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**"A NEW FRAMEWORK FOR
INTERNATIONAL ECONOMIC RELATIONS"**

Mr Peter Sutherland, Director General GATT, today delivered the Third Hayek Memorial Lecture to the Institute of Economic Affairs in London.

The full text of Mr Sutherland's speech is attached.

**A NEW FRAMEWORK FOR
INTERNATIONAL ECONOMIC RELATIONS**

Third Annual Hayek Memorial Lecture

The Institute of Economic Affairs

Peter D. Sutherland, Director-General, GATT

London, 16 June 1994

Two events provide the setting for my remarks this evening. The first is the decision by representatives of 122 countries in Marrakesh in mid-April to propose to their parliaments the creation of the World Trade Organization (WTO). The second event is next month's 50th anniversary of the Bretton Woods Agreements. Those Agreements, as you know, created two of the three pillars of the postwar economic order - the World Bank and the IMF - with the International Trade Organization stillborn. All that remained of the ITO was its chapter on commercial policy, operational since 1947 under the name of the General Agreement on Tariffs and Trade, the GATT. Once the WTO is ratified, the Bretton Woods triad of organizations will finally be complete.

The significance of the entry into force of the WTO, however, extends well beyond the completion of the Bretton Woods architecture. It will mark a major advance in the rule of law in international economic relations. As such, the WTO will play the central role in helping governments deal with the challenges confronting them in the conduct of international economic relations.

Looking back fifty years, the current challenges are, in my view, even more daunting than those faced by the architects of Bretton Woods. True, we have the benefit of their wisdom, and of our experience with their institutions, and we are not faced with the immense challenge of repairing War damage and massive conversion to peace-time activities. Still, as I will try to show this evening, it is hard to escape the conclusion that the challenges facing us today are, collectively, even greater.

I will also describe how we are coping with those challenges, and make some modest suggestions as to how we might improve our efforts. It is with regard to the search for solutions that I will find it very helpful to draw on the work of Friedrich von Hayek, the man we are honouring this evening.

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Allowing for some inevitable over-simplification, the origins of the current challenge confronting international economic relations can be traced principally to four developments. They are largely independent, in the sense that any one of them could have occurred on its own, yet they interact in ways that multiply their separate impacts.

The **first** is the ongoing integration of the world economy. Led by the liberalization of exchange and capital restrictions, technological change, innovations in the organization of international business

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operations, and the more open and secure trading environment made possible by GATT, the volume of world trade has expanded more rapidly than the volume of world output in nearly every year since the end of the Second World War.

As the world's trade-to-output ratio has steadily increased, national frontiers have become less and less relevant for private sector decisions concerning investment, production and consumption. The mirror image of more intense competition on world markets has been an increasingly defensive stance of import-competing industries, especially pronounced in the developed countries in periods when markets have grown slowly or even shrunk. Thus, even as the national economic interest becomes increasingly identified with an open international economic environment, the forces hostile to that openness clamour more loudly for assistance. Whether actually linked to trade or not, persistent social problems including high rates of unemployment are perceived by some analysts as the main "costs" of liberal trade.

Along with pressures for structural adjustment, issues of sovereignty can also generate frictions between countries. As advances in communications and transportation shrink distances between people, and each country's activities become more intertwined with those of other countries, it is inevitable that countries will find that there are increased external influences on what used to be considered purely domestic policies. Indeed, the range of policies considered as trade-related has steadily grown, from measures applied at the border on imported products to policies whose trade effects are incidental to their main purpose, such as production subsidies, taxation, investment, anti-trust and technical standards and domestic regulations. New areas of attention include the protection of the environment which is accepted as being part of the future trade agenda. Other issues which have been raised include for example: the relationship between the trading system and internationally recognized labour standards; the relationship between immigration policies and international trade; trade and competition policy; trade and investment; regionalism; and the interaction between trade policies and policies relating to financial and monetary matters.

The **second** development is the sharply different demographic trends in the developed and developing countries. Very low or zero population growth rates in the OECD countries are aging the populations and bringing many attendant changes, not the least of which are the financial implications for national pension schemes. As for the developing countries, of the nearly two billion people who will be added to the world's population in the next 20 years, 95 out of each 100 will be born outside the current OECD area. One consequence is that between now and the year 2015, the number of new jobs required to keep unemployment rates unchanged in the developing world will exceed the current populations of Western Europe and North America combined. Again the economic implications are manifold, including competition for capital and a continuing shift in competitiveness in labour-intensive activities to high population growth countries. Nor is it a coincidence that migration, and the linkage between pressures for migration from low-income countries and trade barriers in the rich countries, are moving rapidly up the international agenda.

The **third** development is the spread of market-oriented reforms. In transition economies, reforms are liberating markets from government control and creating the basis for faster growth. Export-led growth strategies in developing countries have led to the rejection of import substitution. In both cases difficulties have arisen in this process, exacerbated by limits on export access to vital areas. But the trend remains clear. For much of the postwar period, more than three-quarters of the world's people lived in countries whose governments were sceptical of - and in some instances, openly hostile to - the advantages of integration into world markets. That has changed and the implications for international economic relations are enormous. Since 1982, for example, the developing countries have nearly doubled their share of world exports of manufactures, from 11 per cent to more than 20 per cent last year. One-third of the top 25 traders of goods and services are now developing countries.

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The fourth development is the end of the Cold War. National economic "competitiveness" has now become a rallying cry, and competition has increasingly been refocussed from the political-military sphere to the economic sphere. While the notion of competition between countries and regions is rather simplistic in an era of greater global economic integration where competition among enterprises is a much more relevant concept, it nonetheless seems to influence policy-making to a growing extent. And, as the interests that bound together traditional alliances have shifted, the cohesion that helped countries resolve economic problems can no longer be taken for granted, increasing uncertainty in the area of international economic relations.

The common element in these four developments is continuous pressure for structural adjustments in patterns of production, investment and world trade. From an economic efficiency perspective, the challenge is to ensure that these adjustments take place in a timely and orderly fashion, while from a political perspective the challenge is to prevent adjustment pressures from generating trade tensions and an associated souring of political relations between countries. A key task of the WTO will be to help countries meet both the economic and political challenges of coping with continuous structural adjustment.

In designing a set of rules and an institution to carry out this task, the drafters of the GATT, and more recently of the WTO, drew on two of Hayek's key insights - the role of the price system in conveying information and the importance of the rule of law.

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Hayek was an articulate and forceful advocate of the view that the price system is a mechanism for communicating information, and that the most significant fact about this system is the economy of knowledge with which it operates. This is critically important in modern economies, which are highly complex, and in which "knowledge of the particular circumstances of time and place" is widely dispersed among millions of individuals. No central planner could hope to collect, let alone process, all this economic information. The price system, by acting "to co-ordinate the separate actions of different people", permits that widely dispersed knowledge to guide, spontaneously, the continuously changing allocation of society's scarce resources.

Valid as it is for a single economy, this insight acquires even more significance in a globalizing world economy in which the amount of information about market conditions and trends is vastly greater. Surely, the ongoing integration of the world economy is one of the key reasons for the spectacular demise of central planning. The illusion that the planners could cope simply became unsustainable.

GATT's rules and disciplines reflect the view that a decentralized system of market-determined prices is the best way of ensuring an efficient allocation of resources. They are also consistent with Hayek's observation that "how well the market will function depends on the character of the particular rules". The GATT rules are designed for market-oriented economies, laying down the conditions of competition for a free enterprise system. In particular, the "tariffs only" principle ensures that where protection exists, it does not block the working of the market mechanism, and the principle of non-discrimination ensures that a country buys from the lowest cost foreign suppliers. Once inside the border, goods are required to receive "national" treatment, that is, treatment on a par with domestically produced goods. The binding of tariffs, countries' obligation to observe the multilateral rules and disciplines, and the procedures for resolving disputes bring, in turn, an element of stability and predictability to the conditions of competition. Nor is the system static. In successive negotiating rounds - the Uruguay Round was the eighth - GATT's member countries have strengthened the role of the market system by cutting tariffs, removing quotas and extending market-oriented rules into new areas. Meanwhile, the membership has grown from 23 in 1947 to 123 today.

International norms, such as those contained in the GATT, play a critical role in

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enhancing freedom. In the *Constitution of Liberty*, Hayek developed further John Locke's very important idea of law as a guarantor of freedom:

"The end of the law is, not to abolish or restrain, but to preserve and enlarge freedom. For in all the states of created beings capable of laws, where there is no law there is no freedom."

At the international level, such norms not only ensure freedom for economic agents to operate in their commercial interest across national frontiers. They also enhance the freedom of governments in their trade policy interventions, by defining the scope of actions permissible within the confines of international law. The behaviour of all governments becomes more predictable when all accept the rules of the game.

I should add that the multilateral norms or rules are also helping countries which are engaged in moving from central planning and import-substitution to market-oriented economies. The rules provide important guidelines for the reform of the trade régime, and the willingness of a country to adhere to GATT/WTO rules and disciplines enhances the credibility of the reform process, both domestically and among foreign investors.

A rules-based trading system is only as good as the credibility of its rules and procedures. For several years prior to the successful conclusions of the Uruguay Round, a number of developments had been contributing to a steady erosion of GATT's credibility. These included the failure to bring agriculture under GATT disciplines, the exclusion of textiles and clothing from the normal rules, the spread of bilateral quantitative restrictions imposed outside the GATT rules, widely different levels of obligations among the member countries, and a perception that the rules had not kept pace with a changing world economy. As a result, the system was rapidly approaching a point where even routine problems - let alone the new challenges I have outlined above - threatened to overwhelm it.

The success of the Uruguay Round was absolutely essential. It is no accident that the agenda for the Round was the most ambitious and complex in GATT's history, rivalled only by the drafting of the Havana Charter. It had to be: the negotiators meeting in Punta del Este in September 1986 were aware of the growing pressures on the trading system, and they successfully sought to include in the negotiations all the key issues as they understood them at the time.

What did the Uruguay Round achieve? In the area of market access, the developed countries have agreed to a cut of nearly 40 per cent in their tariffs, and most countries have bound all or a major portion of their tariffs. Furthermore, the system itself has been substantially strengthened through new rules, procedures and institutional arrangements.

The main features of the agreement on trade in goods include bringing trade in agriculture, long a sector on the margin of GATT rules and a major source of conflict between GATT members, firmly under the normal rules. The agreement on goods also provides for the eventual elimination of bilaterally negotiated restraints on trade in textiles and clothing imposed under the Multi-Fibre Arrangement (MFA), as well as of the so-called "grey area" measures taken outside the GATT rules. Elimination of bilateral quantitative restrictions was a major objective of developing countries in the Uruguay Round, many of whom depend on labour-intensive manufactures to start up the development ladder.

The agreement on services - the first-ever set of multilateral rules for this key sector of economic activity - is the equivalent of GATT for trade in services. But since trade in services covers not only the cross-border movement of services but also commercial presence, the services agreement has an

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investment dimension which the GATT has never had. Equally new is the agreement on intellectual property protection, which provides for a minimum standard of protection to apply in all members of the WTO, with a transitional period for developing and transition economies, as well as for least-developed countries.

Placing the agreements on goods, services and intellectual property protection under the legal umbrella of the new WTO has made possible a "single undertaking" approach, whereby the WTO and its annexes must be accepted as a whole by the member countries. This is an important change with respect to the Tokyo Round, where there was no obligation to accept the agreements covering anti-dumping, subsidies and countervail, import licensing, technical barriers to trade, to name just a few. The replacement of the GATT legal system by the WTO system will mean essentially the same rights and obligations for all members, ensuring that the scope and depth of the multilateral trading system will be much greater than ever before.

These extended commitments of WTO members will be enforceable by trading partners through the new dispute settlement procedures, which have been modified in order to achieve a greater automaticity. Under the WTO, the adoption of a dispute settlement panel's report will no longer require the agreement of the losing country. There is, in addition, another new element, which is the option of an independent review by any appellate body before the panel's recommendations become legally binding. This is a safeguard against possible mistakes, ensuring that the greater automaticity is accompanied by a greater confidence in the results of the dispute settlement system.

The fact that it took three years longer than expected to complete the negotiations does not in any way detract from the magnitude of what will be achieved once the agreement is ratified and in operation. Very conservative estimates point to annual income gains of around \$250 billion from the market access part of the Round, that is, from the reductions in tariffs and the removal of non-tariff barriers on merchandise trade alone. Large additional income gains can be expected from improved market access for services.

However, from the viewpoint of managing international trade relations, it is evident that the most important parts of the Uruguay Round are those involving new and improved rules, disciplines and institutional arrangements. These changes will benefit and stimulate trade flows that currently total 4.5 trillion dollars a year. There is no way of making a meaningful estimate of the income gains from these "systemic" improvements, but in my view there is no doubt that they will be a multiple of the income gains from the market access part of the Uruguay Round.

The Uruguay Round may be behind us, but the WTO is not yet in place. Legislatures are now starting the process of ratification, which I trust will be as speedy as possible, so as to permit the WTO to enter into force by the agreed target date of January 1, 1995. Once the new system is in place, the members will face the task of ensuring that it functions smoothly and continues to evolve. The course of international economic relations during the next two or three decades will depend importantly on countries' attitudes and policies in two areas of the functioning of the multilateral trading system.

The first is **achieving further reductions in trade barriers**, to continue enlarging the scope for trade flows to follow comparative advantage. In the area of goods, tariffs on industrial products are low in OECD countries, but tariff peaks remain in sensitive categories. Average tariffs will remain much higher in developing countries. On agricultural products, tariffication will eliminate quantitative restrictions on imports, but most tariffs will be significantly higher than for industrial products. In

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the area of services, we have in front of us a very active schedule, beginning with the negotiation of commitments on financial services.

Greater difficulties are likely in the case of trade restrictive policies that until recently have been considered strictly domestic. Technical standards, health and safety requirements, government procurement were among the examples I mentioned earlier of policies that have been brought into the international sphere by the ongoing integration of the world economy.

While maintaining a liberalization momentum is important, a more critical and challenging area concerns **the willingness of the WTO members to abide by the letter and spirit of the new rules**, in particular, the major developed and developing countries. This should be easier under the WTO than it has been under the existing GATT, because the agreement to establish the WTO not only provides a major *institutional* boost to the multilateral trading system, but also a fundamental reform of the dispute settlement system.

Other considerations, however, caution against too much complacency. One important reason for the spread of illegal trade actions beginning in the late 1960's was the absence of third party complaints. There was nothing in the Uruguay Round negotiations to suggest any change in the reluctance of third parties to file formal complaints about bilateral agreements that are inconsistent with WTO obligations. As I noted, the Agreement includes a commitment to phase-out bilateral quantitative restrictions over a five-year period - ten years in the case of MFA quotas - but the experience of the past 25 years suggests that this will not be easy. Here I need only remind you that Hayek, in an early anticipation of what today we call "managed trade", warned about the ever present pressures to convert the "competitive order" into "ordered competition".

A more fundamental threat to countries' willingness to abide by the rules and disciplines of the new WTO is the concerns being voiced in some countries about the implications of those rules and procedures for national sovereignty. Part of the explanation undoubtedly involves a development I touched on earlier, namely the tendency for trading partners to seek to influence a range of policies that traditionally have been considered strictly domestic. Two more specific charges levelled by those who are concerned with the possible erosion of national sovereignty concern the way in which rules may be changed under the WTO and the binding nature of the new dispute settlement procedures. Both of these concerns are completely unfounded.

Can the WTO take decisions that will legally bind its Members without their accord? No. The WTO does not have the power to impose new trade policy obligations. For example, the terms of accession of a new WTO member require the approval of two-thirds of the WTO members. But each WTO member remains free to decide not to apply the WTO Agreement to the new member. Thus, the WTO's individual members are protected against the imposition of an obligation to establish trade relations with another State on terms and conditions they do not wish to assume.

Amendments of the WTO Agreement that alter the rights and obligations of members are effective only for those countries that have accepted them. Although it is true that certain institutional and procedural provisions may be amended with effect for all members, changes in the dispute settlement procedures can only be made by consensus. Indeed, compared with the formal provisions of the existing GATT in these areas, the amendment and non-application procedures of the WTO offer much more protection against unwanted change. In many instances in which the GATT requires a majority of one-half or two-thirds of the contracting parties, the WTO now requires a three-fourths majority or even unanimity or consensus. Any legislator worried about the legislature's prerogatives has reason to support the change-over from the GATT to the WTO system.

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The change in the current practice of consensus for the adoption of rulings of the dispute settlement panels is significant. The option of refusing the ruling of panels will no longer be available. Some countries have interpreted the right to refuse panel findings as the prerogative of a sovereign nation. But what this amounts to is a country choosing to be above the law whenever it is inconvenient to observe the law. This is not the prescription for a stable and predictable trading framework. And, of course, the counterpart of each member's giving up the right to block panel findings is a quid pro quo agreement by its trading partners.

It is important to add - as Hayek surely would have - that there is a more fundamental misconception behind the concerns with the impact of the WTO national sovereignty. He was, as I have already noted, an articulate modern advocate of the view that freedom should not be equated with an absence of restraints on behaviour. Freedom, rather, is possible only under the law. Hayek was, of course, concerned with individual freedom, but the arguments carry over to national sovereignty, which is the equivalent for countries of what freedom is for an individual. If sovereignty is equated with the ability of a government to carry out its legitimate functions, the acceptance of the new WTO rules and procedures by governments around the world will **increase** the sovereignty of each and every one of them.

One conclusion to be drawn from this analysis of the challenge facing international economic relations is that there is a need for new cooperative arrangements at the international level to promote global coherence in economic policy-making, not only in trade relations, but also more generally in other aspects of economic policy.

The Uruguay Round decision regarding greater coherence in trade, financial and monetary policies states that "the WTO should therefore pursue and develop cooperation with the international organizations responsible for monetary and financial matters" and ministers invited the Director-General of the WTO to pursue this question with the heads of the Bank and the Fund "with a view to achieving greater coherence in global economic policy-making". The specifics of that cooperation were left open for the future, and developing such a coherence between the Bretton Woods institutions, including the WTO, is a very important challenge for the future. For example, rather than each body conducting separate reviews of country policies, is there not a case to be made for a more integrated approach, building on precedents in the GATT in this area? Clearly, much more thought needs to be given to this subject to increase our understanding of the impacts of various options.

Another priority is the further expansion of the multilateral system, to give it a truly global scope. There are currently 123 contracting parties of the GATT; and 19 more countries are in the process of negotiating their accession or resumption of membership. They include: China, Russia, Ukraine and other ex-Soviet republics; Saudi Arabia; the Baltic States; and the only two remaining Latin American non-members, Ecuador and Panama. It is clearly in everyone's interest for the disciplines and the guarantees of the multilateral system to apply as widely as possible, to the great economic potential of China, for example. But it is equally clear that the enlargement must be carefully managed in order to maintain the integrity of the system which has just been reinforced in the Uruguay Round.

The outstanding priority is, however, the one which is the key to realizing all of the efforts and hopes that have gone into the Uruguay Round. It is the urgent need to ratify the Marrakesh agreements so that they can enter into force on the agreed target date of 1 January 1995. This process, which is in the hands of national legislatures around the world, is the essential step that must be taken before the new international economic framework becomes a reality. Delay in ratification, especially by the major economic powers, would delay the assembly of that framework and leave its elements vulnerable to corrosion. The challenges I have discussed tonight clearly cannot be put on hold. Any hesitation, therefore, in making full use of our newly-won capacity to respond to them must surely be unthinkable.

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