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*By Kathleen Macmillan and Patrick Grady**

On the cusp of the millennium and as the century that was supposed to belong to Canada draws to a close, we find ourselves as a medium-sized nation exercising an influence out of all proportion to our size. This special issue on *Canada in the Global Economy* gives us a chance to sum up where we have been and look forward to where we might be going. All the papers contained in this issue were delivered at the annual policy conference of the Canadian Association for Business Economics.

This gathering provided an opportunity for reflection after an eventful year in the global economy. The financial crisis that began in Asia and spread to Latin America and Russia shattered confidence in the world economic system. Even Canadians, perennial world traders that we are, were jolted by the crisis. Added to our unease were a series of recent trade disputes that has left us chafing from the international ties that already bind us. While most economists — and certainly a majority of those attending our conference — accept the idea that closer trade and economic integration translate into higher living standards, most would acknowledge their confidence has been shaken in the past year. The challenge of constructively interacting with the global economy while maintaining our economic and political sovereignty is a formidable one indeed.

There is no disputing the signs of increased globalization and their significance for Canada. International trade has exploded in importance, reaching US$5.4 trillion out of a total world gross domestic product of US$29 trillion. Capital flows and financial transactions dwarf even these impressive magnitudes. The Bank for International Settlements estimated that every business day US$1.5 trillion of currencies are traded. Figures such as these underline the fact that borders are becoming less important.

Globalization has forced changes in international institutions as well as inspiring the creation of new international organizations. The most important of these is the World Trade Organization, which in 1995, 40 years after having been conceived at Bretton Woods, finally was born to join its two older siblings, the International Monetary Fund and the World Bank, as one of the three institutional pillars of the global economy.

While still seeking to stake out its role in the international economy, the WTO is facing the prospect of another round of multilateral trade negotiations – the Millennium Round – and bringing China and Russia formally into the world trading system. Meanwhile, the IMF and the World Bank have struggled to deal with the global financial crisis. Problems encountered have led to calls for reform of these international financial institutions.

Canada has been an active participant in the financial institutions underpinning the global economy. Canadian representatives, including the legendary Bob Bryce, played leading roles at Bretton Woods in establishing the International Monetary Fund and the World Bank. The World Trade Organization sprung from a Canadian proposal made during the Uruguay Round Negotiations.

As a middle power that is highly dependent on trade, Canada has much to gain from a rules-based international trading system and a smoothly functioning global economy. Consequently, much is at stake in the upcoming Millennium Round of multilateral trade negotiations and in the reforms to the IMF and World Bank.

The papers presented at the 1999 CABE policy conference, some of which are published here,[1] shed valuable light on the difficult issues facing Canada in the global economy on the threshold of the 21st century. The themes they address can be grouped under the headings: the outlook for the global economy; the Millennium Round; the Free Trade Agreement/ North American Free Trade Agreement after 10 years; globalization and borders; and the reform of international financial institutions.

The outlook for the global economy. Allen Sinai, president of Primark Decision Economics, offered an encouraging perspective on the outlook for both U.S. and world growth. In his view, the Asian crisis has passed and with it the potential for a global recession. He attributes this in large part to the remarkable resilience of the U.S. economy and the strong growth and low inflation it has experienced, under the capable monetary management of Federal Reserve Chairman Alan Greenspan who has kept interest rates low. Sinai expects the pace of U.S. expansion to remain strong, even if slowing from recently unsustainable levels, and the East Asian economies to recover. If his forecast comes true, it would be a favourable environment for the Millennium Round of trade negotiations and the reform of international financial institutions. The risks to the outlook he sees relate to policy errors and to a resurgence of oil prices. If inflation were to pick up, the Fed could be expected to tighten undermining U.S. growth and threatening the global expansion. This would be a much tougher environment for strengthening international institutions and the global trading system.

The Millennium Round. Sylvia Ostry captures the high expectations held for the WTO with her prediction this newest Bretton Woods institution may offer the best opportunity for improving coherence in international economic policy-making. This is good news for Canada, as she points out, because the considerable role Canadians have played in the old General Agreement on Tariffs and Trade system and in establishing the new WTO have accorded us more profile and influence in the WTO than we have enjoyed at either the IMF or World Bank.

Elaine Feldman provides a comprehensive picture of the state of play leading up to the Seattle WTO ministerial meeting and preparations for the widely anticipated Millennium Round of trade negotiations. While there is general agreement, certainly among developed nations, on the need to continue the momentum of trade reform, the structure and scope of future negotiations is less than clear. The "built-in agenda" of outstanding items from the Uruguay Round will require negotiators to turn to services and agriculture. Whether they restrict themselves to these narrow items, undertake sectoral trade discussions or opt for a comprehensive round remains to be seen. Yet another option, which is proposed in the paper by Canadian Minister for International Trade Sergio Marchi is that negotiations proceed on the basis of clusters of sectors.

Marchi's paper emphasizes Canada's enthusiastic support for continued trade liberalization. He sets out the six objectives for the next round of negotiations:

- Tariff reductions, including the possible elimination of "nuisance" tariffs (those lower than 2 per cent).
- Addressing non-tariff barriers.
- Curbing the abuse of antidumping, countervailing duty and safeguard actions.
- Bringing services and agricultural trade within the rules.
- Extending WTO rules to new issues including intellectual property, e-commerce, investment and competition policy.
- Safeguarding the ability of governments to regulate in areas relating to health safety, social policy and other areas of legitimate public interest

Elaine Feldman's observation that trade policy is increasingly about domestic regulatory matters was echoed by Marchi, Ostry and other speakers. Investment, competition policy, intellectual property, agricultural sanitary and phyto-sanitary measures are examples of the types of complex issues that are certain to dominate in the upcoming round. Agreement in these areas will require governments to concede sovereignty, something Feldman argues is more effectively done through multilateral negotiation than on a purely domestic basis.

Her paper stresses the importance of treating developing country members as full participants in the trade negotiations. She maintains that the success of the Millennium Round will depend on the extent to which the negotiating agenda includes issues of real importance to the developing world. Clearly, compromises will be necessary and trade-offs required to keep developing nations inside the system. While the developing world has the most to gain in economic terms from trade liberalization, the adjustment burden they face is the most acute. As the greatest export potential for developed nations lies in tapping developing country markets, the WTO needs to be sensitive to the interests of its newest members.

Both Ostry and Feldman discuss the need for greater co-ordination between the WTO and its Bretton Woods sisters. Ostry's view is that the WTO could make a meaningful contribution to this effort by tackling a specific, well-defined project and spearheading its success. The task she would assign is the full integration of China into the WTO. The result she would seek is a comprehensive transition framework housing specific commitments on liberalization in a number of areas. This process "template", if successful, could then be applied to other countries, including Russia.

The FTA/NAFTA after 10 years. In an interesting and provocative session, Andrew Jackson and John Crispo reflected on the merits of the Canada-U.S. Free Trade Agreement and North American Free Trade Agreement a decade after the signing of the FTA

In Jackson's view, the trade agreements have fallen well short of expectations. While he concedes they had a spectacular effect on trade flows, he argues they have not delivered on their promise of economic enhancement. The result, instead, has been depressed living standards for working people. Not only has there been a growing divergence in income per capita between the U.S. and Canada, but job creation in Canada has been relatively weaker. While some of the Canada-U.S. differences are attributable to different macro economic policies, much is the result of deeper integration in the two economies.

Behind the impressive statistics on trade volumes, Jackson observes some disturbing trends. He notes that large increases in manufacturing shipments have not translated into substantial increases in value added in Canada. Instead, cross-border flows of intermediate goods dominate the trade statistics. The Canada-U.S. productivity gap has widened, investment capital has fled the country rather than been attracted here and manufacturing employment has fallen in absolute terms. Workers have experienced no growth in real wages but face more intense competitive conditions in the workplace. Implicit pressure exists to harmonize to U.S. standards in terms of tax rates and regulation.

Concerning the widening Canada-U.S. productivity gap, Richard Harris made the point in another session that globalization and the resulting specialization, particularly in intermediate inputs and components, are making international productivity comparisons "increasingly meaningless." Consequently, a "non-convergence of productivity" began to emerge as an international phenomenon in the mid-1980s and is not unique to Canada. Unlike Jackson, Harris does not regard this with alarm. In his view, the real growth effects of productivity change, which remain important for national welfare, can be transmitted through changes in the terms of trade and the international patterns of specialization.

Jackson concedes that closer integration with the U.S. is a fact of life that is here to stay. Trade and investment liberalization can be a positive force if domestic policy focuses on shaping comparative advantage and mitigating the tendency of unbridled market forces to contribute to social inequality. Measures to protect the rights of workers and to regulate in critical areas of public interest, such as the environment, public safety and health, should be a cornerstone of all efforts to increase trade liberalization.

There is no disputing Jackson's conclusion that Canada's economic performance over the past decade has been less than stellar. Statistics released since the conference showing a decline in real family income only underline his point that international economic integration has not guaranteed economic prosperity for Canadians. However, he is less than fair in attributing most of the fault to trade agreements, when many other factors provide a better explanation for weak economic performance. In fact, the prodigious U.S. demand for Canadian exports fueled much of the growth that did occur. The failure of domestic policy to better distribute the economic gains from trade can hardly be attributed to the constraints of the FTA and the NAFTA. While the trade agreements fell short of expectations in a number of respects, arguably Canada's economic situation would be a lot worse off at present had they not come into being.

John Crispo's view is that the spectacular increase in Canada-U.S. trade is clear enough indication of the success of the trade agreements in expanding economic opportunities. He is less sanguine about the blessings of further integration, however. He views with alarm the pressures trade agreements place on the environment, workers' rights and cultural autonomy. Canada will have to remain vigilant in future dealings with trading partners to ensure that domestic policy is free to regulate in these important areas.

William Watson, drawing on his recently published book (1998), presented compelling evidence that globalization and continental integration do not lead to a leveling down in social or tax policies. For countries belonging to the Organization for Economic Co-operation and Development, he showed there has been only slight convergence of the size of the government sector in GDP or of aggregate tax rates in spite of the forward march of globalization. He also noted there has also been no convergence between Canada and the U.S. after the FTA. Watson believes globalization leaves plenty of room for diversity in tax and spending policies, and it should not be used as an excuse for inappropriate policies.

Globalization and borders. John Helliwell offers striking evidence that borders still matter even in a global economy. Using a gravity model first applied by McCallum (1995), he estimates that even after the FTA, trade flows within Canada are 12 times higher for goods and more than 30 times higher for services than comparable trade flows between provinces and states. He also estimates that border effects for merchandise trade within and among OECD countries are about 10 for countries not sharing a common language or membership in the European Union. A common language boosts the border effect by 60 per cent and EU membership by 40 per cent. For developing countries, he reports the border effects are even higher reaching up to 100 and more. Border effects on migration of Canadians are of a similar magnitude. Clearly, the rumours of the demise of national economies are vastly overstated.

Helliwell argues that some degree of openness is good for economic growth, but further increases in openness beyond those achieved by OECD countries may not produce great efficiency gains. This is based on his reading of the evidence that bigger countries do not have higher levels of GDP per capita. He also cites a study by Sachs and Warner (1995) that divides countries into open and closed, and shows the open economies tend to converge in terms of GDP per capita, but the closed do not. This result reinforces Helliwell's view on the importance of a certain degree of openness. He interprets the fact that economic relations are much denser within than between countries to mean one of two things: the initial large gains from trade could turn into diminishing returns and/or that national boundaries could be an efficient means to segment markets into manageable chunks, taking into account real world constraints. Helliwell makes a convincing case that in such a world national institutions have an important role to play in supporting stable growth even in the global economy.

Globalization and culture. Nowhere are the strains of globalization felt more acutely than in the realm of cultural policy. In an impassioned paper, Sheila Copps, the Minister for Canadian Heritage, defends the ability of governments to support and defend national culture.

Copps argues Canada is the most open country in the world to foreign cultural influences, pointing out that 95 per cent of films shown in Canada and 80 per cent of magazines read in Canada are of foreign origin. Left to their own devices, however, she believes market forces would have wiped out a Canadian presence in many cultural fields, including broadcasting. Programs to protect Canadian cultural institutions have been integral in ensuring Canada's identity is preserved.

She believes Canada is far from the only country that is concerned about preserving its cultural diversity. Discussions are under way in various forums aimed at promoting the importance of cultural sovereignty in future discussions on investment and trade liberalization.

Copps' paper — and the spirited discussions her remarks generated at the conference — underlines the complex challenges certain to be encountered in future rounds of trade negotiations. While moved by the minister's eloquence in defending our national spirit, economists tend to have a natural skepticism toward protectionism, however noble its guises. Added to this is the realization that a middle power such as Canada derives much benefit from rules-based regimes such as the WTO. Questions also arise about the effectiveness of regulatory efforts to limit foreign cultural influences in the age of the Internet and other communications advances. While the task is far from an easy one, most economists' inclination would be to design domestic cultural policy in a way that is compatible with our international trade obligations. This was the course ultimately followed by the Canadian government in reaching a mutually satisfactory deal with the Americans to resolve the magazine dispute. It was recognized that the cost of flouting trade rules would have, in the end, proved far more damaging to our domestic autonomy than finding a creative way to support our culture within a multilateral framework.

The reform of international financial institutions. Canada participates in the formulation of international responses to emerging global crisis through its membership in international financial institutions including most importantly the IMF and the World Bank. Are the responses of these institutions adequate? Are they up to the job? Indeed, are they even necessary? Two of the authors of articles in this issue address these questions: John Crow focuses on the international financial institutions, the IFIs as he calls them, and Ostry, touches on the role of the World Bank and the IMF. Jim Peterson, Secretary of State for International Financial Institutions, who also spoke at the conference, gave the Canadian government's view.

Peterson sketched the government's six-point program to address the short-term problems raised by the current financial crisis and the longer-term underlying issues associated with open capital markets. It includes:

1. More vigilance by the Group of Seven central banks who need to be prepared to act quickly as risks appear on the horizon, or if economic activity continues to slow.
2. A renewed commitment from the emerging market economies to strong policy foundations.

3. Greater global attention to the needs of the poorest economies.
4. Expeditious action to strengthen national financial systems and international oversight.
5. Development of a practical guide or "road map" for safe capital liberalization in developing countries; and
6. Agreement to work urgently toward a better mechanism to involve private-sector investors in the resolution of financial crisis. (Martin, 1998b:2)

Peterson argued that this program, which included lower interest rates in industrialized countries, helped to contain the crisis. Interestingly, Sinai contended in his luncheon address at the conference that it was really the U.S. that played the key role in preventing a global recession by keeping U.S. interest rates low and allowing its economy to continue to grow strongly. The substantial increase in the U.S. trade deficit to US$250 billion, while the EU and Japan continued to run large, and in Japan's case growing, surpluses suggests it is indeed the U.S. economy that is propping up demand in Asia and elsewhere. In times like these it is not so bad for Canada to be reliant on exports to the U.S.

Crow gives us a hard-headed and somewhat skeptical view of the role of international financial institutions, based on his own extensive experience as a senior official of the IMF and as Governor of the Bank of Canada who spent much time attending meetings at the BIS. His article also draws on his recently completed work as a consultant to the board of the IMF. In that capacity, he was responsible for preparing a report on the Fund's surveillance activities.

He argues that the role of the IFIs is to mediate between the predominantly private-sector forces driving the global economy and what their shareholders, national governments, want. He regards the IMF and the BIS to be the IFIs concerned with the most important systemic issues for the global economy. He sees a strong instinct for self-preservation behind the efforts of these institutions to anticipate changing demands. But he recognizes the importance of "international spillover effects and co-ordination problems" and regards international financial stability as "a global public good that will be undersupplied by national actions in the absence of peer pressure."

According to Crow, the IMF had to scramble to find a role after the collapse of the fixed-exchange-rate Bretton Woods system in the early 1970s. But in dealing with the debt crisis of the early 1980s and the challenge of Eastern Europe and Russia starting in the late 1980s, the IMF took the leading role. But as he observes if all the world was like the North (as opposed to the South) with access to private capital, the IMF would be "on the margin of the big financial picture."

Crow acknowledges the moral hazard problem associated with bailouts, but he emphasizes that co-ordination problems among international private-sector lenders require international leadership. Even so, the scope for lender of last resort activities is relatively modest given the size of the potential drain. He sees a role for the IMF in enforcing standards on such issues as accounting, fiscal transparency, and monetary and financial policies. This is complementary to its existing Article IV country surveillance framework. He is more doubtful about what he calls its "superfluous" involvement in issues like poverty, the environment, and military spending, which are out of the range of competence of the mostly macroeconomists on its staff.

Crow also wonders about the inconsistency for the IMF between being a confidential adviser to its country shareholders and a public whistleblower.

Crow sees a continued role for the BIS in a world where national financial systems need to be managed in a global international environment. Through its access to the financial regulation networks in Basel, it has the required technical expertise. It has also drawn up a code of core principles for banking supervision. The president of the BIS will, in his personal capacity, chair a committee concerned with the co-ordination of the supervision and regulation of internationally dispersed financial institutions made up of representatives of the IFIs and G-7 representatives from regulatory institutions.

Concerning the OECD and the World Bank, Crow is much less sanguine about their utility. While he sees a role for the OECD in broadening the horizon of government officials and carrying out studies on micro and structural questions such as the jobs study, he doubts there would be a urgent need to create the OECD today if it did not already exist. He also thinks there is no overwhelming need for the World Bank. It has become increasingly marginal as a "bank" as private capital flows have grown.

Both Crow and Ostry mention the recent public disputes between the World Bank and IMF over macroeconomic policy in countries suffering from Asian flu. At a minimum, this raises the question of the desirability of an overlapping mandate. More critically, it could be argued the World Bank should stay out of macroeconomic stabilization issues. But as Ostry points out the overlap runs both ways. The concept of structural issues, which the IMF had included in its policy framework since the 1980s, was so broadened during the Asian crisis that it virtually duplicated the World Bank's new policy framework. And Crow notes the Bank still has overlapping responsibilities with the Fund over financial sector restructuring in crisis countries that must be considered. The solution to the problem of overlapping responsibilities is a concordat signed at the two institutions' meetings in the fall of 1998 that looks suspiciously like the previous agreement to Ostry. Given the vast domain of development policy, she is skeptical this agreement will be workable.

Finance Minister Paul Martin made the following points at the World Bank-IMF meetings:

- Co-operation between the IMF and the World Bank needs to be strengthened at all levels, not just at the level of the heads of the two institutions.
- Policy advice to member counties must be effectively co-ordinated.
- A clearer delineation of the roles and responsibilities of each institution is helpful and the proposed liaison committee is a step in the right direction.
- Collaboration on financial sector reforms should be a priority. (Martin, 1998:3-4)

Whether this will be enough to resolve the conflicts is still an open question. Crow contends that the changes being made at the World Bank are concentrating on doing its "development work more efficiently – with less bureaucracy, less centralization and more accountability." In his view, this will make little difference to how the Bank deals with the macroeconomic and financial big picture. Moreover, he cites the recommendations of an independent assessment of the Bank carried out by Anne Krueger that laid out three choices: continue as a development institution and focus on the countries that are truly poor (the option favored by Ostry); continue to try to embrace poor and middle income countries by focussing on “soft” issues, for example, the environment, labour standards, and women’s rights; or shut down. Crow notes with disapproval the Bank has apparently chosen the “mushy” second option.

In defence of the Bank, there are some things that can be said. The recent Asian crisis was an extreme situation that, it is hoped, will not be repeated. As the problem involved many countries and more fundamentally the stability of the entire international financial system, it was much more complex than the usual case of a single country encountering balance of payments difficulties because of imprudent fiscal and monetary policies. It raised profound questions about the proper way to proceed that do not usually arise. In these circumstances, the standard prescriptions could not be applied in the usual ways, i.e., higher interest rates to defend the exchange rate are not necessarily the appropriate response to a financial crisis. But if it is back to business as usual, public controversies are unlikely to recur. If not though, such controversies are probably necessary and useful to make sure the nature of the problem and the policy options are fully understood before proceeding.

The World Bank has a useful role to play in the international economy. It takes a longer view than the IMF and focuses on economic development through structural and sectoral reforms. It takes responsibility for the microeconomic policy issues of resource allocation, whereas the IMF takes responsibility for macroeconomic policy issues of stabilization and balance of payments. When working with the IMF on adjustment programs, the World Bank helps to make sure the composition of government expenditure cuts and tax changes make economic sense as well as the planned reduction in the deficit. For instance, from the IMF’s short-term point of view, it makes little difference if a country facing balance of payments difficulties cuts business subsidies or health and education spending. But it makes a great deal of difference to long-term growth prospects of the country.

Conditionality imposed on World Bank loans is important in putting pressure on client countries to take the necessary steps to improve long-run economic efficiency. The financial framework established by the IMF and the World Bank is more important than the funds provided suggest. Which is not to say the money involved is not important, particularly in a situation like the Asian crisis where private capital temporarily dried up. Private-sector financial institutions supplying credit often take their cue from the Bretton Woods twins.

The World Bank has also done much to liberalize trade in the Third World. Larry Summers, the newly nominated U.S. treasury secretary, claimed the “IMF and – World Bank programs not just in Asia but in India, Latin America, Central Europe and Africa, have led to more systematic trade liberalization than – bilateral or multilateral negotiations ever achieved” (quoted by Ostry). Ostry sees an important role for the World Bank in working with the WTO to facilitate the integration of China into the WTO.

Finally, the World Bank’s economic and country studies can provide valuable intellectual input to countries bent on developing comprehensive economic growth strategies, but lacking the analytic capabilities. No private financial institutions are likely to play this role because of the public good nature of the information produced.

Conclusion

As a nation irrevocably connected with the global economy, Canada has a huge stake in the smooth functioning of the world economic system. Events of the past year have underscored the need to improve international economic coherence, modernize international financial institutions and continue the pace of trade liberalization. The upcoming round of multilateral trade negotiations provides an opportunity for the world community to address some of these tasks. Others will require separate initiatives and a determined resolve.

The next round of trade negotiations will bring special challenges as liberalization efforts turn to areas of domestic regulation. Countries that have been so recently shaken by the Asian crisis will be understandably reluctant to concede domestic policy sovereignty. However, the key to making globalization work better lies in improved policy co-ordination and stronger international institutions. This can only be achieved by open communication and good faith negotiations. If nothing else, the conference reinforced this notion.

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Notes

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1. The conference speakers, whose presentations are not available as papers to be published here, are: Allen Sinai, William Watson, Andrew Jackson, John Crispo and Richard Harris. A summary of their presentations was published in the *CABE News* for June 1999.

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