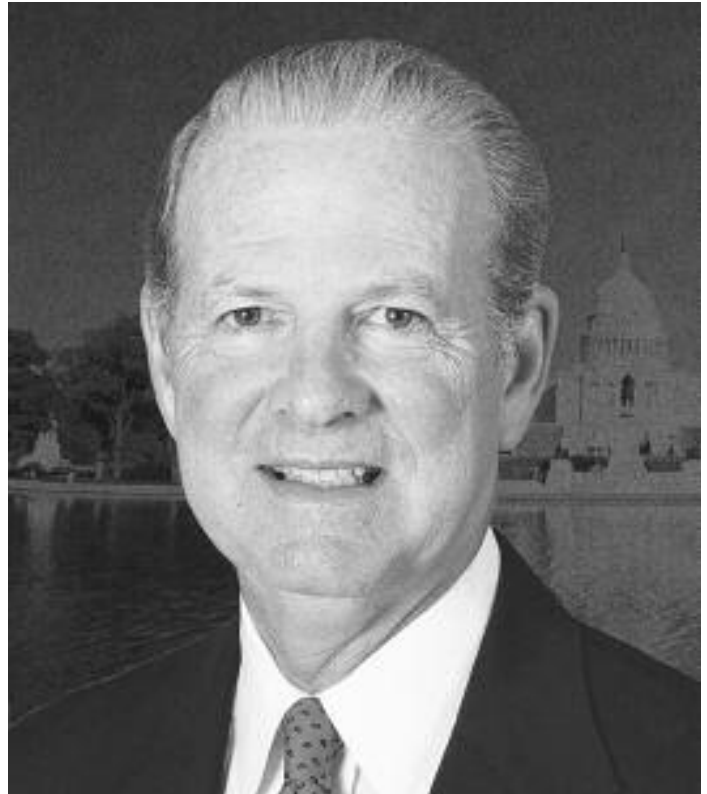


James Baker on Free Trade and International Finance

James A Baker III was the Secretary of the Treasury in the Reagan Administration from 1985 to 1988, in which capacity he was central in dealing with the Latin American debt crisis, fundamental reform of the US tax code, and negotiating the US-Canada Free Trade Agreement. He also served as the Secretary of State in the Bush Administration from 1989 to 1992. He was interviewed at the McGill “Free Trade at Ten” conference in Montreal by Christopher Ragan, Editor of World Economic Affairs.



Negotiating the FTA

WEA: In retrospect, what do you think was the most difficult part of negotiating the FTA?

Baker: I think the dispute-settlement mechanism issue was the most difficult. It was the last one we could resolve. It was very difficult for us in the United States and the Congress, particularly the committee leaders who had to approve this thing. They had some serious difficulties from the standpoint of whether we were ceding sovereignty to a dispute-settlement panel. We ultimately resolved that in both countries by saying that if the issue arises in the United States, we will apply US law, and if it arises in Canada, we will apply Canadian law. So we could go to Congress and say, “Look, we are not ceding any sovereignty. US

laws apply here. We are just agreeing to a method of selecting the mediators, that’s all.”

WEA: In reading descriptions of the FTA negotiations, one clearly gets a sense that the dispute-settlement mechanism was a deal breaker for Canada. But one also gets a sense that the Americans didn’t see why it was such an important issue to the Canadians.

Baker: Well, I don’t know about the American public, but the American negotiators could understand why it was important. It’s like Derek Burney said at the McGill conference: Canadians were not interested in just a tariff deal, because Canadian tariffs were higher than US ones. Canada needed to get something more out of it. We knew that and we understood that. There was

another issue that was very difficult to bridge and that was the cultural arguments that Canada would come up with. Quite frankly, that’s something that’s really hard for us to understand.

WEA: That’s because you don’t live beside a country with 300 million people that happens to be the richest and most powerful country in the world.

Baker: Well, that may be. But that’s a pretty good basket under which you can hide a lot of protectionism if you want to. So we had to look at it with that in mind, and we ultimately resolved those differences. There were times during the FTA negotiations when I looked at Derek Burney or Michael Wilson and said “Hey fellas, let me tell you something. Automobiles are cultural to us. If this is cultural to you, automobiles are cultural to us. Fine, we’ll trade them off.”

WEA: Your mention of culture makes me want to jump ahead a bit. Do you have any views on the recent deal that the United States and Canada struck on the split-run magazines?

Baker: I think it would have been a good deal if we could have struck it back there in the days of the negotiation of the FTA, but the way we solved that was just to eliminate that from the discussion. I don't approve of the recent magazine deal but I'm not surprised by it. One of the major strengths of our country, the reason we occupy this uniquely pre-eminent place in world affairs, not just politically but economically, is because we have been open to immigration and we have been open to foreign investment from around the world. We think foreign investment creates economic growth, which, in turn, creates jobs. And so it's hard for us to understand why a country, particularly in today's globalised economy, would say to another country "We require that, before you can sell your magazines in our country, you have to have 51% Canadian content." That's hard for us to understand—it moves in the opposite direction from economic growth.

WEA: With the benefit of hindsight, what would you say were the serious shortfalls of the FTA? Given your previous comments, perhaps culture is part of the answer.

Baker: I think we eliminated a lot of things that were very tough. I don't think we got very far on financial services. We didn't get as far as we could have on investment, but it was such a revolutionary dream that I don't think you ought to look at it in terms of shortfalls because it has been a very good agreement for both countries. At the time it was a major step forward, and not an easy one to take. If you want to include the treatment of culture as a shortfall, that's fine with me.

WEA: As you know, the Canadian election in 1988 was fought exclusively on the FTA. I was a graduate student in Boston at that time and missed the

election, but it was quite clear that in America it was a non-issue—in the newspapers, to the man in the street. Why didn't Americans care?

Baker: Well, I think it was because we had just been through a major economic issue that occupied centre stage in our political and economic life—fundamental tax reform. We were successful in reducing the top marginal rate and eliminating a whole host of deductions. All of these things hit the American taxpayers in their pocket-books and it was easy for them to judge the impact of that. It was easy for them to understand. It's a lot harder for them to understand how they're going to benefit from reducing tariffs or entering into a free-trade agreement with Canada.

WEA: But five years later, NAFTA was a much bigger issue. Was this because Mexico was a low-wage country and was seen as a threat, whereas Canada was not much of a threat?

Baker: You could argue that. But the real reason was that when we negotiated the FTA with Canada our economy was booming. Nobody was worrying about it. They were focused on tax reform. But when we negotiated NAFTA five years later we were in a recession. Everybody was worried, and it was much harder therefore to negotiate a free-trade agreement.

Expanding the Circle of Free Trade

WEA: What is the promise you see for greater trade in the Americas? And what is required to actually get it?

Baker: Getting a hemispheric free-trade agreement is going to depend upon getting fast-track trade negotiating authority for the President of the United States. And it isn't going to happen, in my view, until after the 2000 election.

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WEA: Is a President that sells the idea of free trade going to be sufficient, or will we also need a change in Congress?

Baker: You certainly need a President to sell it. Congress is always going to be tough on free trade. Doesn't matter what the party is. We faced a very hostile Democratic majority in the Congress. Clinton is facing a very difficult task with the Republican Congress. But without presidential leadership, without political will on the part of the President, we are not going to get it. The President has got to lead. He's got to say "This is important." He's got to put it at the top of his agenda. He's got to devote substantial presidential time and assets to it. But it's not a partisan thing. It's not a party thing. You'll find protectionists in the Republican party in the United States and you'll find an equal number of equally vociferous protectionists in the Democratic party. It's presidential leadership that is going to make the difference.

WEA: It's sad to think that protectionism is just one of those elements of human nature.

Baker: Sure it is. And it's easy to demagogue—it's so easy. That's what Ross Perot was doing when he was talking about the "giant sucking sound". It's just a hell of a lot harder to make the case for free trade and to make the case for internationalism *per se* than it is to demagogue against it.

WEA: I was pleased to see in your comments at the McGill conference that you thought it was one of those things that if you make the case, and you make it right, then it can be politically successful.

Baker: Leaving the economic ground for a moment, we made it in the Gulf War. When we first started talking about going to war in the Gulf, nobody supported it. Fifteen percent of the American people said "Yeah, we would support

the idea of fighting a major war in the Gulf." President Bush—through leadership, through making the case, through going at it, and putting together an

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unprecedented international coalition—pulled together sufficient support and he had the strength of his convictions to take it to the Congress and get an up-or-down vote in both Houses. That's the kind of presidential leadership it takes.

To be fair, that's what Clinton did on NAFTA. He bucked his own party on NAFTA—the same people who objected to his sending up the fast-track negotiating authority for hemispheric free trade. He bucked them on NAFTA but he wasn't willing to buck them again before the 1996 elections. And that's why we didn't make progress on hemispheric free trade.

WEA: Many people have expressed concern about the distortions that accompany regional trading blocks. Do you have the same concerns, or are you more pragmatic?

Baker: I don't have any concerns about them as long as they are GATT consistent. As long as they are consistent with the global trading rules, I don't see a problem. I don't see that NAFTA is a problem to other regions, or to other countries. I don't see that the European Union is a problem. As long as they are not protectionist in nature—as long as they reduce impediments to trade and don't increase them.

Recent Financial Turmoil

WEA: Let's change over to discuss financial issues. What do you see as the impact of the euro on the US economy? Do you see any danger of the greenback losing "market share"?

Baker: None at all, and I'll tell you why. The greenback is the *de facto* reserve currency in the world. It's going to remain such. Why? Because of a whole host of things—the strength of our

economy, the size of our economy, but more than anything else, the political stability that our system offers. And it's political stability that is represented by one country, not fifteen. Let me preface all of this by saying it would be really good for the United States, and I assume for Canada, but certainly for the United



James Baker addressing the "Free Trade at 10" Conference in Montreal.

States, if the euro succeeded because it would be really good if we could deal with one Europe. It would also be good for Europe because it would increase their growth and eliminate all the exchange-rate problems.

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My job as Secretary of the Treasury was to co-ordinate one country's fiscal policy with its monetary policy. And it was damn tough. I don't understand how it's possible to co-ordinate one monetary policy with 15 fiscal policies. What are they going to do when

France is booming and Germany is in a recession? What will be the monetary policy for the European Central Bank? This, by the way, is one of the problems with dollarisation. We are talking about

dollarising now in this hemisphere, particularly in South America. That may protect those currencies from manipulation and currency speculators but if the United States is booming and one particular South American economy is not and we are raising interest rates in the United States and they dollarise—it's a problem. I hope the euro succeeds. I see some problems for them on the horizon but even if it succeeds it is not going to displace the dollar as the world's *de facto* reserve currency. Not in my lifetime and probably not in yours.

WEA: For the last two years, beginning with the Asian crisis, there were many calls to reform the world's "financial architecture". Two years later, things seem to be pretty much on the mend. What do you see as the main problems in the global financial system?

Baker: I think it's really good that every country in the world has embraced reform, politically and economically, save a few rogue nations like North Korea, Iraq, Iran, Cuba and a few others. Everybody wants democracy and free markets. That's good, but it is not enough just to say you want the benefits of the free market. You've also got to take on the obligations of the free market. The obligations are that your free-enterprise system has to be transparent. You have to have suitable bank regulatory laws. You have to be as free as possible of corruption. You have to avoid the problems and the pitfalls of crony capitalism. These emerging economies that have signed on to the free-enterprise system have got to, if they are going to be successful, reform their economies so that they are more like the economies of the United States, western Europe and Canada—where transparency, fairness and a system of laws is paramount. The lack of such reforms is one of the things that led to the Asian financial crisis.

WEA: Does it worry you when, in the wake of such a crisis, you see countries like Malaysia starting to think seriously about capital controls?

Baker: Yes. One of the problems with such a crisis is that the country will be tempted to backslide. Malaysia has been backsliding. Russia has been backsliding. The worst possible thing that could happen is that we would lose the impetus for reform on the part of countries all over the world to embrace the free market. We can't afford to lose that. Now that it looks like we are coming out of the problem there is a temptation on the part of these countries to stop reform—slow it down or stop it. You are seeing it in South Korea.

South Korea took on an IMF programme, they implemented it pretty well, they're coming out, they're doing well, but now the *chaebols* are resisting the reform steps that they have to take.

WEA: Who should be the force making sure this backsliding doesn't happen? Or do we just leave it to private decisions?

Baker: No. The IMF has to play a role in it because the IMF programmes have got to insist upon reform. One of the mistakes we've made in Russia, frankly, is throwing \$18 billion at the problem and not insisting that the reform part of the programme be implemented. It's sad to say, but a lot of the money is going into Swiss bank accounts. The US Treasury also has to be involved and so do all of the countries of the industrialised world that have successfully functioning free market systems. Everybody's got to be engaged in it and we have to continue to promote the benefits that can flow from successfully embracing the market.

WEA: I take it that you don't put much importance on re-designing the financial architecture.

Baker: When I was Secretary of the Treasury, a lot of people used to say we need a new Bretton Woods, we need a new system of exchange rates, we need to go to target zones or fixed rates. I don't think we need those kinds of things today. What I think is needed are two

things in the financial architecture. We certainly don't need to flip back to capital controls, centrally planned economies, and managed trade and all that those things that have been proven not to work. What we need is to reform the IMF (there are some important changes that are needed there) and then

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we need intensive efforts, by the G7 countries particularly, to co-ordinate their underlying economic fundamentals. Not fixed exchange rates. But take co-ordinated and co-operative actions that work. Last fall we had a co-ordinated round of interest rate reductions at a time when the global economy looked like it was in the tank, and it was terrific. That is the

kind of thing we need more of.

WEA: You have just said that one of your criticisms of the IMF is that it does not enforce its programmes well enough. Other people—Jeffrey Sachs, for example—would claim that the IMF has been enforcing the *wrong* programmes. What is your response?

Baker: Well, Sachs has suggested that we give the Soviets a hell of a lot more money. But it doesn't do any good, as we have seen, to give them all that money if you don't get the reforms implemented.

But there are a few changes that I would like to see in the IMF. They need to address the moral hazard problem. They need to deal with that so that imprudent investors *do* get penalised if they have made a dumb investment. They need to not put any money out for countries to support an exchange rate that is pegged at an unrealistic level. They ought to get rid of that as a cornerstone in their policy. They need to be more transparent in what they are doing. Tell us what it is so people understand what these structural adjustment programmes are. And they need to understand that one size does not fit all—that the problems of East Asia in the 1990s are not the same as the problems of Latin America in the 1980s. These are some of the things that need to be changed.

WEA: Are you optimistic that those sorts of reforms are going to happen?

Baker: I think they can happen. I think many of them will happen because the IMF has lost a lot of support, not just among the countries that have benefited from its programmes or that are subject to its programmes but from contributing states as well.

Foreign Policy

WEA: Do you think the process of globalisation has changed the way foreign policy gets conducted?

Baker: Well, I think it has affected it in the sense that the technological revolution has created one global market and has impacted the formulation and implementation of foreign policy. Foreign policymakers, for instance, no longer have days to consider a reaction to a fast-breaking event around the world. You do it in hours. You have to have your policy ready to go in hours or you have to at least know what it is you are going to say about it. That is different than the way it used to be. And that's a function, I think, of globalisation. Beyond that I am not sure I see a major impact on the implementation or formulation of foreign policy.

WEA: What are the big challenges for foreign policy in the years ahead?

Baker: I think one of the most important things we have to do is integrate Russia and China into the community of nations. It's really important for the West to make those relationships work—to have viable and good relationships with China and Russia. We need to deal with the proliferation of weapons of mass destruction in a realistic and strong and forceful way and we need to find ways to band together to sanction rogue nations that deal in weapons of mass destruction. We need to figure out what we are going to do about global terrorism. We need to find ways to make the global economy function effectively and we need to find ways to smooth out the natural bumps in the road that are going to occur as emerging markets embrace the free market. We need to encourage these countries to adopt the kind of free enterprise systems that have been successful in the West. These are some of them. There are probably others.

WEA: It was a pleasure speaking with you today. Thank you very much for your time. ♦