Policy Analysis

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Executive Summary

In May President Reagan will meet in Bonn with the leaders of the six other major Western industrialized nations: France, Great Britain, Italy, Canada, West Germany, and Japan. Such meetings have been held annually in recent years to aid in the coordination of economic policy. Although little of substance is usually accomplished, they do afford an opportunity to discuss the prominent economic issues facing the free world's leading economic powers. It is important that President Reagan take this opportunity to focus world attention on the key economic problems facing the West and especially on the correct solutions to those problems. The president should urge the allies to pursue sound domestic and international economic policies and should resist efforts to harm the American economy in a futile attempt to aid other countries. The following is a brief discussion of some key economic issues that will be, or should be, on the agenda of the economic summit.

Economic Growth

The first order of business must be ways of sustaining the economic recovery and preventing the recurrence of either another recession or another burst of inflation. Part of this will involve measures relating to trade, international monetary policy, Third World development, East-West relations, and defense. This section will concentrate on actions that can be taken regarding domestic economic policy, either individually or in coordination with other nations.

Although there has been a major improvement in both inflation and real economic growth in the last two years, it has not led to similar gains in employment, except in the United States. Table 1 summarizes recent developments.

Table 1
Recent Economic Developments

Country	Consumer Price Increase (%)	Unemployment Increase (%)	Real GNP Growth (%)
United States			
1984	4.2	7.4	6.9
1983	3.2	9.6	3.7
1982	6.1	9.7	-2.1
Japan			
1984	2.3	2.8	5.8
1983	1.9	2.6	3.0

1982	2.7	2.4	3.3
German			
1984	1.5	8.3	2.5
1983	3.3	8.2	1.3
1982	5.3	6.7	-1.1
France			
1984	7.1	9.3	1.8
1983	9.6	8.2	0.7
1982	11.8	8.0	2.0
United Kingdom			
1984	4.7	11.8	2.0
1983	4.6	11.5	3.2
1982	8.6	11.0	2.5
Italy			
1984	9.9	10.0	3.0
1983	14.6	9.7	-1.2
1982	16.6	9.1	-0.4
Canada			
1984	3.8	11.5	4.5
1983	5.9	11.9	3.3
1982	10.8	11.1	-4.4

Source: Organization for Economic Cooperation and Development (OECD).

As one can see, unemployment in every country except the United States is higher today than it was in 1982, at the bottom of the recession. To a certain extent this is simply a matter of timing, the recovery having begun in the United States first. It is also a major reason for the large U.S. trade deficit,[1] which, in turn, has been a prime factor contributing to the recovery in other nations. Table 2 shows the U.S. merchandise trade deficit with the other leading industrialized nations.

Table 2 **U.S. Merchandise Trade Deficit with Major Industrialized Nations in 1984 ($ Billions)**	
Japan	36.8
Canada	20.4
Germany	8.7
Italy	4.1
United Kingdom	2.8
France	2.5
Total	75.3

Source: Department of Commerce

With the overall U.S. merchandise trade deficit in 1984 at $123.3 billion, these six countries thus accounted for 61 percent of that deficit.

What is often lost in the discussion of the trade deficit is the fact that U.S. exports have actually increased, from $200.3 billion in 1983 to $220.3 billion in 1984. This is no small accomplishment, since the U.S. dollar rose in value by 13 percent in 1984. When the dollar rises in value, foreign imports become cheaper in terms of dollars and exports become more expensive. Thus one would expect that the United States would have its largest trade deficits with those countries against which the dollar has risen most. But what happened has been almost exactly the opposite, as Table 3 demonstrates.

Exchange rates and trade will be discussed in more detail below. For now, the important point is that the U.S. trade deficit is not a problem to be concerned with. Its principal function is to motivate people to support trade restrictions so as to protect the jobs and profits of companies facing international competition. If the trade deficit truly represented a fundamental weakness in the American economy, the result would be a falling dollar instead of a rising one.

Foreign leaders can be expected to put considerable blame on the U.S. budget deficit for their deteriorating currencies. The deficit, so the argument goes, raises U.S. interest rates and causes capital to flow to the United States, thereby raising the value of the dollar. In fact, the U.S. budget deficit

Table 3
Exchange Rates (Cents per Unit of Foreign Currency)

Country	1983 (IV)	1984 (IV)	Change (%)
Japan	.42714	.40635	-4.9
Canada	80.743	75.837	-6.1
Germany	37.344	32.726	-12.4
France	12.251	10.673	-12.9
Italy	.06156	.05288	-14.1
United Kingdom	146.91	121.50	-17.3

Source: Federal Reserve

is about the same size relative to GNP as budget deficits in the other leading industrialized nations, and a similar parallel holds for interest rates as well. (See Tables 4 and 5.) The explanation for the rising dollar has to be found elsewhere.

Although the United States has run large budget deficits in recent years, the public debt as a share of GNP has been falling. By contrast, it has been rising sharply in most other major industrialized nations. (See Table 6.) Moreover, nations with rising debt burdens appear to have had faster growth than those with declining or less swiftly rising public debts. This suggests that efforts to sharply curtail deficits and public debts will not necessarily enhance growth.

This is not to say that growth of public debts is unproblematic;[2] the rising burden of interest payments, for example, is a matter of some concern. Debt service payments have risen sharply in all the major industrialized countries since 1970.

Table 4
Central Government Surplus or Deficit as a Share of GNP

Country	1979	1980	1981	1982	1983	1984
United States	+0.6	-1.2	-0.9	-3.8	-4.1	-3.2
Japan	-4.8	-4.5	-4.0	-3.4	-3.3	-2.2
Germany	-2.7	-3.1	-3.8	-3.4	-2.7	-1.7

France	-0.7	+0.2	-1.8	-2.5	-3.4	-3.5
United Kingdom	-3.2	-3.8	-3.1	-2.4	-3.3	-3.1
Italy	-9.5	-8.0	-11.9	-12.7	-11.8	-13.5
Canada	-1.8	-2.7	-1.6	-5.0	-6.2	-6.0
Total	-1.7	-2.4	-2.6	-4.0	-4.2	-3.6

Source: OECD

Table 5
Interest Rates (Government Bond Rate)

Country	1979	1980	1981	1982	1983	1984
United States	9.3	11.4	13.7	12.9	11.3	12.5
Japan	7.7	9.2	8.7	8.1	7.4	6.7
Germany	7.4	8.5	10.4	9.0	7.9	6.7
France	9.5	13.0	15.7	15.6	13.6	12.7
United Kingdom	13.0	13.8	14.7	12.9	10.8	10.7
Italy	14.0	16.1	20.6	20.9	18.0	15.2
Canada	10.3	12.5	15.2	14.3	11.8	12.7

Source: International Monetary Fund (IMF)

Table 6
Public Debt as a Share of GNP

Country	1970	1983	1983 as % of 1970	Real GNP Growth 1972-82
Japan	12.0	66.8	557	4.3
Germany	18.4	41.1	223	2.0
Italy	44.4	84.5	190	2.6
France	29.4	32.6	111	2.7
Canada	53.7	55.5	103	2.8
United States	46.2	45.8	99	2.2
United Kingdom	86.2	54.2	63	1.5

Source: OECD

Since such payments must be made, they tend to increase overall government spending. Table 7 illustrates this fact.

However, efforts to deal with deficits may exaggerate the benefits that may result from their elimination, and such efforts may utilize tax increases rather than spending cuts to achieve their goal--also matters for some concern. This is because deficits in and of themselves are not the problem. The real problem is high levels of government spending and taxation.[3] Much recent research indicates that countries with high levels of taxation and spending have lower growth rates than countries with lower tax and spending levels.[4] This suggests that countries that deal with their deficits by reducing spending will do better than those that raise taxes.

Faster economic growth will, of course, help reduce unemployment, but additional measures are also necessary. In particular, greater flexibility needs to be restored to labor markets, especially in Europe. Although there is evidence that European labor unions are losing some of their power in the wake of the disastrous coal miners' strike in England, there is still considerably less flexibility in European labor markets than in the United States or Japan.[5]

Table 7 **Debt Service and Total Spending as a Share of GNP/GDP**				
Total Government Spending			Debt Service	
Country	1970	1983	1.2	2.1
United States	32.4	37.6	1.2	2.1
Japan	19.3	34.5	0.6	4.4
Germany	38.6	49.4	1.0	3.0
France	38.9	50.7	1.1	2.6
United Kingdom	39.2	47.9	3.9	4.9
Italy	34.2	53.7	1.7	9.1
Canada	35.7	45.8	3.8	7,2

Source: OECD

But perhaps the most critical difference between the United States and Japan on the one hand and the European nations on the other is in their attitudes toward entrepreneurship. Entrepreneurship has been an essential element in the growth of America's high-tech industries. A number of European countries, especially France, are desperately trying to duplicate America's success by creating "Silicon Valleys" of their own.[6] Unfortunately, they have been unable to break free from the idea of planning and have tried to plan a high-tech program the same way they have planned everything else. This effort is doomed to failure because entrepreneurship cannot be "planned"; it must develop spontaneously in an environment of freedom, both economic and creative. Until they are prepared to supply entrepreneurs with such an environment, the Europeans are likely to continue lagging behind the United States and Japan in the hightech race.[7]

What the European nations need in order to bring unemployment down and achieve a higher level of economic growth is a dose of the free market. President Reagan should point out, diplomatically but forcefully, that government taxation and spending need to be scaled back, union power needs to be curtailed to restore flexibility to labor markets, and government tinkering with the economy should be resisted. The following sections suggest other measures that can also help sustain economic recovery through greater reliance on the market and less on government.

Trade Policy

There is little question that tensions in the trade area have risen sharply in recent years. There is hardly a major country that has not increased trade protection levels.[8] Unfortunately, this protectionism has increasingly taken the form of non-tariff barriers, such as quotas, rather than old-fashioned tariffs. As Table 8 indicates, tariff levels have actually fallen in most of the major industrialized countries. Table 9 presents estimates of the percentage of imports covered by non-tariff barriers in these countries.

As one can see, even countries with relatively low tariff levels may still subject a substantial amount of imports to other types of restrictions. It may also be true, as it is in the United States, that although the aggregate amount of tariffs may be small in terms of government revenue, the rates on particular products may be quite high. To the extent, therefore,

Table 8 **Taxes on Imports as a Share of Total Imports**		
Country	1977	1982
Canada	5.1	3.9
United States	3.4	3.5

United Kingdom	2.4	2.2
Japan	2.7	2.1
France	1.8	1.0
Italy	0.4	0.3
Germany	0.04	0.04

Source: IMF

Table 9
Percentage of Imports Covered by Non-Tariff Barriers in 1983

Country	Developed Countries	Developing Countries
United States	13.0	5.5
Japan	19.2	5.4
France	20.1	7.1
United Kingdom	14.9	14.3
Italy	12.5	7.0
Germany	12.6	8.5

Source: World Bank

Table 10
Percentage of U.S. Imports Free of Duty

1979	50
1980	45
1981	29
1982	31
1983	32

Source: Census Bureau

that imports are discouraged by such tariffs the amounts of imports duties collected will be reduced, giving the false impression that tariffs are quite low. It may also be that while aggregate tariff levels may fall, tariffs are extended to a wider range of products than before. As Table 10 shows, the percentage of U.S. imports free of duty has fallen sharply in recent years.

There is a widespread belief that this growth in protectionist pressure is simply a function of the worldwide recession. When the recovery has spread to all countries, so the argument goes, protectionist pressure will diminish. A report from GATT (General Agreement on Tariffs and Trade), however, disputes this idea:

Those who hope that conditions of trade will automatically loosen up with the progress of recovery forget that the protectionism of the last fifteen years or so has been more ideological than pragmatic in origin. It has been the logical concomitant of a particular perception of the powers and responsibilities of governments that emphasized the importance of protecting existing jobs and existing wage levels, even in the face of market pressure for structural adaptation.[9]

Moreover, nothing seems to have changed the basic political situation that is creating pressure for protection. Although the protectionist Walter Mondale was defeated by the generally pro-free trade Ronald Reagan, institutional pressure, especially within Congress, has continued to keep support for protectionist policies at a high level. We are now hearing proposals for such overtly protectionist measures as a 20 percent surcharge on all imports.

The basic problem is this: the people who suffer from international competition know who they are and are well organized; by contrast, those who bear the cost of protectionism are widespread, disorganized, and may bear only a relatively small burden on an individual level. Hence it is extremely difficult to organize support for free trade and quite easy to organize support for protection.[10]

Consider the case of the automobile industry. Although imports are usually blamed for the industry's problems, the data indicate that they are largely of its own making. As Table 11 shows, the total number of imported autos has not increased substantially over time. Rather, total auto sales have fallen sharply, entirely at the expense of domestic producers, thus increasing the share of imports as a proportion of the total.

Rather than looking at the fundamental reasons imported autos were able to hold their market while domestic autos lost theirs, such as the higher quality and lower prices of imports, the auto companies and unions sought to maintain the status quo through import restrictions. In 1980 they filed a petition with the International Trade Commission charging that auto imports were a substantial cause of serious injury to domestic producers. The commission failed to find evidence that imports were the major cause of the industry's problems, however, and cited reduced demand, changing consumer preferences, and general economic conditions as real causes of the industry's situation.[11]

Table 11
New Car Sales (Millions)

Year	Total	Domestic	Imports	Imports as % of Total
1983	9.2	6.8	2.4	26.1
1982	8.0	5.8	2.2	27.5
1981	8.5	6.2	2.3	27.1
1980	9.0	6.6	2.4	26.7
1979	10.6	8.2	2.3	21.7
1978	11.2	9.2	2.0	17.8
1977	11.1	9.0	2.1	18.9

Source: Department of Commerce

In spite of this, the industry continued to push for re- strictions on imports, especially those from Japan. In early 1981 it convinced President Reagan, despite his avowed free- trade philosophy, to ask Japan to voluntarily restrict imports to the United States for three years.[12] In 1984, in the midst of the election campaign, Reagan asked that the restrictions be continued for another year. In 1985 he finally allowed them to lapse.

The cost of these "voluntary" restrictions has been high. The International Trade Commission estimates the total cost to U.S. consumers between 1981 and 1984 to have been $15.7 billion, resulting from higher prices on both domestic autos and Japa- nese imports than would have existed in the absence of restric- tions.[13] Robert Crandall of the Brookings Institution puts the cost of every job saved in the auto industry at $160,000--a rather high price by any standard.[14] Moreover, domestic auto producers may now find that Japan will be an even tougher compe- titor today than before because the quota had the effect of strengthening Japan's largest auto companies at the expense of its smaller ones.[15]

A similar story is told in the steel industry. Although the industry has claimed that imports are the major cause of its problems, analysis suggests that the real problems are do- mestic.[16] Nevertheless, President Reagan has granted the industry relief that may cost consumers as much as $18 billion over the next five years.[17] Indeed, domestic producers are already raising prices because of the import restrictions.[18]

Table 12 Balance of Merchandise Trade in 1983 ($ Billions)	
United States	-69.4
Japan	20.5
Germany	16.5
France	-10.1
United Kingdom	-8.3
Italy	-7.6
Canada	10.5
Source: Department of Commerce	

The United States is not alone in its concern over imports. As is evident in Table 12, a number of other major countries are likewise suffering from trade deficits and a deteriorating competitive position.

Much of the discussion at the upcoming summit will undoubt- edly center on Japan, which is alleged to use various devious methods to keep out foreign imports.[19] Japan is also alleged to "target" its export industries with government aid to help them outdo their competition, but efforts to prove this have not been successful.[20] Japan has also been accused of artifi- cially holding down the value of the yen in order to discourage imports and encourage exports.[21]

It will take major effort to resist protectionist pressure and maintain an open trading system. Politically, it will probably be necessary for Japan to make some concessions toward opening its market to foreign producers. This will be easier to accomplish, however, if we can offer something to Japan in return. One suggestion is to unilaterally reduce U.S. barriers on exports to Japan.[22] If similar export barriers exist in other countries, such a move might provide the basis for a gen- eral agreement not only to maintain an open trading system but to expand it.

The argument for free trade, however, ultimately rests on self-interest. We want to maintain open borders because it is good for us, not as a favor to our allies. But protectionist myths persist and political pressure from affected groups is acute. Still, it is worth restating the case for free trade. It is a simple one. As the president's Council of Economic Advisers put it in its most recent Economic Report:

The persuasive power of arguments for free trade arises not from abstract economic reasoning, but from concrete historical comparisons of the achievements of free trade against those of protectionism. The conclusions to be drawn from such comparisons over the past two centuries are unambigious: Countries that have followed the least restrictive economic policies both at home and abroad have experienced the most rapid economic growth and have enabled the great- est proportion of their populations to rise above subsistence living standards [emphasis added].[23]

East-West Trade

One area where the Reagan administration has had a partic- ular problem with free-trade is that of East-West trade. The administration strongly believes that U.S. high technology must be kept out of the hands of the Soviets. Since it is very hard to keep track of such goods once they leave the United States, the administration has put pressure on our allies to refrain from trading with the Soviet Union. This is a great irritation to our allies and will certainly be raised at the summit.

There is little question that the Soviets strongly desire Western goods, especially high-tech goods. There is also little question that the United States and other Western nations have legitimate reservations about supplying the Soviet Union with goods that will enhance its military strength at their expense. However, given the reality that trade does take place and is even encouraged in certain areas, the problem of where one draws the line and enforces it is extremely difficult. Generally speaking, the United States has been much more restrictive to- ward trade with the Soviet Union than have our European allies. This has not only created friction but has undermined legitimate efforts to restrict militarily sensitive commodities. It is in everyone's interest to resolve these issues.

One of the first facts that must be faced is that we cannot hope to keep everything the Soviets want out of their hands. To do so would effectively require shutting U.S. borders to all trade. This is especially true for high-tech products that may be very small and readily available on the open market, like minicomputers. The Soviets invest considerable effort in obtaining Western technology, and it is inevitable that they will have some success.[24]

Another point is that we cannot impose restrictions on trade with the Soviet Union without imposing a substantial cost on ourselves. This is abundantly clear in the case of the 1980 grain embargo. The embargo strengthened our major competitors and gave the United States a reputation as an unreliable sup- plier. Not only has the United States never been able to re- claim its lost market share, but billions of dollars of sales have been lost in areas unrelated to those where embargoes had been imposed.[25] Ironically, though we suffered greatly as a result of imposing an embargo on grain in 1980 and on gas pipe- line equipment in 1982, the Soviet Union seems not to have suf- fered much from the experience, having obtained grain and pipe- line equipment elsewhere.[26]

Still, such embargoes could perhaps be justified if they led to a change in Soviet behavior. Consistent with the history of trade sanctions, however, there is no evidence that the embargoes have done anything except strengthen Soviet re- solve. Historically, there is almost no evidence that trade sanctions ever do succeed.[27]

Ironically, the most effective means the United States has of keeping the Soviets from fully utilizing Western technology to our detriment is the Soviet system itself. For example, although we worry about the use to which the Soviets might put our increasingly powerful minicomputers, the Soviets discourage their use. The Soviet system demands centralization, and the spread of personal computers undermines central authority. Thus a recent Rand Corporation study concluded that "the most effective barriers to technology transfer are those erected by the Soviets against themselves.'[28]

It is too much to expect, given the current level of ten- sions between East and West, that there could ever be a resto- ration of free trade between the United States and the Soviet Union. However, we need to do a lot more thinking about what we are trying to accomplish and about the appropriate means. If trade restrictions are to be maintained, we must be certain that they are coordinated with our allies and that the cost of such restrictions to the Soviet Union exceeds the cost to our- selves. It certainly accomplishes little for the United States to withhold goods from the Soviet Union only to have our allies supply them instead. And it does little to advance our cause when U.S. trade restrictions sow greater discord within the Western alliance than they do within the Soviet bloc. If prog- ress in this area can be made at the Bonn summit it will be to everyone's benefit.[29]

Defense Issues

The principal defense issue that could be raised at an economic summit is the growing disparity between U.S. defense expenditures and those of our major allies. As Tables 13 and 14 indicate, the burden of defense expenditures is significantly heavier on (and growing for) the United States as compared with that carried by our allies.

Table 13
Military Expenditures as a Share of GNP

Country	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
United States	5.9	6.0	5.8	5.3	5.2	5.1	5.1	5.5	5.8	6.4
Japan	0.8	0.8	0.9	0.9	0.9	0.9	1.0	0.9	1.0	1.0
Germany	3.5	3.6	3.6	3.5	3.3	3.3	3.2	3.3	3.4	3.4
France	3.8	3.7	3.8	3.8	3.9	4.0	3.9	4.0	4.2	4.2
United Kingdom	2.7	2.6	2.5	2.3	2.4	2.4	2.4	2.4	2.5	2.6

Italy	2.7	2.6	2.5	2.3	2.4	2.4	2.4	2.4	2.5	2.6
Canada	2.0	2.0	1.9	1.9	2.0	2.0	1.9	1.9	1.9	2.2

Source: Arms Control and Disarmament Agency

It has been argued that the heavy burden of U.S. defense spending is a major reason for disparities in economic growth

Table 14
Military Expenditures per Caplta (1981 $)

Country	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
United States	687	686	659	621	645	644	659	691	739	798
Japan	64	61	69	73	76	81	86	89	92	96
Germany	326	341	338	341	340	351	357	362	374	372
France	339	343	352	365	385	404	414	428	441	444
United Kingdom	408	420	411	426	416	419	432	462	435	461
Italy	140	140	128	126	132	135	142	148	154	163
Canada	195	198	193	200	212	223	207	210	215	235

Source: Arms Control and Disarmament Agency

rates. Specifically, it is contended that nations spending less on defense tend to grow faster than those spending more.[30] One does not have to accept this view, however, to still feel that our allies are getting a free ride at U.S. expense.

Redressing this imbalance will be difficult. Many of our allies have strong left-wing and pacifist elements, such as Germany's Greens, that strongly resist any increase in defense expenditures. Others have levels of government spending as a share of GNP far higher than levels in the United States. For them to increase the share of spending going to defense would require either reducing domestic spending sharply, which would likely create a political crisis for present governments, or raising taxes, which could derail economic recovery. Japan is constitutionally prohibited from increasing the size of its defense establishment (a provision inserted during U.S. occupa- tion after World War II) and, moreover, suffers from being the only nation on earth to experience the reality of nuclear war. In short, efforts to get our allies to increase the level of their defense expenditures could very well lead to a strength- ening of leftist and pacifist elements and, ultimately, to an undermining of the overall defense effort. Given the problems the United States has had with New Zealand's refusal to allow U.S. nuclear warships in its ports and with the deployment of cruise and Pershing missiles in Europe, we would do well to respect our allies reluctance to increase defense spending much beyond current levels.

There is another option: a cutback in U.S. defense commit- ments on behalf of our allies. It is difficult to estimate the precise amount of money expended on the defense of other nations by the United States. Earl Ravenal of Georgetown University gives the following estimates for such expenditures in fiscal 1985: on behalf of NATO, $129 billion; for Asia, $47 billion; for the Rapid Deployment Force, $59 billion, of which $47 bil- lion is for the Persian Gulf.[31]

According to the Department of Defense, the following U.S. forces are currently dedicated to NATO: 4 army divisions, 2 brigades of U.S.-based divisions, 2 armored cavalry regiments, and 28 air force tactical air squadrons. In the event of war, the United States is prepared to commit 10 army divisions, 88 air force squadrons, and 1 marine brigade within 10 days. In addition, the United States maintains the Second Fleet in the Atlantic and the Sixth Fleet in the Mediterranean, largely for missions unrelated to the direct defense of the continental United States.[32]

U.S. forces dedicated to the defense of East Asia include 2 army divisions, approximately 2 marine divisions, 1 strategic bomber squadron, 10 tactical fighter squadrons, 5 tactical sup- port squadrons, 6 aircraft carriers, 89 surface combat ships, 32 amphibious ships, 40 attack submarines, and 12 maritime pa- trol squadrons. These forces could, of course, be reinforced from the United States in the event of war.[33]

In addition, the United States maintains forces around the world, in 359 different places according to one count.[34] Except for the fact that no world wars have broken out in the last 40 years, it is hard to point to any concrete evidence that the people of the United States, who pay for these far- flung forces, benefit materially from the expense.[35] As a result, a number of responsible commentators on both left and right have suggested curtailing U.S. commitments to NATO and elsewhere.[36] Even among acknowledged "hawks" there seems to be a growing sense that our allies are ungrateful for the ef- forts we expend on their behalf, especially in the wake of New Zealand's decision to block U.S. nuclear warships from its ports. As William Safire recently wrote:

The [New Zealand] episode raises some questions. . What have we been defending New Zealand from, anyway? What are we getting in return for our nuclear um- brella protecting Japan? Why are a third of a million U.S. troops stationed in Europe, 40 years after the war? New Zealand's willingness to "cut it," in both slang senses, reminds us of our need to reexamine periodically our regional commitments everywhere. For too long, we have viewed our alliances as good in themselves--as if the purpose of an alliance is to have an alliance. Too often, our allies have taken our continued commitment to their security for granted and have shied from making comparable sacri- fices to the common defense. At the start of a new presidential term, with a new Senate Foreign Rela- tions Committee in place, the time is right to take a new and critical look at our age-encrusted guarantees to others in the light of our national interest today.[37]

Given the U.S. budget deficit and pressure from Congress to cut back on defense spending, the Reagan administration would do well to do as Safire suggests and reexamine our defense com- mitments. It is an issue worth raising at the summit.

The Dollar and the Trade Deficit

The U.S. trade deficit has created much concern both at home and abroad. Table 15 illustrates the upward trend of the U.S. current-account deficit, a broader measure of U.S. inter- national transactions that includes trade in commodities and services, investment income of U.S. firms' overseas operations, and other items

Table 15 U.S. Balance on Current Account ($ Billions)	
1984	-101.6
1983	-41.6
1982	-9.2
1981	6.3
1980	1.9
1979	-1.0

Source: Commerce Department

In reality, the trade deficit is no more a matter of con- cern than whether the state of New York runs a surplus or defi- cit in its trade with California. It is a relic of mercantil- ism.[38] As Adam Smith put it, "Nothing . . . can be more ab- surd than this whole doctrine of the balance of trade."[39] In fact, it is imports that are the true measure of prosperity, not exports. As Henry George observed a hundred years ago:

In a profitable international trade the value of im- ports will always exceed the value of the exports that pay for them, just as in a profitable trading voyage the return cargo must exceed in value the car- go carried out. This is possible to all the nations that are parties to commerce, for in a normal trade commodities are carried from places where they are relatively cheap to places where they are relatively dear, and their value is thus increased by the trans- portation, so that a cargo arrived at its destination has a higher value than on leaving the port of its exportation. But on the theory that a trade is profit- able only when exports exceeds imports the only way for all countries to trade profitably with one another would be to carry commodities from places they are relatively dear to places where they are relatively cheap.[40]

The problem is that those who think they are suffering losses of income or profits because of foreign competition use the trade deficit as an argument for imposing import restric- tions.[41] They often argue that foreign countries with large trade surpluses with the United States in effect subsidize their exports by "targeting" domestic industries and giving them gov- ernment aid.[42] A thorough investigation of this issue by the U.S. International Trade Commission, however, failed to find evidence that such targeting materially affects the U.S. cur- rent-account deficit.[43] Nor is there evidence that foreign competition is a principal cause of unemployment in the United States.[44] In any case, nothing would be gained by imposing such import restrictions as a 20 percent surcharge in the hopes of reducing the trade deficit. A recent Congressional Budget Office study points out the self-defeating nature of the pro- posed surcharge:

Since the surcharge would lower foreign real GNP, import-competing industries might be helped but ex- porters would be worse off: the dollar would be stronger while foreign real incomes would be lower, thus reducing overseas demand for U.S. exports; and the U.S. price level would be higher, as a result of the surcharge itself and because of higher domestic prices of close substitutes. Indeed, the strength of the foreign feedback effect on U.S. exports might by itself lower U.S. real GNP, unless a stimulative mone- tary policy was used to achieve the base-case assump- tion of no change in aggregate demand and real GNP.[45]

The protectionists are nothing, however, if not persist- ent. They constantly find new reasons to justify import quotas, tariffs, and other trade restrictions. Lately, much has been heard about the United States becoming a debtor nation, as foreign-owned assets in the United States exceed U.S.-owned assets abroad, and about foreign ownership of the U.S. govern- ment debt. TRB in the New Republic says that the U.S. budget deficit "is increasingly being financed by borrowing from abroad. This undermines the traditional solace about the na- tional debt that 'we owe it to ourselves.'" "We are therefore," Felix Rohatyn warns, "at the mercy of foreign investors who, should they lose confidence in the U.S. economy, could create a dollar crisis and higher interest rates in short order."[46]

Unfortunately for these doomsayers, the data simply do not support their argument. The fact is, foreign holdings of U.S. government debt have been falling, not rising, as Table 16 shows.

Table 16
Foreign Ownership of U.S. Government Securities

Year	Percent
1984	15.9
1983	16.3
1982	17.6
1981	19.7
1980	21.0
1979	22.0
1978	26.2

Source: Treasury Department

The reason U.S. assets abroad are not growing and foreign assets in the United States are is simple: profit-making opportunities are greater in the United States than elsewhere, and both U.S. and foreign investors are investing more here as a result. That, moreover, contributes a great deal to the cur- rent-account deficit. The fact is, capital is a commodity imported and exported just like anything else, and the flow depends on comparative advantage, the rate of return, and other factors that also affect the flow of goods and services. If country A has a higher saving rate than country B, and country B has a higher rate of return than country A, then country A will tend to export capital to country B. This will show up in international accounts as a current-account surplus for country A and a current-account deficit for country B. The International Monetary Fund recognizes that such a situation can exist and does not, therefore, indicate a balance of payments "problem" for country B. As a recent IMF study put it:

One important drawback of measuring external adjust- ment by considering only the current account is that it ignores the possibility of continuing intercountry differences in savings behavior and in real rates of return on investment. Such intercountry differences make is possible for a country with a relatively low domestic savings rate but with relatively attractive domestic investment opportunities to run a persistent current account deficit by drawing on foreign savings. Further, so long as the host country invests those savings wisely (i.e., obtains a rate of return in excess of the cost of borrowing), there is no reason why it cannot sustain a current account deficit for a prolonged period and, just as important, there is no presumption that such a continuing current account imbalance would be suboptimal from a global welfare viewpoint.[47]

Seeing the United States as country B and Japan as country A explains a great deal about the U.S. current-account deficit. Capital is merely flowing from where it is relatively more abun- dant and the return to it is relatively lower (Japan) to a country where it is relatively scarce and the return is rela- tively higher (the United States). It does not in any sense, therefore, represent any fundamental weakness on the part of the United States or a situation that is not sustainable. It is simply the law of comparative advantage at work.

One consequence of the increase in the attractiveness of U.S. dollar-denominated assets is a rise in the value of the dollar. As noted earlier, the dollar has risen sharply in value against most other major currencies. This followed many years during which the dollar fell sharply against these currencies after being set free to "float" in 1971. Such major changes in exchange rates make it difficult to conduct international trade, since the terms of trade, as mediated by a specific currency, may change radically.

It is difficult to measure exchange rate volatility, but it does appear that exchange rates are far more volatile today than they were under Bretton Woods.[48] According to the IMF, exchange rate variability in the major industrialized nations has increased about 2 or 3 times by any standard of measure- ment.[49] Although in theory any increase in uncertainty ought to be detrimental to trade, it is not clear from statistical studies that the increase in exchange rate variability has in fact hampered world trade.[50] This does not mean, however, that such a relationship does not exist. As the IMF put it:

The failure to establish a statistically significant link between exchange rate variability and trade does not, of course, prove that a causal link does not exist. It may well be that the measures of vari- ability used are inadequate measures of uncertainty; that other factors overwhelm the impact of variabil- ity in the estimating equations; or that the presence of statistical problems . . . interferes with the effectiveness of statistical tests. It may also be that the lags with which greater variability in the exchange rate regime affect trade flows are longer and more variable than imagined by previous investi- gators.[51]

Consequently, some critics charge that floating exchange rates cause unemployment.[52] Others confine their criticism to the steep rise in the value of the dollar.[53] Intervention is often suggested as a response, but it is not clear that this would be of any help absent a basic change in macroeconomic policy.[54] Also, there is little evidence that changes in exchange rates affect trade flows.[55] This casts great doubt on the belief that a forced reduction in the value of the dollar would do anything to improve the U.S. trade balance.[56]

The common thread running through much of the discussion, however, is the need for more stability. Greater stability could be achieved by some form of modified fixed exchange rates, as suggested by Professor Ronald McKinnon, or by some form of gold standard.[57] Recently, the French have proposed talks linking trade liberalization with monetary reform. The idea would be for major countries to more closely coordinate domestic monetary and fiscal policies so as to create a more stable macro- economic environment and thereby reduce exchange rate volatility. In practice, however, virtually all of the burden of adjustment would fall on the United States because the dollar is the re- serve currency and because the United States is by far the most dominant economy. Hence the idea has received a cool reception from the Reagan administration.[58]

Nevertheless, the issue is unlikely to die. The French will undoubtedly press it at the summit and, in any case, the continuing problems resulting from fluctuating exchange rates will impel policymakers to find some way of stabilizing them. As Federal Reserve Chairman Paul Volcker recently said, "cer- tainly the exchange rate today is too important an economic variable to ignore in our policy-making."[59]

Foreign Aid and Development Issues

The problem of economic development in the Third World is likely to arise at the economic summit for two reasons. First, the debt problem has not gone away, and second, the industrial- ized nations are increasingly dependent upon exports to and imports (raw materials) from the developing countries. More- over, if Third World countries are to be able to raise the foreign exchange necessary to service their debts (which are owed largely to the industrialized nations) without the danger of default, they must be able to export to the industrialized nations. It is therefore in the interest of all industrialized nations to do what they can to promote development in the Third World. Sound development there will assist in retaining good markets for Western products and reliable sources of essential raw materials, and will prevent the recurrence of a debt crisis.

Unfortunately, developed countries have not done all they can to help developing countries and have, in may cases, encour- aged them to adopt unwise economic policies. If they really want to help these countries--and themselves in the long run-- the industrialized nations must have a clearer idea of what policies are necessary and appropriate for development in the Third World.

The classic error of the industrialized countries is that of using foreign aid as the principal engine of development. In fact, foreign aid has stifled sound development in the Third World. First, because foreign aid is typically a government-to- government transfer, it encourages expansion of the public sec- tor. As Milton Friedman puts it: "Foreign aid, far from con- tributing to rapid economic development along democratic lines, is likely to retard improvement in the well-being of the masses, to strengthen the government sector at the expense of the pri- vate sector, and to undermine democracy and freedom."[60]

Second, foreign aid tends to encourage the development of large industrial projects at the expense of local agriculture. The Third World is filled with steel plants and other indus- trial "white elephants" that can never hope to compete econom- ically, while at the same time the ability of the Third World to feed itself diminishes. The result is that scarce foreign exchange is wasted importing food, and scarce domestic resources are squandered to keep the uneconomic projects going. Ironi- cally, these countries often end up, in effect, having to subsi- dize their industrial exports in order to raise foreign exchange, thus becoming direct competitors of the industrialized coun- tries.[61]

Such problems have led industrialized nations to rely in- creasingly on multilateral development banks, like the World Bank, to encourage development. However, these organizations merely perpetuate the same mistakes that result from bilateral aid.[62] Indeed, in some cases their advice makes things far worse. Thus the International Monetary Fund often requires developing countries to raise taxes, restrict imports, and de- value their currency as a condition of aid.[63] Such actions frequently exacerbate the problem of development and create political instability.

A better strategy for encouraging development would be a renewed commitment by developing countries toward their private sectors, the substitution of private investment for government aid, a reduction of government interference with the market in developing countries, and a more liberal attitude on the part of industrialized countries toward trade with developing countries.

Experience indicates that the private sector, contrary to the views of most development "specialists," is a far more effi- cient engine of development in the Third World than government. Although there has been relatively little attention paid to the private sector's role in development, it appears that the suc- cess of certain countries such as South Korea in utilizing the private sector has encouraged the World Bank and some Third World countries to look at this option more closely.[64]

Cutbacks in aid and Third World debt problems have also caused some developing countries to take a more liberal atti- tude toward international investment. In the past, many countries discouraged foreign investment by imposing unreason- able restrictions on it, for example, restricting foreigners to minority ownership of domestic enterprises and restricting the repatriation of profits. Now, however, there seems to be more of an understanding that multinational enterprises can be major forces for development if the climate for investment is im- proved.[65]

Government interference with the market is another area that seems to be receiving new attention. Traditionally, it has been thought that planning was necessary for development and that Third World countries should rely on government rather than markets to allocate resources. I. M. D. Little refers to this as the "structuralist" school of development.[66] Common forms of price distortions include managed exchange rates, price controls (especially on agricultural products), import restrictions, credit controls, government subsidies to export industries and, of course, inflation. In recent years, how- ever, there has been new appreciation for the role of markets and unhampered prices in the allocation of resources and hence in development. A recent World Bank report is encouraging in this regard:

The analysis of the experience in the 1970s . confirms the view that price distortions hurt growth, particularly when they assume high proportions. Coun- tries with low distortions are found to have rela- tively high growth. There is no evidence that price distortions hurt equity. In fact, they may hurt equity in addition to creating serious administrative problems and corruption.[67]

Lastly, industrialized nations must recognize that Third World nations depend on trade with them to raise foreign ex- change. Moreover, industrialized nations are the natural mar- ket for the kinds of products Third World nations produce, given their resources and comparative advantage. Industrial- ized nations, therefore, must be especially careful not to im- pose any trade restrictions that would hamper the ability of developing nations to export to them. Although such a hands-off policy often creates domestic political problems, with Western workers facing competition from the Third World, it is ulti- mately in the West's own best interest. For unless the Third World can trade freely with the industrialized nations, in- creased aid to the Third World will ultimately be required, we will run the risk of default on Third World loans, and we will create political problems that could well lead Third World coun- tries toward the Soviet bloc. Third World countries, on the other hand, should also understand that trade is a two-way street and that they do nothing to help themselves by imposing restrictions on imports from industrialized nations. The fact is, free trade ultimately benefits everyone.[68]

It is in the interest of both industrialized and developing nations to foster as great a degree of economic freedom as pos- sible. All nations would benefit from faster growth and relief from the debt problems that have plagued us for the last several years. The United States has taken a lead in this regard with its participation in the Generalized System of Preferences and the Caribbean Basin Initiative. More needs to be done, espe- cially in concert with the other industrialized countries. It is a topic that should be discussed at the summit.

Conclusion

The virtues of free-market policies are coming to be recog- nized by intellectuals and even policymakers throughout the industrialized world. The success of more market-oriented poli- cies in the United States and in the rapidly growing countries of Asia is becoming clear. From privatization in England to Francois Mitterrand's second-stage reforms in France to the "supply-side communism" of the Italian Communist party, there is a growing disillusionment with statist and socialist solu- tions. Now is the time for President Reagan to make a forceful case for free trade and free markets at the summit.

The preceding is obviously a rich agenda for a summit that will last only a few days, and it is certainly not expected that many of these issues can be resolved in such a short time. What the leaders of the major industrialized countries can do, however, is make a commitment to work on the problems discussed, organize staff and ministerial meetings on them, and work to- gether so that progress can be made in future bilateral and multilateral meetings. What is most important is to recognize where we should be going and get started in that direction.

FOOTNOTES

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[63] For criticism, see Louka T. Katseli, "Devaluation: A Criti- cal Appraisal of the IMF's Policy Prescriptions," American Eco- nomic Review 73 (May 1983): 359-63.

[64] See, for example, Economic Development and the Private Sector (Washington: World Bank, 1981); Yung Whee Rhee, Bruce Ross-Larson, and Gary Pursell, Korea's Competitive Edge (Balti- more: Johns Hopkins University Press, 1984).

[65] Ann McKinstry Micou, "The Invisible Hand at Work in Devel- oping Countries," Across the Board (March 1985): 8-17; see also Richard E. Caves, Multinational Enterprise and Economic Analy- sis (New York: Cambridge University Press, 1982); Robert D. Tollison and Thomas D. Willett, "Foreign Investment and the Multinational Corporation," in Tariffs, Quotas & Trade: The Politics of Protectionism (San Francisco: Institute for Contem- porary Studies, 1979), pp. 109-21.

[66] I. M. D. Little, Economic Development: Theory 2 Policy, and International Relations (New York: Basic Books, 1982), pp. 19-21, 29-59.

[67] Ramgopal Agarwala, Price Distortions and Growth in Develop- ing Countries, World Bank Staff Working Paper no. 575 (Washing- ton, 1983), p. 46; see also World Development Report 1983 (New York: Oxford University Press, 1983), pp. 57-63.

[68] See Clyde Farnsworth, "Third World Trade vs. Debt," New York Times, April 26, 1984, pp. D1, D3; Gottfried Haberler, "Protectionism or Freer Trade in the Less Developed Countries," Il Politico 34 (September 1969): 407-15; Martin Bronfenbrenner, "An Old Reactionary Free Trader on the New International Eco- nomic Order," Nebraska Journal of Economics and Business 16 (Autumn 1977): 5-18.