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COPING WITH GLOBAL INTERDEPENDENCE

Speech by Sylvia Ostry, Canadian Ambassador for Multilateral Trade Negotiations and Personal Representative of the Prime Minister, Economic Summit, to the International Monetary and Trade Conference, Philadelphia, December 8, 1985.

It has now become fashionable to talk about global interdependence. It has made its way from the pages of dull textbooks to the desks of bright politicians. But its precise meaning is not always clear; still less its policy implications.

I see two broad meanings in global interdependence as applied to matters of economics. It embraces the term of increasing economic linkage among countries through the continuing development of trade and especially financial flows. It also covers a somewhat different, though related concept, that is, the interrelationships among the powerful forces shaping the present and foreseeable world economic system: most obviously in the complex nexus emanating from macroeconomic policy, capital flows, exchange rates and trade.

In these two manifestations of interdependence there is a common message. Interdependence clearly conveys a sense of amplified risk but also unprecedented opportunities for joint gains.

The policy implications are important both for individual governments and for international economic institutions. Many policy issues traditionally perceived as subject only to internal criteria are increasingly exposed to the intrusion of international objectives or have major spill-over effects on the international economy. In no country as yet is the decision-making process fully adapted to this blurring boundary between domestic and international economic policy.

The multilateral institutions are also under pressure to adapt. The structure established after the Second World War to promote economic development, orderly financial markets, and an open world trading system, rested on a tripod — the World Bank, the International Monetary Fund (IMF), and the General Agreement on Tariffs and Trade (GATT). Today's world economy has become immeasurably more interdependent than the one these institutions were designed to serve. The "old multilateralism" worked surprisingly well for several decades, but unless it is adapted and strengthened it will be unlikely to meet the needs of the 1980s and beyond.

The problem, however, is one of timing. There are two clocks ticking: the clock of rapidly accelerating economic interdependence and the clock of domestic and multilateral decision-making. But they are not, as yet, ticking to a simultaneous schedule. We have yet to agree on the economic policy equivalent of Greenwich Mean Time.

Nonetheless there are signs, very recent ones, that we may now be moving toward synchronization. The last half of 1985 has seen some highly interesting developments pointing to a possible breakthrough in international economic co-operation. I want to talk about this tonight. First, however, to put these developments in perspective, let me sketch the economic background.

The world economy is now in its third year of recovery from the 1981-82 recession. But it is a recovery characterized profoundly by assymetry and imbalance. The place and nature of the up-turn differed markedly among the major "blocs" of the Organization for Economic Co-operation and Development (OECD) – North America, Europe and Japan. This divergence, apparent in 1983, was even more marked at the peak of the recovery, in 1984, when the US grew at nearly three times the pace of Europe and a full percentage point more than Japan. The present and projected convergence in growth rates is largely due to a slowing in US growth rather than a compensatory acceleration in the other two blocs.

The divergent growth pattern – especially marked across the Atlantic – was itself both the consequence and the cause of the serious imbalances in the OECD economy.

The most visible manifestation of divergent recovery has been the dramatic imbalance in current account positions within the OECD, as exemplified by unprecedented current account deficits in the US and growing surpluses in Japan, Germany and some other European countries. Differential growth rates accounted for perhaps a third of the US current account deficit. The other major factor (in addition to the loss of dynamic less developed country (LDC) markets) was the stunning appreciation of the dollar. The US locomotive had an extra engine.

The exchange rate misalignment itself was a function of capital rather than trade flows (an indication of how the trend to global integration of capital markets has turned the external "adjustment process" upside down). These capital flows, in turn, were at least in part attributable to another fundamental imbalance in the OECD economy – the stark contrast in fiscal policy between the US on the one hand and Europe and Japan on the other. While the cumulative swing to fiscal ease between 1982 and 1985 in the US amounted to nearly 4 per cent of its gross national product and was the primary force pulling the world economy out of the deep recession of the early 1980s, the comparable change in the direction of fiscal restriction was 2.5 per cent in Japan and over 3 per cent in Germany.

The fiscal imbalance and consequent high real interest rate was, obviously, one major cause of the dollar's rise. Yet, at a deeper level, there is a more ominous disequilibrium. The gap between US savings and US demand (including the massive budgetary deficit) has been filled by drawing on savings from abroad. A mirror image of this basic savings-investment gap exists in Japan. There, net savings are not fully absorbed by domestic demand but exported as capital flows, mainly to the US, matched by a huge and growing flood of manufactured exports. The Japanese structural savings surplus is the root cause of the enormous and growing Japanese current account surplus.

Finally – to complete the catalogue of imbalance – the recovery has produced dramatically different results in employment as betwen Europe, on the one hand, and the US and Japan on the other. The European unemployment problem goes back 15 years and is most vividly revealed by a startling statistic:

there has been no net job creation in Europe as a whole since 1970. The recovery after the 1982 recession made little impression on the European unemployment rate: it appears to be stuck in the 11 to 12 per cent range. By contrast, the US unemployment rate dropped from a recession high of nearly 11 per cent to its present level of around 7 per cent.

European unemployment is variously attributed to rigidity of labour markets and deficiency of demand, but there is little agreement on what portion of this unemployment would yield to an easing of macroeconomic policy, without re-igniting inflation. There is a growing risk, moreover, that as unemployment persists, the demand-deficient portion becomes resistant to the easing of policy, both through a process of inadequate investment over a prolonged period, and an erosion of workers' skills and work habits.

These imbalances that I have described have separate identities but they are clearly interrelated. Moreover, in combination they pose a signal danger: they provide a uniquely fertile breeding ground for protectionist pressures. In all countries the temptation is present to resist the consequences of the imbalances by resorting to protectionist devices.

The so-called new-protectionism has been on the increase for at least 15 years but appears to have accelerated since the recession of the early 1980s. The increasing use of non-tariff barriers (NTBs) is particularly noteworthy. According to the OECD, by the end of 1983 the product groups subject to NTBs accounted for 30 per cent of total consumption of manufactures in OECD countries, up from 20 per cent in 1980. An especially pernicious aspect of the border measures is that they create a constituency for their maintenance or even extension in both the importing and exporting countries. There is nothing in the history or analytics of managed trade which suggests it would be self-correcting.

Neo-protectionism also takes another insidious form, more difficult to measure: a proliferation of domestic policies (subsidies, regulation, tax expenditures, transfers) that have the effect, if not always the express intent, of managing the flow of trade but are considered domestic terrain and largely immune to the rules and procedures of the GATT.

The well-spring of neo-protectionism in the industrialized world has been the unwillingness or incapacity to adjust to the on-going structural changes and shocks of the 1970s – exacerbated by exchange rate turbulence and the deep recession of the 1980s. GATT – the unfinished leg of the postwar multilateral tripod – was not designed to deal with the blurring boundaries of domestic industrial policy and trade policy nor with the massive diversion of trade flows impelled by prolonged exchange rate misalignment.

Finally, apart from its harmful effects on industrial countries, rising protectionism is incompatible with the sustainability, let alone the resolution, of the global debt problem. Continued access to OECD markets is a necessary, though not sufficient, condition for the debtor countries to earn the foreign exchange necessary for managing existing debt, for building the confidence in the international community on which future financial flows will depend, and for growth.

Thus the economic background to the "events" of 1985 (the Bonn Summit, the G-5 [the United

Kingdom, the US, the Federal Republic of Germany, France and Japan] meeting of September 22, the Baker initiative in Seoul) was characterized by a complex matrix of interrelated problems. What are the implications for policy?

First, and most fundamental, is the fact that the prolongation and exaggeration of imbalance has ruled out a unilateral US solution to the growing systemic strains. The standard prescription of summiteers and others – a substantial and sustained reduction in the US fiscal deficit – would both lower interest rates and the dollar but would also, for a time, reduce (already slowing) US growth, since the induced lower interest rates would stimulate activity and the lower dollar [would] increase net exports only with a lag. The net result of this unilateral policy would be to lower activity in the rest of the world because the impact of lower US growth and enhanced US competitiveness would outweigh the (lagged) stimulative effects of lower interest rates and improved terms of trade.

The consequences of lowered world growth on the heavily indebted countries would be very serious indeed and hardly needs spelling out here.

Further, although the main focus of US trade policy prior to the Bonn Summit had been the launch of a new GATT round as a bulwark against the rising protectionist tide, it was increasingly clear that a new round in and of itself could prove inadequate unless US export prospects were enhanced by improved competitiveness and by growing, rather than shrinking markets abroad, a development which was rather improbable with unchanged policies in the other major economic blocs. Moreover, enhanced American competitiveness (and the need to service expanding US net foreign debt) implies an eventual turnaround in the US trade account which could provoke serious protectionist response in a sluggishly growing Europe and "import-resistant" Japan, thus again threatening the breakdown of the trading system and the renewed eruption of a global debt crisis.

The logic of linkage is thus both clear and relentless. It starts with macroeconomic co-ordination as the necessary foundation to preservation of the international trading and monetary system. But the lessons of recent years show that it is not enough. In both the domestic and international sphere, trade policy and structural adjustment – micro and supply-side – are as important as monetary, fiscal and exchange rate policies – macro and demand-side – to the effective functioning of the world economy. The required scope for effective co-operation is thus very broad indeed.

In 1985 Act One in the long-running drama entitled "Coping with Global Interdependence" took place in the Palais Schaumberg, Bonn. The critical reviews were not kind. One, headlined "The Little Summit that Wasn't," captures their flavour:

"From May 2 to May 4, some 3 000 newspaper and television reporters revived old friendships in Bonn, and a day later President Reagan laid a wreath at the West German military cemetary at Bitburg. Oh yes: at more or less the same time the leaders of the US, Britain, West Germany, France, Italy, Canada and Japan held their annual economic summit. Not much happened." (*Business Week*, May 20, 1985)

That assessment is not only unkind but also misleading. If (with the benefit of hindsight) the critics had known that what took place at Bonn was not the first act of the 1985 drama but the last act of a play that started in 1980, quite a lot happened.

The most significant outcome of Bonn — a "first" in summitry — was a declaration by each country of its own economic strategy and objectives. These were strikingly similar: reducing structural rigidities and maintaining prudent fiscal and monetary policies (Japan, in addition, stressed her determination to reduce import barriers).

But the remarkable degree of policy convergence — on the importance of the role of markets and the reduced role of the state — had a deeper implication. Policy convergence — getting one's own house in order — was the recipe for coping with global interdependence which had dominated summitry and other fora since the onset of the 1980s. Policy convergence implies "hands off" both domestically and internationally. Bonn was the apogee of this view.

Act Two was staged at the Plaza Hotel in New York on September 22: the cast — the G-5 finance ministers and bank governors.

There has been a good deal of debate about the true significance of the G-5 meeting, not because the G-5 met since they have done so regularly for many years, but because of the degree of publicity attached to the meeting and its timing — on the eve of a major trade policy speech by President Reagan and just before the annual meetings of the World Bank and International Monetary Fund.

The main focus of the Plaza meeting was exchange rates. The G-5 announcement noted that "exchange rates should play a role in adjusting external imbalances...[and] in order to do this...should better reflect fundamental economic conditions". They signalled the need for "some further orderly appreciation of the main non-dollar currencies against the dollar" and their willingness to "co-operate more closely to encourage this".

In exchange markets, words often speak louder than actions. As we know, there has been a significant realignment among the three world currencies since September 22 —, especially an appreciation of the yen against the dollar, some of it due to intervention but a good deal due also to a perceived change in policy stance on the part of the US.

What was this change? In its reassertion of world leadership in international economic matters the US was also, it seems to many observers, rejecting the "hands off" or policy convergence view of international economic co-operation which was the heart of the Bonn Summit. By stressing the link between misaligned exchange rates and protectionist pressures or, alternatively, the interrelationship between the international trading system and the international monetary system, the G-5 underlined a fundamental aspect of interdependence which had not been explicitly acknowledged either at Bonn or any previous summits since 1980. What was missing from the Plaza *communiqué*, however, was a recipe for macroeconomic co-ordination. If we distinguish between policy compatibility and policy convergence, the former involving, as Henry Wallich has suggested, a significant modification of national policies in recognition of international economic interdependence, the G-5 *communiqué* revealed little trace. *On verra.*

From the Plaza we go to Seoul for Act Three, the annual bank-fund meetings, where the "Baker Initiative" was unveiled in early October. This plan proposed that structural adjustment efforts on the part of debtor countries be supplemented by increased structural and sectoral- (as opposed to more traditional project-) lending by the World Bank group, accompanied by net new lending by commercial banks and "a continued central role for the IMF...in close co-operation" with the International Bank for Reconstruction and Development. The full implications of the US proposal for the role of the Bank, its relationship with the Fund and the commercial banks as well as with the debtor countries remain to be fully spelled out, but there is little doubt that the initiative is another significant development in, and test of, international co-operation.

Finally, on November 28, in Geneva, the contracting parties of the GATT took a decision to establish a preparatory committee for the program of a new round of multilateral trade negotiations for adoption at a ministerial meeting in September 1986. You will be hearing more details of this welcome and important development tomorrow. I simply want to note that what will really be on the table in this round is a strengthened and reinforced multilateral trading system. This system is an international "public good" and it remains to be seen whether the obvious temptation for "free riding" which has characterized the past decade can be overcome.

Let me conclude on a hopeful note. There are signs that policy-making, both domestic and international, is beginning to adapt to growing global interdependence. The question, as I said, is one of timing. Perhaps fear of mutual peril will be the forcing mechanism rather than more high-minded appeals to concord, reciprocity and teamwork. A poem by Lewis Caroll is apt:

The Valley grew narrow
and narrower still,
And the evening got darker
and colder,
Til merely from nervousness
(not from goodwill)
They marched along shoulder
to shoulder.

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