

STAN KELLY MEMORIAL LECTURE  
1987

Southern Cross Hotel  
Melbourne

21 July 1987

**GATT:  
WILL THE NEW ROUND  
MAKE IT WORK?**

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## FOREWORD

"Trade is Australia's lifeblood, and if we restrict the blood flow we hurt ourselves as well as our neighbours". Bert Kelly wrote these words in 1978 and they are as true now as they were in the days when his father, Stan Kelly, was arguing with some success against excessive tariffs and quantitative restrictions on imports.

The Stan Kelly Memorial Lecture series has as its theme: "The desirability of maintaining free the channels of trade throughout the world". William Stanley Kelly, OBE, was a South Australian farmer who devoted his life to public service.

After being wounded at Villers Bretonneux and working for the AIF Education Service in England (1918-22), Stan Kelly chaired the South Australian Advisory Board of Agriculture (1922-24), sat on the Tariff Board in Melbourne (1929-39), represented the Australian Wool Board on the Wool Secretariat in London (1940-41), advised the Commonwealth Prices Commissioner on primary products (1942-48), chaired the Joint Dairying Industry Advisory Committee (1951-53), and sat on the Consultative Committee on Import Policy (1952-60).

Bert Kelly has generously endowed these lectures in his father's memory and in recognition of Stan's close connection with the Victorian Branch of the Economic Society via contemporaries such as Professor L.F. Giblin.

John McDonnell is the sixth in a distinguished line of Stan Kelly Memorial Lecturers, beginning with Sir John Crawford in 1977 and continuing through Mr. J. Uhrig, Mr. (now Senator) John Stone, Mr. R.A. Johnston and the Hon. R.J.L. Hawke. John holds degrees in Arts, Law and Economics and is a Barrister of the Supreme Court of New South Wales. After practising in customs and trade law for four years, he joined the Department of Trade in 1972 and was engaged until 1985 in drafting and negotiating various charters, agreements, treaties and initiatives governing Australia's bilateral and multilateral trade relations, including GATT, UNCTAD, ASEAN and EC.

John has written and lectured extensively in economics and trade law. He is presently Visiting Lecturer in International Trade and Finance at Georgetown University. Since leaving the public service, John has worked as International Trade Advisor to a number of private clients and regional governments, including the People's Republic of China which is seeking re-admission to the GATT.

The Victorian Branch of the Economic Society of Australia greatly appreciates John McDonnell's acceptance of our invitation to him to present this, the sixth Stan Kelly Memorial Lecture.

Colin Richardson  
Acting President  
Economic Society of Australia  
(Victorian Branch)

## Introduction

I, of course, never knew Stan Kelly, nor before tonight did I know his son Bert. I had, however, read Bert's columns in the newspapers for many years and more recently, I have read of his father.

Both Stan and Bert Kelly were men of principle. They worked in government but believed that those who hold government office should also work against its unnecessary intrusion into the lives of individuals. Moreover, Stan Kelly realised that government intervention into the social and economic structure was not without penalty. His son, Bert, brought this message home in a way that trusted the ordinary person to accept it as common sense. I wish that this particular Kelly Gang's philosophy was more evident in government life today.

I want to start my analysis of the prospects for a new GATT round by describing the current trading situation. I will try to describe it from both the trade policy expert's and the economist's perspective and, as it were, have a foot in both camps.

## The American Scene

The United States is pivotal to world trade. It was critical at the Bretton Woods negotiations even though the US delegation should have been handicapped by having as its leader Henry Dexter White, who is said to have been a Soviet spy, and the Europeans were represented by no less a force than John Maynard Keynes. The dominance of the US after the war may be explained by the weakness of prewar Europe. However, at the 1964 Kennedy Round talks when Europe was well and truly re-established, the causal link between the US Trade Act and the outcome of GATT negotiations was firmly established. US trade legislation provided both the agenda for the negotiations and the shape of its outcome.

The same was true of the Tokyo Round where the parameters of the outcome were firmly set by the 1974 and 1979 US legislation.

The present US draft legislation is highly relevant as the basis for the next negotiation. On 30 April, the US House of Representatives passed by a huge margin a protectionist trade bill. Although the final version may be modified because of the threat of Presidential veto, the bulk of the bill seems certain to be passed. This new law would include:

- The right to impose blanket protectionist measures against countries running persistent trade imbalances with their partners.
- A provision relating to fabricated steel products which will place severe restrictions on steel exports worldwide and cripple infant steel industries in Indonesia, Thailand, Malaysia and Singapore. It would impose restrictions on Australian steel exports.
- An amendment to Section 301 of the Trade Act to introduce new trigger mechanisms. These reflect new sensitivities to unfair trade practices, i.e. doing better than the US in particular products in particular markets and will result in more retaliatory action against imports.
- An amendment which would provide that denial of basic workers rights would be considered an unfair trade practice and would call for US retaliatory action. South Korea, Taiwan and Thailand are the principal targets in Asia.
- US anti-dumping measures will be made much tougher and will include down stream dumping.
- A new subsidy, called a resource subsidy, has been added to the list of subsidies which make for unfair trade.
- The US Special Trade Representative will be able to ban products which violate US trademark, patent or copyright laws.

- The US Treasury will be directed to determine a competitive exchange rate for the dollar against all major currencies to achieve "a sustainable balance" in the current account.

The US is moving to a position of managed trade. It is characteristically trying to export its domestic economic problems. Having failed to manage its own economy and thus having created major problems for the world trade and payments system, it is now trying to resolve its domestic problems through the "management" of the world trade and payments system.

This latest legislation is the culmination of a trend that has been going on for some time. The American economy has been far from a "free market" economy since 1980. In 1980, one eighth of US trade was covered by restrictions; in 1984, one quarter. A considerable number of industries have their prices determined by deliberate policy. The list begins with crude oil and includes agricultural products, textiles and clothing, iron and steel, automobiles and petrochemicals. Since the US Congress is not seeking the repeal of these measures but rather treating them as "fair" - as opposed to the "unfair" consequences of free trade - it is a pretty safe assumption that if Congress has its way the US objective in the Multilateral Trade Negotiation (MTN) round will be to seek a rationalisation of such arrangements in GATT terms. As the US Administration sees its position as one of holding the line against Congress, and both the EC and Japan have so far been reluctant to put forward alternative manifestos, the prospect of increased trade restriction as the result of MTN round is a distinct possibility. This will result in persistent low growth in the world economy for years to come. The position will not be eased by the present tightening of liquidity for developing countries. With the exception of Manufacturers Hanover, the major American banks are reconciled to offloading \$500 billion dollars worth of debts. In the process the LDCs' access to new funds will be cut back to the extent that they will become, as one banker said, "the COD countries".

The slow down in trade is, of course, not the only cause of the present low growth. Reduced total savings and inflation are equal partners. As inflation erodes the purchasing power of private savings, governments resort to deficit financing to meet electors' expectations. This in turn drives up interest rates and soaks up money that should be available for private investment. The resulting uncertainty is like a thick fog on a highway. The disappointed expectations of some firms cause other firms to postpone their

investment plans. Investment projects languish, adjustment slows down, unemployment rises, new and ever more desperate policy measures are being tried out, the longer consequences of which no one can foresee. Business, not knowing what to expect, demands a modicum of security through protection. Governments, trying to maintain a semblance of international co-operation, push each other into manipulation of exchange rates. Protection and inflation each feeds on itself, and compounds the other.

### The Role of Governments

Governments are in a dilemma. Inflation still smoulders, but finishing the job of disinflation threatens to raise interest rates and crush fragile financial structures. At the same time governments persist with treating only the cyclical problems while ignoring the structural ones.

[It is an interesting thought that this approach is most evident in countries where the Treasury dominates economic policy making. Treasuries tend to ignore areas of economic policy outside their power and to redefine both the problems and the measures needed to fix them in terms that match the limits of their responsibilities. Structural problems which are not part of the Treasury portfolio therefore cease to be part of economic management.]

As a consequence adjustment continues to lag, demands for protection multiply, the degree of competition is declining nationally and internationally. New excuses are found for inactivity. In the 1970's phrases such as "politically feasible" and "inflation is an international phenomenon" began to appear in the lexicon of politicians. In the 1980's even more vagueness has crept into the pronouncements of international statesmen, firstly with the 1982 Ministerial Declaration of GATT which Doug Anthony, to his credit, refused to sign, and more recently with the proposal to have a GATT conference to reform the international trading system. As one noted commentator has said, "What useful reforms of the world economic system can be expected from a mass meeting of representatives of more than a hundred sovereign states in one room? Their consensus is perfectly foreseeable: nothing can be done about anything until everything has been done about everything else. The cheapest demonstration of concerned statesmanship is to say: Let us call a universal meeting and if it fails, as it most likely will, we shall have demonstrated both our willingness to reform and that no reform is possible."

There can be no reform in the international trading system as long as governments are paralysed. But why are they paralysed? It is because of the nature of present day democracy. The solutions to economic problems are not in the hands of legislators but of the executive and, more particularly, the bureaucracy. The bureaucracy is confronted by pressure groups with demands that cannot be satisfied. Bureaucracies are frightened of a fuss. They attempt to formulate policies which give everybody a little bit. The result is the creation of more property rights than there is property. In an attempt to swell the cake, bureaucracies seek to filch from the non-voters - those who are, to quote an old Australian phrase, "overpaid, oversexed and over there". Thus foreign aid is cut, currencies are manipulated and protection increased.

Now as this degeneration continues, the social contract is beginning to break down and societies are reverting to an economic state of nature. The GATT as presently drafted is the last bulwark against this in most countries. Australia has an additional safeguard with its Industries Assistance legislation and the existence of the IAC. But this has to be balanced against Australia's failure to enter into real commitments in the GATT. Other countries have made strong commitments in the GATT but have not backed them up with domestic legislation which would prevent their governments acting contrary to GATT obligations. What this reveals is that governments are prepared to believe that free trade is good for the international economy but not for their particular domestic economies (either this or, unlike Bert Kelly, they cannot communicate the value of free trade to the electorate.)

### The Consequences of Failure

If governments cannot come to grips with these problems, the world economy is in for a prolonged period low and unstable growth. This will result from a number of consequences of government policies with which governments themselves will be unable to deal.

The first is the failure of the price system. Foreign trade connects the national price system into the international price system. This enables investors to make their decisions on the basis of economic rationality. A price system is basically an information processing mechanism. The relative prices formed by the international price system inform promptly



about incipient scarcities and surpluses anywhere in the world economy. Given the high degree of international economic interdependence, these scarcities and surpluses will eventually affect every national economy in the world. The speed with which the information about them is carried (relative price changes often anticipate the actual emergence of scarcities or surpluses) makes it possible for the enterprises on which the change will impinge first to begin their adjustment in time and to accomplish it smoothly and gradually. Conversely, an interruption in this information process will lead to investment uncertainty and what is popularly known as an "investment strike."

The second consequence is that inflation takes on structural characteristics. The IAC has often pointed out the impact of protection of the sensitive industries (e.g. textiles, clothing and footwear) on the inflation rate in Australia. The inflationary impact of European Community agricultural prices on EC inflation have been documented by the BAE. A wider study has been undertaken by the OECD. Both these studies show that agricultural support represents a drag on manufacturing industry in Europe. As such they vindicate the theoretical proposition that import protection is a tax on exports - making the prices of exports higher than they should be.

[A useful way to gain LDC support for a reduction in agricultural protection would be to point out the impact of it on the price of LDC industrial imports.]

Thirdly, there is the redistributive effect of persistent and widespread protection. Countries cannot protect their economy at large (contrary to the beliefs of some politicians, trade unionists and economists). If protection is applied only industries receiving protection of more-than-average incidence actually benefit; all others are penalised. Since the well known monopoly theorem - that the monopolist's gain must always be smaller than the loss it causes to the society from which it is extracted - applies to redistribution by protection as well, it follows that each country must benefit most from reducing its trade barriers and that conversely it must suffer from increasing them.

Finally, there is the effect on trade. If a country wishes to increase its exports then it must inevitably recognise the ultimate absurdity of mercantilism as a policy crucially concerned with the balance of trade. It is manifestly absurd to adopt a policy of increasing exports when export industries are invariably among those most heavily penalised by protection.

The consequences of a failure to deal with protection over the next three years are therefore likely to be:

- less investment, particularly in the major economies;
- increased inflation;
- reallocation of resources in the direction of less productive industries with a consequent reduction in real income; and
- slower world trade, increasing the balance of payments problems of the majors (and Australia) and exacerbating the debt problems of the LDC's.

#### Where are the Solutions?

What is a new GATT round to be about?

Up until the Tokyo Round, GATT rounds were essentially about cutting the tariff. With the 40% tariff cut in the Tokyo Round, most countries do not have any significant tariff left to cut. The Tokyo Round attempted to go further and to amend the rules to deal with the post-tariff age - the age of non-tariff barrier protection - by amending the rules. The perception of a declining observance of the rules had been the main motive for engaging in the exercise. Very soon a common approach, a guiding philosophy, crystallised among the main participants. The rules are failing, it was said, because they were too unrealistic to begin with, too theoretical, too demanding. If we relax the rules, make them more permissive, the argument went, governments will find it easier to abide by them. Now less than a decade later, those new rules are seen to be in need of amendment.

The policy makers who drafted the Tokyo Round rules were self assured; they knew what was wrong with the regime and how to fix it. The mood now, following the failure of the GATT Ministerial Meeting in November 1982 and the almost simultaneous emergence of

the international debt problem and a chauvinist US Congress, is closer to panic. Everybody knows that something is fundamentally wrong and some even know what it is; but nobody knows what to do about it. Governments are prisoners of the precedents they have created.

#### Tumlr's Solution

I would now like to turn to what Jan Tumlr describes as "the two transcendent questions". How can the "new protectionism" be brought under control and how can this be manifested in an international negotiation?

It is important to recognise that only a small part of the income and wealth redistribution, around which democratic politics has come to revolve, is now effected explicitly through the budget. Although in countries like Australia, an (unspoken) conspiracy between the Treasury and the beneficiaries of regulations and other forms of intervention serves to propagate the myth that non-budget matters have nothing to do with economic policy. The Treasury view is invariably supported by politicians because to admit otherwise is to admit the governments' own helplessness. The group claims and entitlements created through what Tumlr calls "the politics of pluralism" have incapacitated governments for action.

The only way out of the morass is for governments, or at least the key governments, to take an internationally binding commitment which they are also committed to implementing domestically. For this to occur there should be enabling legislation on the statute books before any international negotiation takes place. This would mean that the international agreement would have the form of a self-executing treaty so that it would become domestic law at the moment it was signed.

So what new rules should become the subject of this international agreement? The answer is none. A wise delegate to the GATT said some years ago: "We do not need new rules. What we need is a change of heart." However, the current political climate is such that governments will refuse to bind themselves to the GATT in its entirety: that would be too much for them to swallow.

Tumlr has suggested a simple solution - let the Contracting Parties of the GATT bind themselves to Article I only. This would mean that an unconditional most favoured nation commitment would be obtained, introduced into national law, and become litigable.

This commitment would immediately eliminate the selective non-tariff measures, country quotas and voluntary restraint agreements. It would preclude the notions of bilateral balancing inherent in new US legislation. It would compel the public auction of quantitative restrictions.

The last of these is perhaps the most important. Where quantitative protection has to be provided for domestic reasons, the difference between cost price of imports and domestic wholesale price would be captured for public revenue and the quantitative restrictions would become more transparent so the public at large would evaluate the cost to them of the maintenance of the restrictions. This would of course lead to a marked decline in the excesses.

Finally, and most importantly, by making these matters domestically justiciable, it would reduce the possibility of interference in domestic economic policy by diplomats in Geneva or the obfuscation by politicians looking for the easy option in rarified atmospheres.

This solution is simple enough to be adopted by all the majors forthwith. But I doubt that it will be adopted or anything like it. The fact that the Venice Economic Summit preferred to talk about AIDS rather than the issues I have outlined, is a pretty clear indication of the prospects for the forthcoming MTN round.

#### The Probable Outcome

Having outlined what the outcome should be let me take a stab at what the outcome will be.

It is important to bear in mind that the round will not start for another three years. President Reagan is simply not strong enough to successfully conclude negotiations within the next 18 months, so he will not begin. His successor will need a settling in period, so

negotiations in earnest are unlikely to begin before 1990. At that time the US will have suffered what commentators are calling "the hard fall". A recession accompanied by high interest rates.

The new President will be seeking to reduce the domestic deficit by \$200 billion. Latin American countries will be locked into a financial squeeze. Japan will be feeling the downturn in US demand. Trade will have slowed.

Australia will be running a large current account deficit and will be feeling its debt servicing problems more acutely.

I believe the US will have pushed through Congress a trade bill not unlike that which I outlined earlier. Based on this the US will enter into the GATT negotiations seeking arrangements to manage world oversupply of "sensitive" goods. In addition to the Multi-Fibre Arrangement (MFA), there will be a multi-steel arrangement, a multi-autos arrangement, a multi-chemicals arrangements even a multi-hightech arrangement. In each of these sectors Australia is a marginal exporter trying to enlarge its exports. As with the MFA such marginal players are likely to be disadvantaged.

Most importantly for Australia there is likely to be a managed trade regime for agriculture. This may yield results if disciplines can be applied to LDC exporters to stop subsidised exports as their need for foreign exchange increases. The recession itself will place limits on OECD countries' agricultural support schemes, but overall agricultural exports are not likely to improve in the short term and negotiation of an agricultural arrangement is likely to be a long term exercise.

#### Conclusion - Australia's Present Approach

Australia's present trade initiatives are centred on a strong presence in Geneva. Alan Oxley, the Ambassador to the GATT, is Chairman of the GATT Council, which gives him considerable personal weight which he employs effectively. Australia's formation of the Cairns Group has built on the presence which it had in agricultural discussions from 1982 onwards. The Prime Minister's and the Trade Minister's statements on agricultural trade have captured a lot of attention.

However, success in Geneva may have its downside. GATT issues have never been less topical in a domestic sense and paradoxically this may be because people believe that Australia's success in Geneva means things are under control. The quiescence in Australia is to be contrasted with the US where considerable attention is paid by interest groups and politicians to every facet of the Geneva discussion. There needs to be more debate in Australia about GATT issues. The Government and bureaucracy should not be allowed to formulate policy in a vacuum, but to advise them properly the private sector must understand the issues.

Secondly, the US element is being neglected. Australia has a good embassy in Washington but the issues in the US trade legislation are not reaching the interested public. Nor are Australia's representations specific or forceful enough. Other countries seek to influence legislation when it is in draft form by pressing amendments to texts either through the administration or through committees. Australia should be willing to do the same thing. However, this is only possible if interested exporters know about the content of the US bills.

Lastly, Australia should not assume that the GATT will work for it. The chances are that it will not. Therefore there must be contingency plans which will provide for the best chance of dealing with the hard times. The possibility of regional arrangements shouldn't be overlooked. More importantly, the restructuring of the Australian economy should not be delayed pending a GATT outcome. Australia needs to put its house in order - this means reducing protection. We need to make commitments to reduce protection now and the failures of others should not deter us from adopting a sensible policy approach ourselves.



## Tribute

In preparing this lecture I have drawn heavily on an unpublished essay by Jan Tumlr. Tumlr was a man I especially admired because he combined the skills of an international lawyer with those of an eminent economist.

Through his official work, and his participation in "outside" activities, attending conferences and contributing to professional journals and collections of essays, Tumlr had extraordinary influence on the thinking of those in government, and on its fringes, concerned with international economic affairs. Having just retired from the GATT Secretariat, Tumlr was to take up a senior teaching post at the University of California at Los Angeles, where he was a visiting professor in 1983-84.

In his diagnosis of, and prescriptions for, problems afflicting the world economy, Tumlr drew on a close acquaintance with not only economic thought, but also with law, philosophy and history, which in part explained his role in the renewal of interest during the 1970's in the writings of F.A. Hayek and other liberal economists. His own contribution to economic thought was the clarification of the essentials of international economic order.

Tumlr set the pace in economic policy discussion in GATT circles. More than that though, in his capacity as head of its "think tank", Tumlr enabled the GATT Secretariat to be the pacesetter among inter-governmental organisations on many of the basic economic issues of today, tracing all origins of inflation and "slow growth" back to government intervention in the market process, which took a hold during the 1960's, in what Tumlr called "the core" economies.

Tumlr had gravitas. His independence of mind and strength of character were formidable. They were formed in troubled times from which he did not hold back.

Born in Prague on 18 August 1926, Tumlr's father was chief government statistician in Czechoslovakia, his mother being an Agrarian Party member of the Czech Senate in the 1930's until the outbreak of the Second World War. After the war, Tumlr was studying law at Charles University in Prague, at the time of the communist takeover, and was editor of a youth magazine. Jailed in 1948 after trying to escape to the West with his parents, he was later transferred to hard labour in a coal mine, from which he escaped in 1949 to work in West Germany as a journalist on Radio Free Europe.

In 1951 Tumlr went to the United States on a scholarship, enrolling at Yale University to study economics, the most lasting influence there being the late William Fellner with whom he kept in touch to the end. Tumlr obtained his doctorate in 1962 and was assistant professor of economics at Yale University before being recruited by Sir Eric Wyndham-White in 1964 to work at the GATT Secretariat, becoming its Director of Economic Research and Analysis in 1967.

Wyndham-White's successor as Director-General of the GATT was Dr Olivier Long who, also a professor at the University of Geneva, encouraged Tumlr to help and stimulate the work of economists and others in universities and institutes who were trying to make sense of what had become a complex world economy. Tumlr was especially active in the Trade Policy Research Centre and joined its governing Council in 1982.

This lecture is dedicated to his memory.