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The International Monetary Scene and the Next WTO Negotiations

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The History

International monetary and macroeconomic conditions have played a critical role in launching and, to a lesser extent, completing multilateral trade negotiations throughout the postwar period.

One of the motives of the United States in proposing the Kennedy Round in the 1960s was the gold and dollar crisis of that decade, which first erupted during the presidential campaign of 1960. The United States believed that a negotiated reduction in foreign trade barriers (trade barriers remained very high at that early point in the postwar period) would enable the United States to strengthen its balance of payments position without harming the world economy. Quaint as it now seems, President John F. Kennedy also sought to reduce barriers to the exports of "Japan and other developing countries" to enable them to strengthen *their* trade balances and international financial positions.

The Tokyo Round of the 1970s was born even more directly as a result of monetary events, namely, the dollar crisis of 1971-73 that eventually led to the demise of the Bretton Woods system of fixed exchange rates. The United States triggered that crisis not only by terminating the gold convertibility of the dollar but by erecting an across-the-board import surcharge, the most frontal assault on the General Agreement on Tariffs and Trade (GATT) in its 45-year history. Before agreeing to eliminate the

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surcharge (and restore, temporarily as it turned out, a fixed exchange rate for the dollar), the United States insisted, inter alia, that Europe and Japan agree to commence a new multilateral trade negotiation.

Similar linkages pervaded the 1980s. The initial US attempt to launch a successor to the Tokyo Round failed, in 1982, in large part due to the global recession of the day (and, subsequently, the onset of the Third World debt crisis). The next effort succeeded, in 1986, mainly because the huge dollar overvaluation of the first Reagan administration drove the US trade deficit to sky-high levels and induced Reagan—despite his devotion to free markets and free trade—to implement more trade controls (automobile voluntary export restraint agreements [VERs], steel VERs, machine tool VERs, much tighter textile quotas, etc.) than any other president in the 20th century. America's trading partners recognized that a new round was an essential part of the response to congressional pressures for massive protectionism, which leading members concluded "would have led the Smoot-Hawley tariff itself to pass had it come to the floor in the fall of 1985."

History is clear: the monetary and macroeconomic environment has been central to launching every major multilateral trade negotiation in modern history and, thus, has been pivotal to the course of global trade policy. The logic behind this linkage is also clear: the onset of large trade imbalances, though driven primarily by macroeconomic forces, leads to strong political pressures for protectionism that can only be resisted by renewing the momentum for trade liberalization. For the United States, the main deficit country in all of these episodes, there is an additional consideration: foreign markets are less open than the US domestic market, so a new reduction in barriers offers some prospect for reducing the growing imbalance and reducing the political pressure "to do something about it," even though the negotiations are nominally "reciprocal."

The Monetary Setting for the Millennium Round

There are three major prospective monetary/macroeconomic developments that add strongly to the case for launching a Millennium Round (as I shall call the next WTO negotiations) no later than 2000. One is traditional, one is a variant on old themes, and one is quite new.

The American Deficit

The traditional factor is the *likely emergence of a record trade and current account deficit in the United States*. The merchandise trade imbalance has already hit an annual rate of about $225 billion, just under 3 percent of GDP. The impact of the Asian crisis is likely to take that deficit above $250 billion and perhaps as high as $300 billion, and the International

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Monetary Fund (IMF) has projected that our current account deficit will reach $230 billion this year. The deterioration will be almost twice as great in real terms, because our terms of trade will improve significantly with the sharp depreciation of the Asian currencies. The trade imbalance will subtract more than 1 percent from American GDP growth and generate substantial pressure on a number of key industries (Noland et al. 1998).

The administration and Congress have largely ignored the growing trade deficit because of the continuing strength of the economy and, in particular, the rapid growth of job creation and steady fall in unemployment. Indeed, the growing trade deficit (and rising dollar, which has contributed substantially to it) have restrained price increases and, thus, helped to push the unemployment rate far below what most economists believed was compatible with price stability.

The economy will, inevitably, slow within the next year or so, however. When it does, unemployment will begin to rise—at least to 5.5 percent, as projected by the administration for 1999 and beyond in this year's *Economic Report of the President*, or even higher if a new recession were to ensue. This adverse shift will inevitably be blamed, to an important extent, on the sharp rise in the external deficit. Pressures to restrict trade will arise again as they did in the early 1960s, early 1970s, and middle 1980s.

This prospect is particularly worrisome because US trade policy has already fallen into a stalemate between the advocates and opponents of further liberalization. The failure of fast-track legislation in 1997-98, at a time when the economy is in such good shape, is an acute signal that poorer economic conditions could spawn a trade-policy relapse.

The historical parallels are particularly apt, because renewed overvaluation of the dollar is clearly a major cause of our large and growing external imbalance. A new Institute for International Economics study concludes that the dollar is now overvalued, with respect to the other Group of Seven (G-7) currencies, by about 15 to 20 percent (Wren-Lewis and Driver 1998). This is considerably less than the massive overvaluation of the middle 1980s, which converted the United States from world's largest creditor country to world's largest debtor country. However, it is about the same as the revealed overvaluation of the early 1970s, which brought down the Bretton Woods system and triggered the Nixon import surcharge. Every 1 percent of dollar overvaluation produces a deterioration of about $10 billion in our current account (Cline 1989 and as subsequently updated), with a lag of two to three years; thus, the present overvaluation explains more than half the pending deficit.

Dollar overvaluation, in turn, is demonstrably the most accurate leading indicator of protectionist trade policies in the United States (and in the European Union as well). As noted, it was the main trigger of the most protectionist episodes of American trade policy in the postwar

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period. Hence, we can expect the onset of a similar situation in the near future.

The main substantive response to the deficit will, of course, be a correction of the dollar overvaluation and domestic macroeconomic adjustments, notably a slowdown in domestic growth (and particularly of domestic investment, so that smaller net inflows of foreign capital are required). There will, necessarily, be a trade-policy dimension, however, in light of the political tendency to link the two. As in similar past circumstances, the only constructive initiative will be to undertake a new global negotiating effort to reduce trade barriers—both to provide increased opportunities for American exports and to generate renewed momentum for liberalization as a defense against domestic protectionism. In light of the attack on globalization that is already underway in the United States, such a strategy will require substantial domestic complements, as laid out by Dani Rodrik in this volume (see also Rodrik 1997). But a new international negotiation à la Millennium Round will clearly be an integral part of the strategy if the US reaction to its growing external imbalances is to be channeled constructively.

The Euro and the European Problem

One important flip side of the large US trade deficit and dollar overvaluation is the large EU trade surplus and substantial currency undervaluation. The creation of the euro in January 1999 is likely to produce an important change in that situation, however, that adds to the case for launching a new multilateral trade negotiation in the near future.

The European Union, as a group, is now running an external surplus equal to between 1 and 1.5 percent of its GDP. As pointed out by the European Commission in its recent convergence report on the creation of Economic and Monetary Union (EMU), this is a very unusual situation that has not obtained since 1986 (Commission of the European Community 1998), in the aftermath of the large undervaluation of the European currencies that corresponded to the huge dollar overvaluation of the middle 1980s. The clear implication is that the EU currencies are again substantially undervalued. This view is supported by the Institute's new study of fundamental equilibrium exchange rates (FEERs), which concludes that the euro would be introduced at a level that is undervalued by 15 to 20 percent relative to its sustainable long-term trade position if it were launched at today's exchange rates (Wren-Lewis and Driver 1998).

The issue for trade policy is that the creation of EMU is likely to trigger a series of events that will lead to substantial appreciation of the euro, a sharp deterioration of the EU trade balance at a time when unemployment is already very high throughout the European Union, and renewed protectionist steps in the absence of the forward momentum that can be generated by a Millennium Round.

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The first step in this chain, appreciation of the euro, is probable because the new money is likely to become a major international currency fairly quickly. The initial EMU will be almost as large as the United States, in terms of both output and trade, and both theory and history demonstrate that the sheer size of the underlying economy is the best gauge of a currency's international market share (Eichengreen and Frankel 1996). As soon as the European Central Bank establishes its credibility, which is likely to be rather soon, the largest portfolio diversification in history will commence; I have predicted elsewhere that the shift into euros, mainly from dollars, is likely to total $500 to 1,000 billion over a period of several years (Bergsten 1997). The impact of this financial movement on exchange rates is hard to predict, but the euro is quite apt to appreciate by at least the 15 to 20 percent of its start-up undervaluation.

The economic result, in turn, will be a substantial reversal in Europe's external position—it will probably move from its current unusual surplus into a substantial deficit. The currency effect will be compounded by the Asian crisis, which will independently have an adverse impact on Europe's trade balance of at least $50 billion (and, as with the United States, considerably more in real terms) (Noland et al. 1998). With unemployment in all major European countries above 10 percent and sustained recovery from the prolonged stagnation of the 1990s only beginning to occur, these results will be quite unwelcome. The same antiglobalization forces that we have observed in the United States are at least as apparent in Europe, so the pressures for restrictive trade measures will be high there too. For example, France and Italy have already launched a quiet initiative to extend the region's VER with Japan on automobiles—which would be a direct violation of the Uruguay Round compact under which all VERs are to end in 1999.

The same monetary dynamic in the United States and Europe, thus, argues strongly for the launch of a Millennium Round within the next year or two. The United States will be feeling the trade impact of prior dollar overvaluation and the political repercussions of the huge deficit that has built up over the past several years. The European Union will face a new, potentially very sharp, deterioration in its trade balance from a starting position of excessive unemployment. Trade policy in both regions is likely to be highly unstable in the absence of a new liberalizing initiative.

The Asian Crisis and Japan

The third compelling monetary/macroeconomic rationale for launching a Millennium Round is the multifaceted impact of the Asian economic crisis. This year, and probably next, are likely to be "lost years" for much of Asia, including Japan—there will be zero or negative growth, large rises in unemployment, widespread bankruptcies, unstable markets, and

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possible political disruption. Growth in China, the other megamarket in Asia, will be dampened to a substantial extent. Hence, these countries will come under growing pressure to back away from the "outward orientation" models that contributed so importantly to their previous successes and to which they have so far largely adhered despite the crisis.

There are several implications for global trade policy. First, continued openness of the American and European markets is essential for a successful resolution of the Asian crisis. Each of the troubled emerging-market economies in the region must be able to strengthen its trade and current account balances in order to restore its economic health and regain global confidence. All these countries continue to rely on the US and EU markets to absorb a sizable portion of their exports and, thus, must be able to continue selling there. Any US or EU retreat from openness would shatter the prospects for successful resolution of the crisis. Again, forward momentum will be required to head off the risk of backsliding.

In addition, the IMF is quite rightly insisting that the Asian nations remedy their problems in part by accelerating the liberalization of their own economies. Every one of the troubled countries has committed to further opening, particularly of its financial sector but elsewhere as well, far beyond what had been achieved in past international negotiations. The heads of state of the Asia Pacific Economic Cooperation (APEC) forum agreed at their summit meeting in Vancouver in November 1997 to eliminate barriers in nine major sectors with a global trade value of more than $1.5 trillion. Since APEC will seek to globalize its own initiatives in the WTO, as always, this agreement could provide major impetus for the Millennium Round. But any US or EU rejection of market liberalization could jeopardize such a "potential silver lining" in the cloud of the crisis (Roth and Bergsten 1997).

Moreover, any US or EU backsliding on liberalization would clearly strengthen the forces within the Asian countries (and perhaps elsewhere) that would prefer to respond to the crisis by rejecting global norms in favor of protectionism, mercantilism, and even xenophobia. There would be some justification for such a reaction. We know from history that trade policy is dynamically unstable; it either moves forward steadily toward further liberalization or it retreats toward protection. Other countries would be correct to react with some alarm to any toppling of the bicycle of liberalization in the key industrial countries, as is already threatened in the United States by the failure of fast track. The likelihood of such reactions will increase as the real economic impact of the crisis deepens over the next 6 to 12 months in all the Asian countries. It will become even greater if recovery is delayed for more than a year or two, as may well be the case in some countries.

A strategy of "retreat rather than compete" by the Asian countries would almost certainly worsen their crises and cause enormous damage

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to the countries themselves. But it would also cause substantial damage to the global trading system. The monetary/macroeconomic situation in Asia, thus, also counsels an early launch for the Millennium Round.

Finally, the position of Japan deserves special attention. Japan's global trade surplus has already reached record levels in real terms, and it continues to grow. It is adding to the global problem rather than contributing to its solution. Our new study of exchange rates suggests that, with respect to the dollar and the other G-7 currencies, the yen is undervalued by at least 25 percent and will have to return to its earlier level of 90 to 100 yen to the dollar to restore a sustainable position (Wren-Lewis and Driver 1998).

In addition, renewed US concern about its own trade deficit, as described above, will inevitably take on a major Japanese dimension in light of Japan's record bilateral surpluses with the United States and record global surpluses as well. One important component of that concern will be a renewed attack on Japanese trade barriers, little reduction of which was accomplished in the Uruguay Round. Hence, the Japanese situation also requires the initiation of a major multilateral negotiating effort with a particular focus on the barriers that play a large role in impeding access to the Japanese market.

Conclusion

Monetary and macroeconomic conditions have played a vital role in the decisions to launch each of the major multilateral negotiations in the postwar period: the Kennedy Round in the 1960s, the Tokyo Round in the 1970s, and the Uruguay Round in the late 1980s. These conditions have been quite similar in each case: a large (for the time) and rapidly growing external deficit in the United States with corresponding surpluses in Europe and (especially) Japan, an overvalued dollar, a sharp rise in protectionist sentiment in the United States, and, hence, a need to restart the bicycle of liberalization both to open new opportunities for constructive reduction in the trade imbalances and to generate forward momentum to counter the protectionist pressures.

A similar macroeconomic/monetary pattern is beginning to evolve today. The US deficit is headed toward record levels (and the Japanese surplus is already there). This trade imbalance will trigger trade-policy pressures as soon as the economy slows and unemployment starts to rise. Europe, with its high unemployment, will encounter similar pressures as soon as the inevitable currency adjustment begins to take place—as it probably will after the introduction of the euro in early 1999. The Asian-crisis countries will face severe national pressures to deliberalize when the cost of their adjustments becomes clear over the next year or so, especially if there are any signs of faltering economic growth in the

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United States and European Union—on whose markets they are largely dependent to achieve effective recovery from their crises.

Hence, there is a strong case on monetary and macroeconomic grounds, in addition to the more traditional considerations of trade policy, for early commencement of a Millennium Round. Given the central role that monetary and macroeconomic factors have played in the past, their evolution may in fact provide one of the more compelling rationales for moving ahead.

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