micro-chip dispute. I do not think it unreasonable to speculate whether that dispute should be taken as an early warning of more to come in the high-technology sector. An analysis of the problem in economic terms would at least highlight the pertinent policy questions relating to industries with steeply declining cost curves, rapid obsolescence, and major externalities. The discussion would likely not yield a simple answer about a particular rule, in this instance the anti-dumping one. But it might help to decide whether this specific dispute was unique in itself or potentially systemic, and thus required further action.

Indeed some experts on the multilateral system, such as Miriam Camps and William Diebold, Jr., have suggested taking the policy-rules relationship one step further. Thus policy surveillance, as the agriculture and micro-chip examples imply, could evolve into a means of more frequent updating and extension of the rules via the designated ministerial forum.[2]

The framers of the original GATT could not possibly have foreseen the world of the late twentieth century. Indeed, roughly once a decade, rounds of negotiation have served as a means not only of liberalizing markets but also of refining and strengthening the trading rules. This will also be an important item in the Uruguay Round. But in today's world of rapid change and uncommon strains in the international economy the shape of the future is shrouded in uncertainty. This could well argue for building into the GATT system an option of more frequent review and adaption based on the surveillance mechanism at ministerial level.

Conclusion

We have considered the implications of interdependence as they manifest themselves in the multilateral trading system, and have looked more closely at the way they affect the Uruguay Round.

The Uruguay Round offers both a challenge and an opportunity not just for trade ministries but for government policy as a whole. The outcome will affect growth, exchange rates, and debt—the terrain of finance ministers and central banks. Reform of the GATT is important to the effective functioning of the Fund and the World Bank as, indeed, both institutions have strongly demonstrated in the Uruguay negotiations.

The challenge has come at a period of unique transformation in the world economy. The transformation is multifaceted: the global imbalances; the information revolution; the unsettled and unsettling state of the discipline of economics; the emergence of a multipolar world. To meet the challenge and seize the opportunity of this GATT Round will require

[2]Miriam Camps and William Diebold, Jr., *The New Multilateralism: Can the World Trading System be Saved*? (New York: Council on Foreign Relations, 1983, rev. ed., 1986). See also Richard Blackhurst, "Strengthening GATT Surveillance of Trade-Related Policies," Bielefeld Conference, June 1987 (mimeo., publication forthcoming).

changes in both domestic and multilateral decision making. The alternative to making these changes will be the emergence of a world trading system which no government planned or desired. The manifold pressures for adjustment will not abate. The genie is out of the bottle and the genie is blind. Governments should have vision.

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SIR JEREMY MORSE: Ladies and gentlemen: I think the applause shows how amply justified was the choice of Sylvia Ostry to deliver this year's Per Jacobsson lecture.

As I listened to her account of the insidious character of the new protectionism with its interplay of macro and micro, of the Uruguay Round, of the special detour she made on the issue of services, and of the need to strengthen the GATT by structural changes, I had the most refreshing and comforting feeling that I was looking at a story I knew already from the other side. And she made that point herself very amply when she said that this lecture will fit in very well with the sequence of lectures that we have had in recent years.

We now have a little time for questions—20 or 25 minutes, or so—and I hope you will be passing up any questions that you might have in written form. We will also take questions from the floor. Mrs. Ostry will moderate the questions.

Questions and Answers

Following the formal presentation, Mrs. Ostry answered questions from the audience.

You didn't raise the issue of the U.S. trade deficit. I wonder why you think the whole Uruguay Round could be threatened if the trade deficit stays high, say, into the early 1990s?

I think I did raise it, perhaps not as explicitly as I might have. I said that the deficit—or rather that the current account imbalance, of which the deficit is one aspect—had arisen largely from macro-conditions and would require macro-policy to change it, but that the macro-policy would not be enough.

I then said that the structural adjustment implied in the turning around of the trade deficit in the United States would impose enormous structural adaptation on the U.S. economy. The U.S. economy has demonstrated its flexibility, and I think that there are a number of people who think that it's perfectly possible for that enormous structural transformation to take place.

I then said that we have to raise a similar question about the surplus countries, which would have the reverse structural adaptation process.

So I think that the U.S. trade deficit is a very key question, but if one looked further down the road I have suggested that if we get over this protectionist juncture—and one hopes we do—that we should not breathe a huge sigh of relief because coming through the pike in the unwinding of the trading balances may be a marked shift in the protectionist pressures which emanate from the unwillingness to adjust to change.

To what degree do foreign exchange rate distortions have an effect on protectionism?

I don't think I can give you a quantitative answer. I can certainly give you a perceptual answer that, sitting in the GATT and discussing the trade situation during the lengthy effort to launch the Uruguay Round, it was fairly clear to many that the current account deficit in the United States was fanning very substantial protectionist pressure. As this pressure hit the export industries, it appeared to be containable. But as it began to hit the import-competing industries and spread, you could observe the protectionist pressure mounting.

Now there will be great debates as to how much that emanated from exchange rate distortion. As I say, it is not quantifiable. It is my perception that it was a very powerful influence and, moreover, I think it would be again wrong to believe that it will go away quickly. I think there will be a long lag and an echo effect.

The erosion and the distortion which took place will have a continuing effect on the perception of some of American industry and, therefore, the protectionist pressure will not recede very quickly under the best of circumstances.

Do efforts to achieve fair trade produce protectionism? Are "free" trade and "fair" trade separate subjects?

I've been taught, once I started going to the GATT, that I was not allowed to say "free trade." I was supposed to say "freer trade," and I think that's probably true, that freer trade is, in GATT historical terms, and, in reality, the more apt phrase.

This definition of fair trade is going to be a key issue in the Uruguay Round in the review of the rules.

In answer to the question, do efforts to achieve fair trade produce protectionism, I think it is clear that one of the concerns in the Uruguay Round about what is called "U.S. process protectionism" is the definition—the precise definition—of the way the rules are applied. And there's a growing feeling that a unilateral definition or the application of a particular method for dealing with fair trade in the United States has, in fact, produced what is called "process protectionism"—the use of the U.S. system, whatever the definition, is affecting investment decisions, trade decisions, and so on.

Yes, I think that's going to be a very important issue. Our hope is that the multilateral approach will produce a cessation or a reduction of process protectionism, if it is successful in the Uruguay Round.

Could you please expand on the disadvantages of the "special and differential treatment" provided to the developing countries under the GATT in the past?

Could I opt out of that literally? I made an allusion to it—it's a very important issue and I'm not treating it lightly. But I was talking about something quite different and I hope it wasn't misinterpreted.

I said, in the course of my talk, that in the past many of the developing countries had not actively participated in Rounds, and that, if you look at the results it can be argued, I think, fairly or objectively that they reflect this lack of participation. I was not alluding to special and differential treatment particularly. That's a very complex and sensitive subject—one which I would be quite happy to discuss with whoever wrote the question after the meeting.

I made the point that if there was not better participation this time, that the cost would be greater because I do believe that the new issues straddle, as I said, very important sectors. And this Round is supposed to be dealing not with tomorrow but with the twenty-first century. And that's really the point I was making. I was not specifically alluding to special and differential treatment.

If the new trade surveillance mechanism you recommend resulted in a widespread view that a particular country was pursuing domestic policies that while not violations of the GATT in legal terms were destabilizing the international system, what would the Contracting Parties be entitled to do?

In the proposal I made—and remember I have put forward some ideas which are not specific proposals—I think it is a key issue. I had argued that the GATT is a contract and thus the rules are enormously important. But I had also argued that both in the past and more particularly in the future the blurring between domestic policies—which have an impact on trade—and border policies has created the need for something which is not going to be very clear-cut. I called it ambivalent and difficult. This is the proposal for trade policy discussion or surveillance. When the question is put—and it's a legitimate question—what would the Contracting Parties be entitled to do as a consequence of policy surveillance, that is a legal question. And I have suggested that, if the trade policy discussion, which in the end involves peer group pressure, is vague and difficult, it is no more vague and difficult in micro-policy than it is in macro-policy. Nonetheless, I agree that it's not neat and it's not simple.

But if there were a series of domestic policies which had significant trade-distorting effects and were not adequately covered by the rules, there might be a possibility of rule adaptation. In other words, the policy debate might lead to a consideration of a change in the rules. This is different from the present situation. Now, as the rules are violated we don't look at the violation or talk about it. We say that's the world and there's nothing we can do about it. Thus, the violation has gone on for 10 or 15 years and finally we have launched a Round.

Instead, I am arguing that you at least set up a process of looking at the policy issues, the distortion of trade, the impact on other countries. That's the beginning. Whether surveillance leads to the use of the existing legal mechanisms or a modification of the legal mechanisms will depend on how it evolves. This would involve learning by doing.

What role does the success or failure of bilateral trade negotiations play for the strength of the multilateral system?

I presume that this question is referring to an unknown bilateral negotiation or an unnamed bilateral negotiation, which is under Article 24 of the GATT—that is, legal and GATT conformable.

I think that a GATT conformable bilateral agreement, is first of all, part of the GATT, and is assumed to be and historically has been trade-creating; that at this particular time trade liberalization is desirable and important and, with an ongoing Round, would help improve the conduct of the Round.

Do you believe international money and capital flows should be regulated in order to prevent "destabilization" of exchange rates, which, in turn, contribute to protectionism?

I can give a very direct answer to that. It is no.

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SIR JEREMY MORSE: Thank you, again, Sylvia Ostry, for both a splendid lecture and a very trenchant and lucid answering of questions.

There were several questions that she didn't have a chance to answer, and I expect a number of you have others. There will be a reception in a few minutes and you will be able to ask her further questions at that time.

Before we go to the reception, I think I should pay a tribute to Bill Martin and to Frank Southard, who are, as Frank told you at the beginning of the meeting, handing over the leadership of what Frank rather engagingly called "this small Foundation."

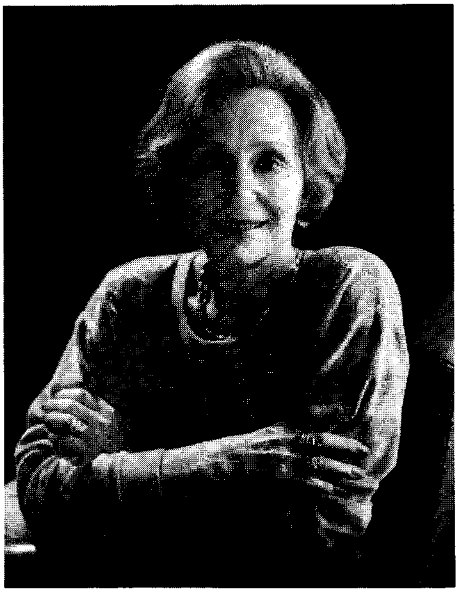
They have done wonderful work in the years since they took over from Randolph Burgess, and both Jacques Polak and I feel very honored to follow in their footsteps—honored because of the excellence of the lectures and programs that they have put on during the time they have been in charge and also because personally we have such admiration and affection for them both.

Bill is at the back of the hall and Frank is on the podium, and I think we should pay them a tribute. (Applause).

As you have heard already from Frank, we have a slightly different program planned for next year. We will have a symposium on Sunday, June 12, in Basle, on the occasion of the twenty-fifth anniversary of the BIS. If you are anywhere in the vicinity, please come along.

That concludes the proceedings of this lecture meeting. Thank you.

Biography



Sylvia Ostry, a Canadian national, was educated at McGill University and at Cambridge University. She did research at the University of Oxford Institute of Statistics and taught at McGill University and the University of Montreal.

Mrs. Ostry then entered Canadian public service. Her posts included Chief Statistician of Canada (1972–75); Deputy Minister, Consumer and Corporate Affairs, and Deputy Registrar General (1975–78); and Chairman, Economic Council of Canada (1978–79). In the period 1979–83, Mrs. Ostry served the Organization for Economic Cooperation and Development in Paris as Head of the Department of Economics and Statistics.

Returning to Canada, Mrs. Ostry held the position of Special Advisor to the Privy Council (1983) and served as Deputy Minister, International Trade, and Coordinator, International Economic Relations (1984–85). Currently, she is Ambassador for Multilateral Trade Negotiations and the Prime Minister's Personal Representative for the Economic Summit.

Ambassador Ostry is the author of many published works and is an Officer of the Order of Canada. Numerous universities have awarded her degrees *honoris causa*. She is a member of a number of learned societies, a Fellow of the American Statistical Association, and a founding member of the Centre for European Policy Studies, Brussels, and a member of the Group of Thirty.

The Per Jacobsson Lectures

1964 *Economic Growth and Monetary Stability*—Lectures by Maurice Frère and Rodrigo Gómez (Basle); out of print.

1965 *The Balance Between Monetary Policy and Other Instruments of Economic Policy in a Modern Society*—Lectures by C.D. Deshmukh and Robert V. Roosa (Washington); out of print.

1966 *The Role of the Central Banker Today*—Lecture by Louis Rasminsky; Commentaries by Donato Menichella, Stefano Siglienti, Marcus Wallenberg, and Franz Aschinger (Rome); out of print.

1967 *Economic Development—The Banking Aspects*—Lecture by David Rockefeller; Commentaries by Felipe Herrera and Shigeo Horie (Rio de Janeiro); out of print.

1968 *Central Banking and Economic Integration*—Lecture by M.W. Holtrop; Commentary by Lord Cromer (Stockholm); English and French editions out of print.

1969 *The Role of Monetary Gold over the Next Ten Years*—Lecture by Alexandre Lamfalussy; Commentaries by Wilfrid Baumgartner, Guido Carli, and L.K. Jha (Washington).

1970 *Toward a World Central Bank?*—Lecture by William McChesney Martin; Commentaries by Karl Blessing, Alfredo Machado Gómez, and Harry G. Johnson (Basle); English and Spanish editions out of print.

1971 *International Capital Movements—Past, Present, Future*—Lecture by Sir Eric Roll, K.C.M.G., C.B.; Commentaries by Henry H. Fowler and Wilfried Guth (Washington).

1972 *The Monetary Crisis of 1971—The Lessons to Be Learned*—Lecture by Henry C. Wallich; Commentaries by C.J. Morse and I.G. Patel (Washington); Spanish edition out of print.

1973 *Inflation and the International Monetary System*—Lecture by Otmar Emminger; Commentaries by Adolfo Diz and János Fekete (Basle).

1974 *Steps to International Monetary Order*—Lectures by Conrad J. Oort and Puey Ungphakorn; Commentaries by Saburo Okita and William McChesney Martin (Tokyo).

1975 *Emerging Arrangements in International Payments—Public and Private*—Lecture by Alfred Hayes; Commentaries by Khodadad Farmanfarmaian, Carlos Massad, and Claudio Segré (Washington); Spanish edition out of print.

1976 *Why Banks Are Unpopular*—Lecture by Guido Carli; Commentary by Milton Gilbert (Basle); French and Spanish editions out of print.

1977 *The International Monetary System in Operation*—Lectures by Wilfried Guth and Sir Arthur Lewis (Washington).

1978 *The International Capital Market and the International Monetary System*—Lecture by Gabriel Hauge and Erik Hoffmeyer; Commentary by Lord Roll of Ipsden, K.C.M.G., C.B. (Washington).

1979 *The Anguish of Central Banking*—Lecture by Arthur F. Burns; Commentaries by Milutin Ćirović and Jacques J. Polak (Belgrade).

1980 *Reflections on the International Monetary System*—Lecture by Guillaume Guindey; Commentary by Charles A. Coombs (Basle).

1981 *Central Banking with the Benefit of Hindsight*—Lecture by Jelle Zijlstra; Commentary by Albert Adomakoh (Washington).

1982 *Monetary Policy—Finding a Place to Stand*—Lecture by Gerald K. Bouey (Toronto).

1983 *Developing a New International Monetary System: A Long-Term View*—Lecture by H. Johannes Witteveen (Washington).

1984 *Economic Nationalism and International Interdependence: The Global Costs of National Choices*—Lecture by Peter G. Peterson (Washington).

1985 *Do We Know Where We're Going?*—Lecture by Sir Jeremy Morse (Seoul).

1986 *The Emergence of Global Finance*—Lecture by Yusuke Kashiwagi (Washington).

1987 *Interdependence: Vulnerability and Opportunity*—Lecture by Sylvia Ostry (Washington).

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The Per Jacobsson Foundation

*At the conclusion of the meeting, Sir Jeremy Morse succeeded Mr. Martin as Chairman and Jacques J. Polak succeeded Mr. Southard as President. At the same time, Mr. Polak became a member of the Board of Directors.