CONDITIONS FOR PARTNERSHIP IN INTERNATIONAL ECONOMIC MANAGEMENT

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A REPORT TO THE TRILATERAL COMMISSION: 32
This report was prepared for the Trilateral Commission and is released under its auspices. It was discussed at the Trilateral Commission meeting in Madrid on May 17-19, 1986. The authors, who are experts from Western Europe, North America and Japan, have been free to present their own views; and the opinions expressed are put forth in a personal capacity and do not purport to represent those of the Commission or of any organization with which the authors are associated. The Commission is making this report available for wider distribution as a contribution to informed discussion and handling of the issues treated.
CONDITIONS FOR PARTNERSHIP
IN INTERNATIONAL ECONOMIC MANAGEMENT

A Task Force Report to
The Trilateral Commission

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The Trilateral Commission was formed in 1973 by private citizens of Western Europe, Japan, and North America to foster closer cooperation among these three regions on common problems. It seeks to improve public understanding of such problems, to support proposals for handling them jointly, and to nurture habits and practices of working together among these regions.

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R. William Lawson (Special Consultant) was Senior Deputy Governor of the Bank of Canada—the second-ranking position—in 1973-84. He was Deputy Governor in charge of international affairs in 1964-73. Mr. Lawson’s distinguished career in Canada’s central bank began in 1950, when he joined the Research Department, of which he was Chief in 1956-62. He was Executive Assistant to the Governor in 1962-64. Educated at the University of Manitoba and Oxford University (Rhodes Scholar), Mr. Lawson began his public service career in the Canadian Army (1942-45), the Foreign Exchange Control Board (1940-42, 1947-50) and the Royal Commission on Coal (1945-47). He was named an Officer of the Order of Canada in 1984.
The Trilateral Process

The introductory and concluding chapters of the report which follows are the joint responsibility of the three authors. Each author is individually responsible for one of the interior chapters—C. Fred Bergsten for the essay on the United States, Isamu Miyazaki for the essay on Japan, and Etienne Davignon for the essay on Western Europe. R. William Lawson is responsible for the closing essay on Canada.

The first meetings among the authors took place in November 1985. Etienne Davignon met with C. Fred Bergsten in Brussels on November 9 and with Isamu Miyazaki in Tokyo on November 12, to discuss the general themes of the report. The three authors met together in Washington on February 25, 1986, a meeting in which R. William Lawson also participated. The beginnings of several individual chapters were on the table for the February meeting. Drafts of the chapters were completed in the course of March and April and circulated for comments. A draft of the overall report was discussed at the plenary meeting of the Trilateral Commission in Madrid on May 17-19, 1986. The final draft for publication was completed at the beginning of June.

Although only the authors and special consultant are responsible for the analysis and conclusions in particular chapters, they have been aided by a number of others in the course of their work. On the European side, Etienne Davignon is particularly indebted to his associate for this project, Catherine Gernay of Société Générale de Belgique. Viscount Davignon discussed his ideas for the project with European members of the Trilateral Commission at their regional meeting in Paris on October 25-27, 1985. He drew on the advice of several others in the course of the drafting. A small consultative group composed of government officials and academics met with Isamu Miyazaki in Tokyo in July 1985 to discuss the general themes of the project, and these individuals stayed in touch with the project as it evolved. Mr. Miyazaki also discussed a draft of the chapter on Japan with Japanese members of the Trilateral Commission at their regional meeting on March 11, 1986. C. Fred Bergsten circulated the first draft of his United States chapter to a number of others for comments in April 1986. R. William Lawson also received informal comments on the first draft of his essay on Canada.
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I. INTRODUCTION

A primary purpose of the trilateral partnership is to provide constructive leadership for the world economy. For the first 20-25 years after World War II, the broad trend was upward in this regard. Cooperation and how to improve it between allies was a political priority, not only on the international scene, but on the domestic one also. Immediate policy tried to implement a larger strategy or at least tie in with the high priority given to cooperation, which can be defined as a collective attempt to tackle problems of concern to partners.

The years which followed were less happy ones. To be sure, the deterioration of international economic order in the 1970s was not nearly as profound as the collapse of the 1930s. Skillful crisis management and a healthy pragmatism helped prevent the worst. But pragmatism and crisis management are not enough over time. We need a leap forward in the extent of cooperation.

The foundations for such a leap forward have strengthened considerably. Price stability has improved greatly in the trilateral countries in recent years. General philosophical orientations have converged, with more emphasis on market orientation in economic policies. Some growth is underway in all three regions. The remarkable Group of Five meeting at the Plaza Hotel in September 1985 indicated that the outlines of appropriate economic strategy are widely recognized, and led to changes in exchange rates that helped restore a degree of confidence in the ability of governments, acting together, to influence events. The American role in the G-5 meeting and the “Baker initiative” on Third World debt announced a few weeks later indicated that the United States—the largest economy among the trilateral countries—is interested again in multilateral approaches.

We must not overestimate what the G-5 meeting and other recent events have accomplished, however. What was essentially crisis management must be turned into systematic cooperation on a continuing basis. Improved international arrangements are particularly critical in three areas, to which we will return in our conclusion: macroeconomic policy and exchange rates, trade, and Third World debt.
Improved international arrangements must rest upon—and themselves serve to reinforce—improved performance on the part of each partner. The heart of this report is in the following essays that examine a central challenge for each partner. C. Fred Bergsten analyzes the wide swings in American participation in management of the world economy. Isamu Miyazaki shows how the correction of Japan's external imbalance requires correction of domestic imbalances. Etienne Davignon examines the dilemmas of a European Community which is more dependent than others on an effective multilateral system running smoothly—within the Community and globally—but has great difficulty focusing its energies as an initiator and driving force for concerted action. In his essay at the end of the report, R. William Lawson analyzes the relatively passive approach of Canada to international economic management, in contrast to its leadership role in the early postwar years.
II. America’s Unilateralism

C. Fred Bergsten

American participation in management of the world economy during the last twenty-five years has been characterized by wide, sometimes sudden swings among three prototypes: passive unilateralism ("benign" or "malign neglect"), active unilateralism and pluralistic cooperation. For example:

• In August 1971, the Nixon Administration reversed course from "benign neglect" of American trade deterioration to Secretary Connally's aggressive pursuit of dollar devaluation and other foreign concessions (via an import surcharge and unilateral suspension of gold convertibility).

• In November 1978, the Carter Administration launched a cooperative international effort to support the dollar to supersede its earlier efforts to persuade other major countries to spur faster economic growth; that earlier "locomotive" strategy, culminating in the Bonn Summit agreements of June 1978, was viewed in some quarters as both a degree of unilateral assertiveness toward others and "malign" neglect of America's own responsibilities toward the dollar.

• In September 1985, the Reagan Administration abandoned its studied neglect of the huge U.S. trade deficit; instead it launched a coordinated G-5 strategy for adjusting the dollar and a new assault on alleged foreign trade barriers.

These shifts in U.S. foreign economic policy have been much more pronounced regarding its monetary and macroeconomic components than its trade components. On trade, the United States has been fairly consistent in seeking to lead the way toward steady reduction of barriers and writing of new rules—though, to be sure, with its own periodic protectionist deviations, and with occasional "get tough" episodes designed largely to limit the extent of Congressional pressures for such deviations. These deviations in U.S. trade policy have occurred especially, as in 1969-72 and 1981-84, when the dollar became substantially overvalued and the trade balance deteriorated
sharply—explaining, as we shall see shortly, at least part of the sharp swings in American international macro/monetary policy.

The foldout chart bound into this report after page 8 attempts to roughly depict the evolution of American policy in the macro/monetary and trade areas since 1960, across a spectrum based on the degree of cooperation pursued with other countries compared with the degree of (active or passive) unilateralism employed. The chart largely abstracts from the substance of the issues, and the merits of the positions taken. Its middle line—"pluralistic cooperation"—is the chosen optimum for these purposes, with active and passive unilateralism as the extremes (with opposite signs). It should also be noted that the "macro/monetary" and "trade" lines cover different types of issues; their absolute levels may therefore not be strictly comparable, though their trends should be. The trend lines are not intended to be terribly precise; they connect the milestones noted without attempting to catch every nuance of the intervening periods.


Three central questions arise from this quick inspection of U.S. international economic policy developments over the past generation. First, why does the United States exhibit such sharp differences over time in the nature of its participation in international economic management? Second, why do its shifts often occur in such volatile (and unpredictable?) ways? Third, what is the underlying trend of U.S. participation, if any, which can serve as a guide to understanding and predicting the likely posture of the United States in the future?

The United States, like most countries, prefers quite naturally to pursue its domestic economic objectives as autonomously as possible. Unlike most countries, however, the United States has the ability to do so for prolonged periods of time. Because of its size, and particularly because of the international financial role of the dollar, the United States is able to export a portion of its domestic problems—either unemployment or inflation—to the rest of the world for an extended duration.

However, even the United States cannot export its problems indefinitely. Global interdependence has reached the point where the chickens inevitably come home to roost, albeit with a substantially longer time lag for the United States than for (all?) other countries. Unemployment or price pressures begin to emerge through the external accounts. When this occurs, the United States is forced to abandon "benign neglect."
America's Unilateralism

Given a universal tendency to resist policy change as long as possible, and since the United States can do so for much longer than most other countries, the domestic problems caused by the international repercussions of such neglect may become very severe. This can trigger a shift toward aggressive pursuit of policies aimed at resolving the “new” problems as promptly as possible, particularly taking into account general American impatience and policy volatility. The precise nature and degree of assertiveness will reflect both the proclivities of the Administration in power and the objective possibilities of the international situation, whose combination may produce either aggressively unilateral strategies (as in 1971) or largely cooperative strategies (as in 1978 and 1985).

There are also periods, such as 1977 and 1981, when U.S. Administrations sincerely believe that their chosen domestic economic policies will promote global welfare: “what’s good for the United States is good for the world.” (These periods often coincide with similarly zealous foreign policy initiatives, adding to the appeal of pursuing “domesticist” foreign economic policies.) In some cases, these views may be objectively correct; American policies promoted international price stability in the early 1960s and the trend toward deregulation in the early 1980s. On other occasions, they may prove incorrect to an important extent, as with the initiatives for coordinated global expansion in 1977 and massive tax cuts in 1981.

But if the rest of the world disagrees with America’s policies and priorities, or if those policies and priorities are simply incompatible with lasting international equilibrium, they will prove unsustainable. Whatever strategy is initially chosen by the United States, and however sincere the belief that American unilateralism will serve global interests, resolution of the resulting crisis always requires cooperative international action. Such an outcome occurred in 1971-73, 1978-79 and 1985-?.

After this occurs, at least some of the newly formed habits of cooperation seem to persist for the remainder of the Administration in question. To be sure, this is partly because the definition of “international cooperation” has by then been modified to an important extent in the direction of pursuing the goals which the United States originally sought via more unilateral methods. Few would advocate international agreement for the sake of agreement, without reference to the substance of an issue. But a single country seldom possesses a

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1This view is articulated in Henry Nau, “Where Reaganomics Works,” Foreign Policy 57 (Winter 1984-85).
monopoly of wisdom, and would seldom be able to sustain a lone position even if it did so. In fact, the record shows no cases of reversion to either passive neglect or aggressive unilateralism after the inevitable cooperative mode has been reached.\(^2\)

Unfortunately, however, new Administrations seem to start the process over again.\(^3\) They tend to lurch to one of the extremes before the impact of their own strategy rebounds and forces them too to change. The main conclusion of this essay will be the need for Americans to understand the inevitable progression of events revealed by this recent history, and to adopt internationally compatible policies on a sustained and consistent basis in order to avoid repeating yet again the dreary cycle.

**Applying the Explanation**

Each of the three major episodes cited at the outset reveals the pattern described in the preceding paragraphs. In both the late 1960s and the early 1980s, growing budget deficits generated substantial pressure on the American economy for increased inflation and higher interest rates ("crowding out"). Domestic corrective action could be avoided largely because much of that pressure was exported, via growing overvaluation of the dollar (vis-à-vis the underlying trade competitiveness of the United States) and the attendant capital inflows.

This dollar overvaluation showed up overtly under flexible exchange rates in 1981-85, covertly under fixed exchange rates in 1968-72.\(^4\) In the 1968-72 case, the main manifestation of the external imbalance was a huge buildup of foreign official dollar balances as central banks intervened to keep the dollar within its Bretton Woods limits. There was also a massive influx of (mainly private) capital during the early 1980s, which was of course the proximate cause of the sharp rise of the dollar. Thus the United States was able to sustain its domestic policy preferences—the Great Society and Vietnam War in the first episode,

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2It should be noted that the Reagan Administration was forced by the Mexican crisis of August 1982 to abandon its "benign neglect" of the Third World debt problem, and of the IMF. It subsequently maintained a basically cooperative mode on those issues, as suggested by the thesis in the text, but this cooperation did not spill over into the macro/monetary field until a crisis loomed in that area in 1985.

3Unlike other trilateral countries, the United States changes virtually all of its policymaking machinery with each shift of administration. All top positions through the Assistant Secretary level, and sometimes even below, change hands. The shortage of institutional memory, and desire to try new approaches, is thus deep-seated (and likely to continue). It provides a partial explanation for the shift in American policy from Administration to Administration.

4The two other big differences in the two episodes were (1) monetary policy, which largely accommodated the budget deficits in the early 1970s and thus permitted rapid inflation but did not do so in 1981-85, and (2) government intervention, with the introduction of wage-price controls in 1971 contrasting with the deregulation of the early 1980s.
the Reagan defense buildup and tax cuts in the second—in large part because the rest of the world was willing to finance those preferences.5

In both cases, however, the growing overvaluation of the dollar produced—with a lag of several years—a massive deterioration of the international accounts of the United States. In 1971, the U.S. trade balance recorded an external deficit for the first time in this century. In 1985, the trade deficit hit $150 billion. Both were viewed as producing huge costs for the U.S. economy, particularly in terms of job losses and the structure of U.S. production. (Another result was a dramatic increase in pressure for trade protection, to which I return below.)

The Nixon and Reagan Administrations thus decided, after several years of virtually total neglect of the international competitive position of the United States, that major steps were urgently needed to improve that position. In 1971, Nixon and Connally concluded that international cooperation would be inadequate to achieve the needed currency realignment and related steps, and thus adopted an extremely aggressive negotiating stance at the outset. A more cooperative scenario emerged around the Smithsonian Agreement which resolved that crisis, however, and for the second devaluation in 1973. An even more cooperative approach has prevailed, at least so far, under the Baker initiative to correct the dollar’s overvaluation in 1985-86.

The 1977-79 episode was more complicated. The incoming Carter Administration inherited a modestly overvalued dollar and also faced a substantial trade deterioration which produced then-record merchandise deficits above $30 billion in both 1977 and 1978. It also worried about a seeming slowdown in the world economy, including the political ramifications thereof in Europe (especially the contemporary fear of “Eurocommunism”) and the developing countries (whose debt burden was already a matter of concern).

Carter responded primarily by pushing Japan and Germany to stimulate their economies (the “locomotive” thesis) and/or appreciate their currencies. Just as that effort began to succeed in mid-1978, however, the needed decline of the dollar accelerated and—prompted by an acceleration of U.S. inflation and growing lack of overall confidence in Administration policies—turned into a “free fall” which overshot on the downside. The authorities thus were forced to work out a cooperative defense of the dollar and adopt more restrictive domestic policies, particularly monetary policy after October 1979, as urged by other countries.

5This willingness was much more of a market phenomenon in the recent period, contrasting with the private sell-off of dollars in the latter part of the earlier episode (1970-71).
In each of these three major episodes, an American Administration shifted from an initial international macro/monetary stance with a substantially unilateralist character (passive or active) to a much greater degree of international cooperation.\(^6\) After going through such a metamorphosis, each Administration then largely retained the cooperative mode which had evolved:

- The Nixon Administration spent two years trying to negotiate a new monetary system (in the Committee of Twenty), while its successor Ford Administration led a cooperative macro/monetary response to the first oil shock and worked out the IMF Amendments which ratified floating rates.
- The Carter Administration maintained joint intervention policies for the remainder of its tenure, and negotiated seriously on the creation of a Substitution Account to reduce the role of the dollar.
- The Reagan Administration is now talking about reform of the monetary system and more serious macroeconomic policy coordination, though it is too early to tell whether the cooperative pattern will persist to a substantial extent.

In retrospect, it is clearly unfortunate that each Administration either failed to learn the lessons of its predecessors or consciously chose to ignore those lessons. Each thus had to proceed through a similar, quite disruptive and costly, shift from one policy extreme to the other.

One other key element helps explain these gyrations of U.S. foreign economic policy. As noted above, one consistent theme of that policy has been the effort to avoid protectionism by maintaining steady momentum toward trade liberalization and development of rule-making authority for the GATT (the "bicycle theory"\(^7\)). This effort has been jeopardized severely, however, by domestic political opposition on the three occasions when the dollar has become substantially overvalued and thus savaged U.S. trade competitiveness—leading to the Mills bill,

\(^6\)The experience of the Johnson Administration was somewhat similar to those of the two Republican Administrations, though much less extreme. Continuing the basic strategy of the Kennedy Administration, it first tried to mollify foreign concerns over the U.S. external deficit through leaky capital controls, applied half-heartedly. But it then moved to at least a modest version of "benign neglect" as the budget deficit increased with the intensification of the Vietnam War and Great Society spending. (French gold purchases were the major manifestation of foreign displeasure with this policy, though most of them occurred before the U.S. budget deficit grew very large.) Market pressures intensified after sterling was devalued in late 1967, and Johnson countered with a swing to mildly aggressive unilateralism by forcing the two-tiered gold system on the rest of the world in March 1968. Passage of the income tax surcharge shortly thereafter represented a return toward cooperation, however, which persisted for the remainder of the Administration.

\(^7\)The history of trade policy suggests that, like a bicycle, it either moves steadily forward (toward further liberalization) or falls over (in the face of protectionist pressures from individual sectors). There are few periods in which trade policy seems to stand still.
US INTERNATIONAL ECONOMIC COOPERATION: 1960–85

--- Monetary/macroeconomic issues
--- Trade issues

**Active unilateralism**

- Swap agreements, Rossa bonds, G-10 created
- Carnets and global textile LTA
- End of Kennedy Round
- Johnson "benign neglect"; Gattist gold purchases
- "Two-tier gold agreement"
- Nixon "benign neglect"
- "Comprehensive" Japanese import surcharge
- "Locomotive theory, "taking down dollar"

**Pluralistic cooperation**

- Dillon Round
- Trade Expansion Act
- "End of Kennedy Round"
- "1st steel VRA"
- Smithson Agreement
- Trade Act of 1974
- "Second dollar devaluation, adoption of floating exchange rates"
- Jamaica Agreement
- Strauss-Ushiba Agreement
- GATT Ministerial
- Plaza Agreement
- "Benign neglect"

**Passive unilateralism ("benign neglect")**

- President initiates Sec. 301 cases
- Dollar support program
- Auto VRA
- "Benign neglect"

Burke-Hartke proposals, steel quotas and broadening of textile quotas in 1969-72; quotas on several individual products in 1976-77; and the escalation of quotas (autos, steel, textiles again, machine tools, several smaller products) and import surcharge and other protectionist legislative proposals in the mid-1980s.

The desire to avoid further protectionist backsliding in the United States—and indeed to enable the United States to resume its traditional role of leading the world toward more open trading arrangements—thus became another reason for the reversal of U.S. macro/monetary policy in each of the three instances. It became clear that adjustment of the dollar and trade deficit was a necessary (if not sufficient) condition for maintaining an open trade policy, and this realization added importantly to the impetus for abrupt U.S. policy change, especially in 1971 and 1985, but also in 1977 when the trade deficit was rising to new heights (rather than in 1978 when the problem was an excessively declining dollar and the Tokyo Round was already in full swing).

In addition, changes in personalities (Shultz for Connally in 1973, Baker-Darman for Regan-Sprinkel in 1985) can significantly alter both the substance and style of policy in individual instances. And style is important, appearing to correlate with party differences to a large extent: the Carter and Kennedy-Johnson teams behaved in much more internationalist fashion, even when seeking to evade domestic policy changes called for by other countries to more effectively defend the dollar, than the early Nixon and Reagan teams.

The Underlying Causes

Underlying the pattern of policy fluctuations described above, and important in predicting their future course, are three structural features of the evolving international economy. First is the increasing impact of external events on the economic health of the United States, both structurally and at the margin:

- The share of exports in American GNP rose over 250 percent from 1950 to 1980 (before falling back due to dollar overvaluation).
- Over 40 percent of U.S. farm acreage produced for export in the early 1980s, and about one quarter of all manufactured goods were sold abroad.
- The oil shocks of the 1970s had a dramatic impact on the whole American economy, as has the "reverse shock" of 1986.
- The improvement in its trade balance accounted for three quarters of total U.S. economic growth during 1978-80.
• The subsequent deterioration in that trade balance was responsible for more than half the recession in 1981-82 and cut domestic growth in half during the second half of 1984 and all of 1985.

• The huge inflow of foreign capital permitted the boom of 1983-early 1984 without renewed inflation or crowding out; the secret of supply-side economics turned out to be that the rest of the world was willing to supply the needed finance for America’s twin (budget and trade) deficits.

In essence, real economic sovereignty now falls far short of nominal economic sovereignty even for the United States—though “autonomy illusion” (to use a phrase coined by Robert Keohane) remains prevalent even in informed American circles. The events of the past fifteen years reveal that it is sheer folly for American policymakers to permit huge problems to emerge by ignoring the rest of the world (as with the trade deficits and protectionist frenzies in 1970-71 and 1985-86) or by trying to reshape it in their own image (as with the dollar’s collapse in 1978).

A second structural feature is the declining ability of the United States to force its will on the rest of the world. To be sure, as noted above, the United States retains substantial power via its impact on world markets, especially financial markets. This power is enhanced when other key countries are in a weakened position, as Europe with its widely perceived “Eurosclerosis” in the early 1980s. But the net result is, at most, a modest lengthening of the period during which the United States can export its internal problems—not a return to economic hegemony.

In essence, the United States thus faces something of a scissors movement. On the one hand, its dependence on the world economy is rising. On the other hand, its power to dictate global economic outcomes has declined. The obvious implication is the need, from a purely national American standpoint, for more effective international economic arrangements. (The same need arises from a global systemic standpoint, because of the decline of the “hegemonic power” and thus a requirement for pluralistic management to replace it.)

The third structural feature is the efficacy of these international economic arrangements. The GATT, despite its well-known shortcomings, continues to function reasonably well to channel and limit the extent of

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8As already noted in several of my writings in the mid-1970s, some of which are included in Managing International Economic Interdependence: Selected Papers of C. Fred Bergsten, 1975-1976 (Washington: D.C. Heath and Co., 1977), e.g., p. 38.

trade disputes. The World Bank and, to a greatly increased extent, the International Monetary Fund are reasonably effective in dealing with key Third World problems (including debt).

The greatest gap, paradoxically, comes in the area where international cooperation is needed most and where the sharp gyrations in American attitudes have been most pronounced: macroeconomic and monetary policy. There are now simply no international rules, or even norms or presumptions, which significantly affect the conduct of national policies in these overarching areas (with the very important exception, for the continental members of the European Community, of the exchange rate arrangements of the European Monetary System).

The IMF largely abdicated any such responsibility after the move to floating exchange rates; its "multilateral surveillance" has had no visible impact. The effectiveness of the OECD has dropped substantially. Meaningful macro/monetary cooperation is thus left completely to ad hoc efforts. Some of these efforts—the Bonn Summit in June 1978, the U.S.-German stabilization of the dollar in November 1978 and the Plaza Agreement of the Group of Five in September 1985—have been commendable and highly successful. But the world is left with neither functioning rules nor effective institutions on the core issues of global economic management.

The United States is thus encouraged to adopt unilateral initiatives to pursue its foreign economic policy goals. (Other countries, like France in 1981, are also so encouraged but cannot succeed for as long so are less inclined to try.) Creation of effective international arrangements, perhaps along the lines of target zones for currency relationships or macroeconomic collaboration based on "objective indicators" (including exchange rates), is thus essential to promote more stable and consistent policies in the United States. The experience of the EMS, particularly regarding France in 1982-83, supports this judgment.

To be sure, such arrangements need to be much more flexible and symmetrical than most efforts in the past—such as the Bretton Woods regime. But they also need to be firm enough to prod all countries, including the United States, to seriously consider the international ramifications of their actions on both themselves and the rest of the world.

Beyond these structural considerations, the usual cyclical elements affect U.S. behavior toward the international economy to some extent. When growth is high and unemployment low, dollar overvaluation may be viewed as less serious. It must be noted, however, that the Baker policy reversal came at a time (September 1985) when underlying
U.S. economic conditions were reasonably satisfactory. The external repercussions can come to dominate at any time.

The domestic political cycle is another variable, at least with respect to timing. The salience of job exports rises as elections approach, and Nixon’s re-election needs for 1972 were clearly at the root of his August 1971 decisions. The generalized loss of confidence implied by the dollar’s sharp fall in late 1978 galvanized the Carter Administration to move to its defense. The export of inflation via dollar appreciation provided important support for the Reagan re-election campaign in 1984, particularly as the overall economy was booming even with the decline in the trade balance; this benefit from a rising dollar deterred any thoughts of seeking its reversal (or even a slowdown in its rise).

Another cyclical, or even random, factor is the extent of cooperation from other countries. Foreigners’ willingness to build their dollar holdings enormously, as noted above, obviated pressure on the United States for much earlier action in both the late 1960s and early 1980s—though whether this delay was healthy, and whether the delay might even have enhanced the prospect that the inevitable American action was more likely to have a greater unilateral character, because so delayed and thus larger in magnitude, is debatable.

On the other hand, other major countries have often been reluctant to change their fundamental economic policies in ways that would permit a truly cooperative American adjustment. In all three cases cited, Germany and Japan (in particular) were reluctant—to accept adequate revaluations in 1971, to locomote in 1977-78 (until it was too late) and maybe, though it is still too early to tell, to do either in 1985-86. In short, these countries (and their private citizens) have been much more willing to finance American deficits than cooperate in adjusting them. Their unwillingness has added to the propensity for the United States to act unilaterally (although it must be added that, except for 1977-78, the United States did not itself press very hard for joint action before moving on its own).

Finally, U.S. international economic policy is governed to some extent by security concerns. Connally was pulled back from his aggressive unilateralism in late 1971 by Kissinger’s (and, ultimately, Nixon’s) fears of severe disruption of the alliances. There may currently be some pressure from the U.S. foreign policy community to ease the upward pressure on the yen and DM because of the internal political effects of those corrections on key allies (with elections coming). Security relationships will tilt economic initiatives toward the cooperative mode, ceteris paribus, but all else is seldom equal and this tends to happen in practice only in extremis.
The Outlook for the Future
There are sufficiently cross-cutting elements in this analysis to preclude any clear predictions of future U.S. attitudes toward global economic management. The "reversal syndrome" of the past twenty years could well continue, with successive Administrations attaching heavier weight to the short-run benefits of neglect than to its costs over the long run—until they too are inevitably forced to cope with the adverse consequences of that neglect. Failure of other countries to cooperate toward needed American adjustment, in a timely and adequate way, could prompt occasional outbursts of unilateral assertion.

To maximize the prospect for dampening America's inherent proclivities toward periodic unilateralism, and heighten the likelihood of more consistent pursuit of internationally cooperative approaches, three sets of steps seem most essential.

First, Americans must be brought to understand the ultimate costs of unilateralist policies for America itself. For example, the Congress and business community are only now beginning to realize that our own budget deficit and high interest rates—rather than trade barriers abroad and other "unfair" foreign practices—are the primary cause of our huge trade deficit. They are also only now beginning to learn the true costs of protectionism, and how their own actions (in pursuit of "reciprocity," for example) could unleash such a movement.

Likewise, all key domestic groups must be brought to recognize the "scissors movement" traced above: that the American economy is heavily dependent on its interaction with the rest of the world, including the repercussions triggered by its own policies, and that the United States alone cannot dictate remedies to such difficulties. There is understandable, if doomed, resistance to accepting these realities in many quarters in the United States. But consistent and constructive policies will probably emerge only when they are much more widely understood.

Second, more effective international regimes need to be erected to foster macroeconomic and monetary policy cooperation. National decisions on these (like all other) issues are usually closely contested among different schools of thought, some of which will seek to take the international dimensions of the decision more fully into account. A relevant international regime, particularly if its goals are widely agreed and its institutional arrangements are seen as effective, can often tilt the outcome toward more internationally compatible (and hence sustainable) outcomes.10

10This theme was developed in an earlier report to the Trilateral Commission, The Reform of International Institutions, authored in 1976 by C. Fred Bergsten, Georges Berthoin and Kinhide Mushakoji.
The GATT system, for all its shortcomings, is a cardinal case in point. Trade policy decisions always pit proponents of protection against proponents of open markets. The latter are strengthened enormously by their ability to point out that new restraints would violate the country’s international obligations and/or require compensation or threaten retaliation, either of which would penalize innocent bystanders and generate political costs which would have to be traded off against the perceived political benefits of granting the protection. American presidents have frequently been persuaded to eschew protection by the existence of the GATT regime.

As noted above, no such regime exists on macro/monetary policy. To be sure, it is probably more difficult structurally to create and sustain regimes in this area, with its pervasive impact and less obvious international aspects (at least in the United States), than regarding trade. But the result of this vacuum is that there is no ongoing pressure to factor international considerations into national decisions, or even to consider the international repercussions of domestic actions. Creation and maintenance of such a regime is a second key requirement for promoting less American unilateralism.

Third, other countries must demonstrate a willingness to cooperate meaningfully with the United States (as vice versa) to add to the prospects for more internationalist American behavior. In part, this would be achieved by creating new regimes as just mentioned. But there will still be ongoing questions of how to manage the regimes, and how to minimize unilateral actions elsewhere which would encourage similar tendencies in the United States.

One clear lesson of the past, particularly from the early 1980s, is that it is a mistake for other countries—in their own interest, and ultimately in America’s too—to simply accept American unilateralism for extended periods of time. As Lenin suggested, one pushes on when one hits mush. The absence of more effective foreign pressure on U.S. policies during the early 1980s, perhaps by discouraging the huge flows of capital which enabled America to ignore its international imbalances for half a decade, clearly encouraged the buildup of those imbalances—which almost brought a breakdown of the international trading system in 1985, and which have yet to be definitively reversed. A functioning system would go far to preclude such benign neglect abroad, but other major countries must be constantly on guard to avoid encouraging America’s worst tendencies.
III. REORIENTING JAPAN'S ECONOMIC STRUCTURE

Isamu Miyazaki

Politicians, it is said, tend to think that if they talk long enough and loudly enough about a policy they can claim to have implemented it. In the economic realm also, the illusion sometimes arises that trumpeting a goal, such as "growth without inflation," will lead to its realization. But in economics, if not in politics, slogans change nothing.

Since the 1985 plenary meeting of the Trilateral Commission, the world economy has not moved in the overall direction of internationalization, liberalization, or greater knowledge-intensity. Some change has been witnessed in the status of "growth without inflation," indicated by the weakening of primary commodity prices (including oil), the transition toward lower interest rates, depreciation of the dollar, and slower growth in the major economies. This change is a product of two mutually contradictory developments. On the bright side, the world economy, having completed its adjustment to the two oil crises of the 1970s (and the resultant inflation), has finally entered a new phase of technological innovation. On the other hand, structural problems in the world economy have become more serious—such as the spiraling external debts of developing countries, chronic unemployment and rising protectionism in some advanced countries, instability in the international monetary system, a huge trade imbalance between the United States and Japan, and the vacillations in international partnership due to self-centered policies of individual countries. Among these problems, I intend to concentrate on Japan's huge trade surplus (particularly vis-à-vis the United States), analyzing the problem from the Japanese side, and to discuss measures that Japan should take to improve the situation.

International comparison of selected macroeconomic indicators (see Table 1) reveals that both the U.S. and Japanese economies have shown relatively good performance: high growth rates (6.6% in 1984 for the United States, and 5.1% and 4.6% in 1984 and 1985 for Japan); low unemployment rates (around 7% in the United States and 2.7% in Japan); and low inflation rates (in 1985, 3.6% in the United States and 2.1% in Japan).
### TABLE 1
Similarities and Contrasts between the U.S. and Japanese Economies, 1985

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Similarities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth Rate (%)</td>
<td>2.2 (6.6 in '84)</td>
<td>4.6 (5.1 in '84)</td>
</tr>
<tr>
<td>Unemployment Rate (%)</td>
<td>7.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Consumer Price Index (%)</td>
<td>3.6</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Contrasts</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth of Domestic Demand*</td>
<td>2.8 (2.9)</td>
<td>3.5 (3.1)</td>
</tr>
<tr>
<td>Growth of External Demand*</td>
<td>-27.5 (-0.7)</td>
<td>22.4 (0.8)</td>
</tr>
<tr>
<td>Current Account Balance (billion US$)</td>
<td>-117.7</td>
<td>+49.3</td>
</tr>
<tr>
<td>Capital Account Balance (billion US$)</td>
<td>+90.5</td>
<td>-65.0</td>
</tr>
<tr>
<td>Interest Rates (long-term treasury bonds, end of 1985)</td>
<td>9.68</td>
<td>5.95</td>
</tr>
<tr>
<td>Savings-Investment Balance</td>
<td>S&lt;1</td>
<td>S&gt;1</td>
</tr>
<tr>
<td>Net Assets Abroad</td>
<td>net debtor</td>
<td>net creditor</td>
</tr>
</tbody>
</table>

*The initial figures indicate the rate of increase over 1984. The figures in parentheses indicate the contribution to the GNP increase.

But between the two countries lies a serious trade imbalance adversely affecting the economy and society of both nations. The trade imbalance between Japan and the United States has contributed also to disorder in the world economy, i.e., obstruction of international trade, instability in the global monetary system, and friction between North and South. Addressing the bilateral trade problem, therefore, is one of the most urgent tasks for the further development of the world economy.

The balance of payments between the United States and Japan is characterized by a persistent Japanese trade surplus, and a U.S. surplus on the capital account. The imbalances have led the two countries to contrasting positions in the world economy: the United States has become, for the first time in 71 years, a debtor country, while Japan has increased its net assets abroad drastically. These phenomena have been caused not so much by business cycles or growth-rate disparities between the two countries, but mainly by the structural elements of these two economies. Unless these structural problems are
redressed, therefore, bilateral imbalances will persist. For example Japan's recent growth has been based on external demand, while U.S. expansion has relied on domestic demand. This contrast in the basis for growth is attributable to the difference in the balance between savings and investment in the two countries. Japan has maintained a high savings level and low domestic investment, while the United States has been characterized by a low savings rate and high domestic investment (including federal government budget deficits). The realignment of such imbalances must be achieved through the coordination of the two nations' macroeconomic policies.

Despite the seriousness of such structural problems, each country so far has continued to implement self-centered policies, resulting in insufficient international policy coordination. Although the United States and Japan have bilaterally attempted to coordinate policies in specific areas, such efforts have by no means been sufficient to correct the imbalances between the two countries. The need for greater U.S.-Japan economic policy coordination becomes obvious when one looks back on the trends in bilateral current account balances and the history of the "trade frictions" over the past 15 years (see Chart 1).

Japan is poorly endowed with natural resources (such as industrial raw materials and energy resources) but abundantly endowed, instead, with a quality labor force. Consequently Japan developed a trade pattern in which imports are financed by the export of manufactured products that use imported raw materials. Particularly in the immediate post-war days, "export or die" was a harsh reality for Japan. And this attitude prevailed in Japan's economic policy-making at least until the end of the 1960s.

It was only in the 1970s that Japan began to enjoy persistent trade (current account) surpluses, which were the fruit of post-war import substitution and export promotion efforts. The Japanese government, however, was not fully convinced that the trade surplus would persist. The government was constantly concerned with the prospect of an excessively strong yen, and very cautious about opening up the Japanese market to imports. Moreover, the untimely occurrence of the 1973 and 1978 oil crises shocked an economy that was heavily dependent on imported oil, throwing the Japanese trade account into deficit, and confirming the fears of those who believed that Japan's trade surplus would be evanescent. Even after Japan adjusted to the oil crises and reestablished a trade surplus, some people would never believe in the "permanency" of Japan's trade surplus.

Business recovery from the bottom year of 1982 and the decline of oil prices since 1983 have steadily increased Japan's trade surplus, whose
CHART 1
Trends of Current Account and Trade Friction

<table>
<thead>
<tr>
<th>TRADE FRICITION INCIDENTS</th>
<th>YEAR</th>
<th>CURRENT ACCOUNT BALANCE AS PERCENTAGE OF GNP</th>
<th>JAPAN'S RESPONSES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1970</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>2</td>
<td></td>
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<tr>
<td></td>
<td>1971</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• U.S.-Japan governmental agreement on woolen and chemical fabrics</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1972</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Voluntary export restriction of steel products to Europe</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Renewal of Voluntary Restraint Agreement (VRA) between Japanese &amp; EC steel exporters and U.S.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1973</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• The U.S. Trade Reform Act of 1974</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1974</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>1975</td>
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<td></td>
<td>1976</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>1977</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Voluntary export restraints on Japanese color TV sets to the U.S.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

• The First Step for the Stabilization of Yen (June)
• The Second Step for the Stabilization of Yen (May)
• The Third Step for the Stabilization of Yen (Oct.)
• Comprehensive Economic Measures (Sept.)
Reorienting Japan's Economic Structure

- Adoption of the trigger price on steel by the U.S.
- Adoption of the basic price policy on steel products by EC

- First Japan-ASEAN Finance Ministers' Meeting requests Japan to open its market
- The U.S. Trade Act of 1979

- Voluntary export restraint on Japanese automobiles to the U.S.

- Increased number of trade reciprocity bills in U.S. Congress
- Consultation under Article 23 of GATT among Japanese & European governments

- Japanese government expressed its intention to review export to EC of 10 items, including VTRs

- ASEAN Finance Ministers' Meeting urges market-opening efforts by Japan
- The U.S. Trade Tariff Act of 1984

- Import surcharge and retaliatory bills (e.g., the Danforth Bill) in U.S. Congress
- Renewal of the voluntary export restraint on Japanese automobiles to the U.S.
- Introduction of the new Trade Act
- Congressional study mission on Japan's tobacco and leather goods imports in relation to Article 301 of Trade Act

- Comprehensive Economic Measures (Sept.)
- External Economic Measures (Dec.)
- Market-opening Measures (May)
- Gov't announcement on promotion of measures for current external economic issues (Jan.)
- Comprehensive Economic Measures (Oct.)
- External Economic Measures (April)
- External Economic Measures (Dec.)
- External Economic Measures (April)
- Action Program for improved access to Japanese market (July)
- Measures to expand domestic demand (Oct.)
- The "Maekawa Report" (April)
ratio to overall GNP has also increased (see Chart I). This tendency has been further strengthened by economic conditions in the United States, by far Japan’s largest trading partner, whose budget deficits caused high interest rates, which, in turn, pushed up the value of the dollar, thereby worsening the U.S. trade balance.

In 1985 the ratio of the current account surplus to the nominal GNP reached an unprecedented 3.6%, which was described by the recent report of the Advisory Group on Economic Structural Adjustment for International Harmony, an unofficial advisory body to Prime Minister Nakasone (the Maekawa Report), as “a critical situation not only for the management of the Japanese economy but also for the harmonious development of the world economy.”

In the 1970s “economic frictions” emerged between the United States and Japan. Chart I clearly shows the recurrent pattern in which frustration on the part of Japan’s trading partners intensified whenever Japan’s trade surplus exceeded 1.5% of nominal GNP—signified by the heavy concentration of measures in 1971-72, 1977-78, and after 1983. When the trade surplus declined (for example, after the two oil crises), the severity of bilateral friction also declined, at least on the surface.

One noteworthy fact in the above pattern is that—except for the immediate post-Bonn-Summit period in 1978 when the United States, West Germany and Japan all increased their respective growth rates as engines of the world economy—frictions have been dealt with by ad hoc negotiations regarding specific sectors, although the focus has been constantly changing, variously including the steel, shipbuilding, television, and automobile sectors. The need for macroeconomic adjustments and changes in economic structure has never been seriously discussed.

The economy’s recovery since 1982 has continually pushed up Japan’s current account surplus, which reached 3.6% of nominal GNP in 1985. It is obvious that this unprecedented surplus was not the result of business cycles, nor the sole consequence of America’s “twin deficits” (federal budget and trade deficits). Japan has become aware, finally, that its chronic surpluses are due principally to structural factors of the Japanese economy, as the above-mentioned Maekawa Report quite accurately notes.¹ As a member of the Advisory Group

¹Prime Minister Nakasone in October 1985 organized the Advisory Group on Economic Structural Adjustment for International Harmony (Chairman: Haruo Maekawa, former Governor of the Bank of Japan), composed of 17 private citizens, including myself. The Prime Minister requested the Group to discuss means to adjust Japan’s economic structure in order to reduce its current account surplus. The Group submitted its final report to the Prime Minister on April 7, 1986. In the report, the Group found the present situation of continued large current account surpluses as “a critical situation,” and proposed a reduction of the surplus as “a national policy goal” to be achieved through: (1) expansion of
and one of the drafters of that report I basically agree with the report's analysis of the current situation and its proposal as to the direction of future policy, but I am not entirely satisfied with it. Much has already been written on this report, so I do not intend to repeat such analysis here. But I would like to discuss my personal views on how to implement the medium to long-term structural adjustments necessary to reduce Japan's current account surplus.

Two general principles should be observed in formulating policies to change the Japanese economic structure to one "appropriate" for international cooperation, i.e., a structure that will allow Japan to play its part in the international division of labor and thus reduce Japan's surplus to an appropriate level. First, the guiding principle of economic policies should be freedom of the marketplace and any artificial controls or restrictions should remain exceptions. This principle follows logically from the fact that Japan is a free-market economy in which the major actor, indeed, the principal contributor to economic progress is not the government but the entrepreneurship and innovation of private corporations and individuals. However, such a non-interventionist government role will require a change of direction from the government's heavy-handed guidance of the Japanese economy for much of the post-war era.

Like many other economies, the Japanese economy is a mixed one, allowing the government to play an important role. The government bears responsibility not only for such areas as politics, diplomacy, and defense, but also plays a major part in such purely economic tasks as optimum allocation of resources, control of excessive fluctuations of the business climate, and the equitable distribution of income, as well as in minimizing the adverse effects of economic activity on the society and the natural environment. However, it should be kept in mind that any activity of the government is eventually funded by private citizens, be it in the form of taxes, public utilities charges or some other form, making it imperative for government activities to be cost effective. It is, therefore, not wrong to pursue the path towards a small government.

The principle of freedom should also be applied to external economic relations, and autonomy should thus be granted in principle to various activities of domestic and foreign financial institutions in the money and capital markets. Following this train of thought, it should be
realized that activities in the foreign exchange market should also be basically unregulated, and that it is not desirable to impose any artificial controls (including so-called administrative measures) over capital movements in order to prevent excessive flows of capital. One may find an analogy to this in a government's use of income policy as an instrument to counter inflation and to stabilize wages. Income policy aims to prevent cost-push inflation by controlling wage increases when the increase of income, including wages, exceeds the growth of productivity. But this is similarly undesirable because it also constitutes an artificial intervention in free-market activities. (Automatic adjustment of wages to prices, on the other hand, aims to maintain the standard of living of private citizens, but is similarly undesirable artificial intervention.)

The second principle to bear in mind in formulating structural changes in the Japanese economy is related to the method by which Japan should contribute to the welfare of the international community. Even if the Japanese economy grows further, it should not use its economic power to strengthen its military power but rather to improve the nation's living standard through expansion of domestic demand; and it should contribute to the stability and development of the international community through expanded international cooperation activities (including official development assistance—ODA—and direct foreign investment). I am aware that this issue really belongs in a discussion of Japan's politics and foreign relations, but I thought it appropriate to emphasize here the importance of utilizing lessons that Japan has learned from the bitter experience of the past. The historical background of this attitude refutes any naive criticism, often heard abroad, that Japan has single-mindedly pursued its economic interests, ignoring altogether its need for national defense. But because of its reluctance to assume a greater military role, Japan should be all the more eager to fulfill its international responsibilities in the economic realm. Japan should, therefore, take initiatives in enhancing global free trade and monetary stability and in improving economic cooperation with the developing countries. To fail to do so inevitably will lead to international criticism of Japan as selfish.

What specific economic policies, then, should Japan pursue in restructuring its economy within the above two principles? In aiming to change Japanese policies to make Japan's economy harmonious with the rest of the world, three basic steps should be taken.

First, Japan should aim for higher economic growth based on domestic demand. This domestic demand should consist of such items as housing, improvement of the urban infrastructure, and reduction of
working hours, all of which will improve living standards in Japan. None of them is expected to provoke criticism abroad. If domestic demand is expanded along these lines, a significant portion of Japan’s private savings will be absorbed in the domestic market, correcting the domestic savings-investment imbalance, which, in turn, could be expected to help set the yen’s value at a suitable level compatible with fundamentals of the Japanese economy. Japan has already completed the necessary adjustments to the two oil crises and entered the new era of technological innovation, and its growth potential is estimated to have recovered, from the lows of the 1970s, to the level of 4.5% to 5.5% annually. It is imperative for Japan to achieve a growth rate closer to this potential.

Second, Japan should further open its import market in order to help expanded domestic demand take full effect internationally. The Japanese government announced in July of 1985 the Action Program to improve foreign access to the Japanese market, which includes reduction and/or elimination of import tariffs, reduction of other import restrictions, simplification of standards and licensing procedures, and improvement in government procurement activities. The full implementation of items included in this Action Program should be undertaken swiftly. While the opening of Japan’s market to imports will promote changes in the nation’s industrial structure, the Maekawa Report goes further by proposing direct adjustments. Industrial adjustment will be a painful experience, but it is expected that the Japanese government will earnestly carry out such adjustment policies to increase Japan’s contribution to the international community.

Third, Japan must take steps in accordance with its status as a capital exporter. This follows from the fact that, even if the steps regarding domestic demand and market liberalization are taken, it will not be easy to reduce in a short period of time the ratio of the current account surplus to GNP from the current 3.6% to less than 2%. As far as the year 1986 is concerned, even though the growth of the export-import gap on a volume basis may be reduced or even reversed in favor of imports, Japan’s trade surplus in dollar terms may further increase due to the so-called J-curve effect after exchange rate adjustment and due to the decline in the price of primary products—such as oil, which occupies a major share of Japan’s imports as a whole. As illustrated by this case, it is evident that longer-term efforts are essential to insure the effect of Japan’s structural adjustment, including expansion of domestic demand, on its international balance of payments. The current account surplus will nevertheless persist, due to two factors. First, the Japanese economy is characterized by low import elasticity (0.74
between the first quarter of 1975 and the second quarter of 1983) and high export elasticity (1.71 in the same period). For this reason, in order for Japan to import more, its economy has to grow faster. Second, the invisible account deficit is expected to decrease and even to turn into a surplus in the medium to long run, due to the return on the overseas investments of recent years.

Indeed, the rapid increases of such investments signify the change in Japan's status from a capital importer to a capital exporter. Accordingly, Japan should expand its contribution to the stability and development of the world economy through an appropriate mix of technology transfer, official development assistance (ODA) and direct overseas investment that will go beyond conventional portfolio investment and contribute to the creation of jobs and the rationalization of management in recipient countries.

Due to a number of uncertainties, it is technically difficult to quantitatively estimate the expected effects of the above policies. It is not necessarily desirable, therefore, for the Japanese government to officially publicize specific figures as goals, like other trilateral countries, and to be restricted by those figures. But it is true that, without concrete figures as goals, policies tend to lose their urgency. Thus, I will try to compare three hypothetical future scenarios (1986-90) for the Japanese economy and to discuss problems in each case. (For the following measurement and analysis, the author is indebted to Susumu Kato of the Daiwa Securities Research Institute.)

Table 2 compares three scenarios for the Japanese economy: (1) no policy change, (2) no policy change with further yen appreciation, and (3) international cooperation. All three scenarios make certain assumptions about such factors as the growth rate of the U.S. economy and oil prices. It should also be pointed out that extensive debate and discussion will be required in the body politic in order to choose a scenario from among the three or policy priorities in each case, since none of the scenarios will satisfy everybody nor every policy objective. Table 3 illustrates the advantages and disadvantages of each scenario and assigns a "score" to each.

As indicated in Table 3, scenario A is superior in terms of reducing the budget deficit but fares poorly according to other criteria. The ratio of the current account surplus to GNP, in particular, will not change greatly from its high current level. Scenario B (appreciation of yen) is expected to bring about stability in prices, but here the deflationary effects on the domestic economy will be the greatest without offsetting positive incentives to business. Scenario C fares best according to most of the criteria: the current-account-surplus-to-GNP ratio will decline to
### TABLE 2

**Three Scenarios for the Japanese Economy, 1986-90**

(annual averages*)

<table>
<thead>
<tr>
<th></th>
<th>Case A: No Policy Change</th>
<th>Case B: No Policy Change with Further Yen Appreciation</th>
<th>Case C: International Cooperation Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981-85</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Main Indicators</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Growth Rate (%)</td>
<td>4.0</td>
<td>3.2 (3.6)</td>
<td>2.0 (1.9)</td>
</tr>
<tr>
<td></td>
<td>4.0</td>
<td>2.0 (1.9)</td>
<td>4.5 (4.4)</td>
</tr>
<tr>
<td>Inflation Rate (%)</td>
<td>2.5</td>
<td>2.1 (2.4)</td>
<td>1.9 (2.0)</td>
</tr>
<tr>
<td></td>
<td>2.5</td>
<td>2.5 (2.5)</td>
<td>1.9 (2.5)</td>
</tr>
<tr>
<td>Unemployment Rate (%)</td>
<td>2.6</td>
<td>3.0 (3.2)</td>
<td>3.1 (3.5)</td>
</tr>
<tr>
<td></td>
<td>2.6</td>
<td>2.8 (2.8)</td>
<td>2.8 (2.8)</td>
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<tr>
<td>Current Account Surplus actual (billion US$)</td>
<td>26</td>
<td>69 (67)</td>
<td>67 (61)</td>
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<tr>
<td></td>
<td>2.1</td>
<td>3.5 (3.2)</td>
<td>3.1 (2.3)</td>
</tr>
<tr>
<td>percentage of GNP</td>
<td>2.1</td>
<td>3.5 (3.2)</td>
<td>2.9 (2.0)</td>
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<tr>
<td>Yen/Dollar Exchange Rate</td>
<td>236</td>
<td>180</td>
<td>160 (140)</td>
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<tr>
<td>Budget Deficit (% of GNP)</td>
<td>3.6</td>
<td>1.8 (0.4)</td>
<td>2.4 (1.9)</td>
</tr>
<tr>
<td></td>
<td>3.6</td>
<td>3.6 (2.9)</td>
<td>3.6 (2.9)</td>
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</table>

**Assumptions**

<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Growth Rate (%)</td>
<td>3.0</td>
<td>3.8</td>
<td>3.8</td>
</tr>
<tr>
<td>Oil Prices (US$/barrel)</td>
<td>31.4</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Interest Rates (discount rate)</td>
<td>5.1</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Public Investment</td>
<td>down</td>
<td>flat</td>
<td>flat</td>
</tr>
<tr>
<td></td>
<td>up</td>
<td>flat</td>
<td>yes</td>
</tr>
<tr>
<td>Income Tax Reduction</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

Note: The 1986-90 scenarios are based on the "Kato Model" of the Daiwa Securities Research Institute. The scenarios are rough projections based on certain assumptions and should not be interpreted with undue precision.

*The figures in parentheses are for 1990. The Japanese fiscal year (April-March) is used.

The assumptions were made in March 1986.

Public investment declined at an average annual rate of 1.8% in 1981-85.

An increase in public investment of 2 trillion yen is assumed for each year.

An income tax reduction of 2 trillion yen is assumed, along with a 1 trillion reduction in corporate tax.

almost 2% by 1990 (see Table 2), and the budgetary-deficit-to-GNP ratio will be lower in 1990 than it is now (although on this latter criterion scenario C fares poorest among the three scenarios). One may notice that, in all three cases, the absolute value of Japan's current account surplus is rather large; this is because the calculation has not included the possible ameliorative effects of Japan's import-market-opening measures. Thus, the actual surplus can be expected to be lower in each of the three cases.
In conclusion, I believe that the third scenario (C), which positively relies on expanding domestic demand, is most desirable from the viewpoint of international cooperation. Scenario C adopts the Japan-as-a-locomotive thesis, but it should be noted that domestic and international economic conditions are different from those of 1978 when this thesis was also put forth. Finally, needless to say, even if such a course is adopted, international cooperation with foreign countries, particularly with the trilateral countries, will remain absolutely essential.

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2At the Bonn Summit of 1978, it was concluded that Japan and West Germany should function as the engines of "growth without inflation" for the world economy as a whole. Japan's efforts toward this direction succeeded in expanding domestic demand and in reducing the current account surplus but, at the same time, produced a budgetary deficit. It was through this experience that some people simple-mindedly related the expansion of domestic demand to government deficits, and now insist that Japan should no longer function as an engine. But these people fail to see major differences in various countries between 1978 and the present in terms of inflation rates and oil prices. It should also be recognized that the Japanese government did not necessarily take sufficient follow-up measures. Therefore, although specific methods have to be worked out more carefully, Japan should play the role of engine again.
IV. RE-STARTING EUROPE

Etienne Davignon

The European Community remains intensely absorbed by its own internal problems: its enlargement, its economic recovery, its financial crisis, and the reform of its Common Agricultural Policy. Foreign Ministers have tended to lose clout, particularly to their respective heads of state and government.¹ And the latter are more than ever attentive to domestic constraints. Less interested in trying to leave their mark on world affairs, they are less prone to use the European Community to that end. Short-term pressures and requirements are dominant.

Economic performance has improved in the Community, in terms of growth, inflation and convergence among the member countries. Yet all along this improvement has relied essentially on “austerity” macroeconomic policies (which mean lower real wages and continuing high levels of unemployment) and on external factors (notably import demand in the United States, and increased direct investment in Europe from the United States and Japan). Despite a significant trend reversal, it is not yet sufficiently based on (a) structural reforms to increase flexibility of labor markets (sectoral and regional wage differentiation and use of productivity criteria) and to open up capital and services markets; (b) the creation of a genuine internal market; (c) corporate strategies designed to master new technologies and reconquer Europe’s market share in the world; and (d) deeper European cooperation in the field of research, at the level of governments, enterprises and universities.

Europe must move further and faster in reforming its structures. The problem of unemployment, in particular, will not be solved merely by faster growth, but by using this additional margin of growth to introduce the needed structural reforms. Restated, the creation of jobs in Europe will come not only from growth of internal demand, but also from lower relative labor costs, better training allowing in turn greater professional mobility, and the creation of new enterprises coupled with a change in work habits.

¹As economic and financial problems have grown in importance, so has the role of Economics and Finance Ministers, both in their respective countries and at the level of the Community.
Finally, and particularly important for this report, recent improvements in Europe have not been buttressed by an adequate participation in the international management of interdependence, where Europe appears divided and without a clear perception of its common long-term interests. Any progress towards more systematic cooperation among the industrialized countries will inevitably have not only a positive impact on world growth; it will also have favorable consequences for Europe's economic and monetary unification and its cohesion of purpose and expression vis-à-vis the United States and Japan.

A. CHARACTERISTICS OF THE CURRENT SITUATION WITHIN THE COMMUNITY

Improved Growth
Growth has gradually resumed in Europe: in 1986, for the fourth year in a row, the rate of growth will be higher than in the preceding year. This higher growth rate, however, remains insufficient to make a significant dent in unemployment. This unemployment is mostly the result of a growth model that emphasizes cuts in manpower; thus, it is a change in model, more than higher growth per se, that could contribute to an improvement of the employment picture.

Unemployment aside, European governments have reasons to be pleased that higher growth has been coupled with a substantial reduction of inflation. From 1981 on, this lower inflation has been achieved despite an expensive dollar—which, in European terms, means expensive petroleum—and despite high interest rates resulting mostly from the situation that prevails in the United States. The reduction of inflation in Europe has been made possible by very tight macroeconomic policies, and by a minimal rise—and in many cases a lowering—of real wages.

Lower oil prices and a lower dollar are having some important positive effects. On the other hand, these developments will have a clear down-side as well: a decline of European exports to the United States and to OPEC countries (which constitute an important market for Europe); and a surge in imports from the "dollar zone"—North America and Latin America.

2On the other hand, the high exchange rate of the dollar has favored growth by opening the American market to European exports and weakening the competitiveness of American products on international markets more generally.

3In the face of these lower prices, no concrete response has been devised to insure the continuation of a responsible energy policy. This, combined with the repercussions of the Chernobyl nuclear reactor accident, could revive our old energy dependency problems with all the long-term consequences they entail.
Convergence
The convergence among national performances in terms of growth and inflation is the logical consequence of policies that have become more closely aligned. Increasing the integration of national economies through trade within the common internal market forces governments to design their national policies as a function of their partners' policies. The experience of France—isolated reflations in the summer of 1981, followed in the fall of 1982 by a realignment with the more austere policies of its neighbors—is a good illustration of the close interdependence that ties the European economies together, and the correspondingly narrowed latitude left to purely national policies. Indeed, that experience has been a decisive test for the European Monetary System: rather than leave the EMS, France chose to harden the very kind of common discipline that will allow her to remain in the system. In the end, this experience will serve as a useful reminder to other governments that might be tempted to go the road alone.

Restructuring
Since, unlike the United States or Japan, Europe cannot pass on to its industrialized partners the burden of its own adjustments or options, the European countries have had to perform deep restructurings of their economies. Such restructuring has been particularly spectacular in zero-growth or minimal-growth sectors (such as steel, textiles, shipbuilding, and shoes). But it has been coupled with massive investments which were made possible by governmental aid and by some trade protection—though by no means more than in the United States or Japan. Now this restructuring is beginning to take place in medium-growth sectors such as the automobile sector, where robotization is already well underway. It might not be as far-reaching as necessary because we are still waiting for the kind of joint ventures and industrial regroupings which an internal market without barriers will allow.

In sectors where demand is high and technology advanced, Europe shows obvious weaknesses despite some strong points (specialty chemicals, biotechnology, nuclear energy, space, railroads and urban mass transit). The problems behind Europe's tardiness in advanced technologies have been identified: governmental intervention along too narrow, exclusively national lines, and a lack of both cooperation and competition across borders. A premium is now being put on the unification of the internal European market, on greater competition as opposed to state intervention, and on joint R&D initiatives. The EC has shown the way with ESPRIT in the field of electronics and RACE in telecommunications. All European governments have in effect
merged—albeit in a vague way—their aspirations under the umbrella of the EUREKA operation.

Other problems have also been identified, although solutions will require some time: an entrepreneurial culture that leaves much to be desired; a lack of capital for high-risk investments; not enough economies of scale; and an insufficient integration between public and private R&D within the industrial and marketing strategies of European companies.

**Trade Policy**

Unable to export its unemployment to the United States or Japan, the European Community has responded to domestic pressure by reacting against disruptive imports (witness its agricultural, steel and textile policies, and its systematic use of anti-dumping measures to pass on to others at least a part of its adjustment effort). The Europeans may seem at times to indulge in fantasies of protectionism. Yet these remain perform limited by the fundamentally open nature of the European economy, and by an equally open decision-making process on trade matters within the Community—which also has to accommodate the conflicting interests of its own member countries. The maintenance of an open trading system is vital to the European Community. Unable to set its choices as decisively as the United States or Japan, the Community needs the kind of reliability and protection which the rules and credibility of an institutionalized system bring with them.

The Community—even more so since Spain and Portugal have joined—is increasingly becoming the crossroads of international trade and production. The EC has not only the most penetrated market of the OECD's three major partners; it is also where U.S. and Japanese multinational corporations concentrate, multiplying the avenues of cooperation within Europe. The evolution of banking services amply illustrates this fundamental feature of the European economy, and its increased vigor during the last few years. In those sectors where demand is high, national production in Europe covers only 60% of domestic demand—as against 90% in the United States and 95% in Japan. Furthermore, a growing portion of this production is carried out by European subsidiaries of American and, I expect increasingly, Japanese groups. Thus, to a much greater extent than in the United States or Japan, there exists in Europe a mesh of interests which makes it more and more illusory for any particular state to conduct industrial and research policies that give exclusive preference to its domestic enterprises.
Integration
The Community—or at least some of its member states—is becoming more tightly integrated. This integration is less the reflection of some kind of centralized common will than the result of increasingly convergent, increasingly complementary national strategies—strategies that are designed separately but coincide *de facto* to a large extent. The workings of the European Commission insure that all member states' policies—macroeconomic as well as microeconomic—are permanently "on the table." The result is both an ongoing educational process and a tacit acceptance of the need for more convergence, which allow for an ever greater compatibility among long-term policies. Initiatives in new domains and partnership seek to replace conflict and overcome contradictions. The success of the EMS and the growing ineffectiveness of national interventionist and protectionist industrial policies are the product of this process of collective apprenticeship—a process which, though relatively new, has gained strength through constant, trial-and-error effort.

This attitude is also the result of the globalization of the world's economy. Because of its openness and the looseness of its structures, the Common Market is the most directly affected by this globalization. In many sectors, national markets and enterprises relate directly to the world market and the multinationals, bypassing the Community in effect (because of the Common Market's imperfect unity, and because of the lack of "European preferences" in law or in practice).

Power-sharing and responsibility-sharing among the member states confine European action within the strictest bounds of pragmatism; they force Europe as such to react and adapt to external pressures instead of being the initiator of policies based on long-term strategies. But if the Europeans' ability to do harm is limited by the very force of inertia, their capacity to create a favorable international economic environment is equally restricted. Thus, their reluctance to step into a leading role in stimulating international economic expansion, a role played by the American economy in recent years, makes them unable to exert a real influence on the course of American policies or, to a lesser degree, on that of Japanese policies. In the short run, this provides at best an alibi and at worst an encouragement to America's budgetary neglect and its penchant for unilateralism. In addition, it should be noted that Europe is conspicuously absent from the difficult, yet growing, dialogue between the United States and Japan.

If Europe functions as a full entity when it comes to external trade policies, and only as half an entity with respect to the internal market,
the fact that it is still a non-entity in the macroeconomic and monetary field is an impediment to improved growth worldwide. This "non-Europe" is more deflationary than would be the case were it better integrated at the macroeconomic level: each member state, seeking a competitive edge, tries to outdo the others in economic austerity and expects more non-inflationary growth to come from a quicker expansion in its neighbor's economy. Meanwhile, it is, of course, in the name of the very same approach that said neighbor hesitates to allow such additional expansion at home. All-in-all, unable to act with enough cohesion at the Community level, the member states wait for external shocks—such as the decline in oil prices and interest rates—to stimulate the additional growth they need.

With respect to unification of the internal market, the European Commission under Jacques Delors has proposed to shorten the process by making 1992 the target date for the elimination of internal barriers (see Lord Cockfield's White Paper), through the implementation of 300 measures of regulatory and fiscal harmonization. To do so, the Commission has proposed, on the occasion of the Rome Treaty revision agreed upon in December by the heads of state and government, that the unanimity rule be replaced by a "qualified majority" rule. The European Council only partly endorsed this proposal—excluding, in particular, all issues of VAT harmonization. In addition, although the Council has agreed to majority rule in certain areas, it has also opened the way for various safeguard clauses, and national exceptions. Unless a new awareness puts a stop to significant slippage, the ultimate outcome remains highly uncertain.

B. EUROPEAN OBJECTIVES

Europe's awareness of the above diagnosis is not new; yet this awareness became more precise and more widespread in light of the remarkable performance of the American economy in 1984. Whereas unemployment in Europe continued on its unbroken, 20-year climb, European public opinion discovered that America had created some 15 million new jobs and was regaining a growth-oriented dynamism and a capacity for innovation which seemed to have become Japan's monopoly. Never mind that Europe overestimated the vigor of the American economy. What is important is that it encouraged a more and

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5 Differences in VAT rates of 10-15% for the same categories of products are frequent.
more widespread recognition of the "Eurosclerosis" which America and Japan had diagnosed on the Old Continent.

From the mass of work by the Community devoted to comparing Europe with the United States and Japan, three leading themes stood out. They quickly became the objectives of a new European initiative and were endorsed as such by the heads of state and government of the member countries:

1. **Unification of the internal market.** The idea is to turn the European Community, now finally enlarged by the accession of Spain and Portugal after seven years of negotiation, into a space free of economic borders, where people, goods, services and capital can move as freely as they do in their national context.

2. **Re-launching the capacity for innovation** of European companies, especially through their greater cooperation with research centers and universities.

3. **Monetary union.** The European Monetary System prefigures this, with the ECU as its most visible expression.

The existence of a broad consensus on these three components of a new European "start" was coupled, however, with considerable skepticism that the means for such an initiative could be found. Such skepticism was justified by the inefficiency of a Community system in which decision-making has been gradually blocked by the practice of unanimity, the procedural consequence of a lack of leadership and political will. Thus the need for institutional reform became clear. It took the form of a revision of the Rome Treaty, signed in 1957 for a more homogeneous Community than the current Community of the 12, which faces different challenges than those of the early years.

**Unification of the Internal Market**

The road to a unified internal market has been laid out very precisely: the idea is the elimination of physical, technical and fiscal borders, along the lines and on the schedule of the White Paper presented by the European Commission in 1985, while freezing the introduction of new barriers. The simplicity of this goal conceals a multitude of decisions to be taken in all fields—transportation, public markets, state assistance, indirect taxes, professional harmonization, phyto-sanitary controls, etc. For these reasons, completion of the internal market will not be easy, despite a political will which has been clearly voiced many times.

According to the White Paper's schedule, the Commission has to move on three different fronts:
• The "Citizen's Europe": in ways both tangible and symbolic, public opinion must rapidly see progress towards completion of the internal market (simplification of procedures at the borders, etc.);
• The remaining national "bastions" within policies that otherwise traditionally fall under the Community's purview: barriers to the free circulation of people and goods (immigration, visas, diplomas, VAT and excise taxes);
• The extension of traditional policies: opening of public markets, harmonization of norms, competition, etc.

To achieve so ambitious a goal, three conditions must be met:

• An annual schedule must fix each step in order to be able to show progress concretely where it is most needed. The technical complexity of the matters at hand prevents negotiation or bargaining at the political level. To sustain this effort it must show results and it will be indispensable to keep the pressure on national administrations. The usefulness of the Commission will be determined by its ability to see that the indispensable decisions are taken on time. A failure in its most natural area of competence would have serious institutional consequences.
• Also indispensable is the active backing of enterprises. They will have to demonstrate what stands to be lost, and the obstacles to innovation, and thus increased pressure to move offshore, if the greater market is not created. It will be their task to inform public opinion about the dangers of too slow or incomplete an evolution. Such intervention is perfectly legitimate: if it is the entrepreneur's job to anticipate, he has a right to demand—since competition is global—working conditions and advantages similar to those of his American and Japanese competitors.
• The criteria for adjustment and innovation cannot be set merely in the context of the Community. The Community must not only compete with the constant progress of the United States and Japan; it must also make up for its own lateness. This dual constraint dictates the pace at which the objectives must be reached.

Innovation and Technological Cooperation
In this area, the way has been opened since 1984 by the ESPRIT program (European Strategic Program for Research and Development in Information Technology). At first glance, ESPRIT is a mere research program co-financed by the Community and the relevant players (industry, universities, research centers). But in fact, it has been from the start an incentive for the development of transnational cooperation
among European firms otherwise separated by age-old traditions of exclusive dealings with their own national governments, and by corporate "cultures" and internal patterns of organization so different as to prevent the birth of truly European industrial groups or ensure their failure after birth.

The success of ESPRIT on this front, and on that of industrial research *per se*, continues to modify attitudes for the better, both in governments and in European companies. But much remains to be done to achieve (a) a systematic coordination of national R&D programs; (b) the development of Community programs like ESPRIT, parallel to those of the European Space Agency; and (c) the multiplication of specific projects with varying degrees of participation from member states and their firms, similar to those which have been promoted in the framework of the EUREKA initiative.

There is agreement on the objectives: greater industrial competitiveness, a better translation of research into products and services for which a market exists, and an acceleration of innovation. On the other hand, much ambiguity persists with respect to the willingness of each nation to tailor its efforts to a broader framework, be it Community-related or not. Uncertainty about the continued availability of financial resources; a frequent reticence to set real priorities or at least avoid excessive dispersion of efforts; the persistence of obsolete distinctions between the civilian and military aspects of some projects; the belated introduction of indispensable incentives to encourage small and medium-size enterprises to take risks—all these negative factors should not be taken lightly. To be sure, Archimedes did say "Eureka"—but he had just discovered a principle which then led to practical applications. The word itself is not magic; what it covers is what may become so.

In this context, a substantial effort will be needed in the field of education. In this subjective domain, such an effort could help create the kind of "community of the young" which might help restore to the Community the self-confidence which has pervaded the United States during the last few years.

It is also in this framework that the social interaction among enterprises, governments and trade unions will have to grow. In the absence of such dialogue, existing rigidities will be difficult to overcome.

**Strengthening of Monetary Cooperation**

A monetary policy emphasizing stability—both internal and external—remains an essential basis for re-starting Europe.
The European Monetary System (EMS) is a tested framework to coordinate national monetary policies; as such, its importance has recently been confirmed by a new chapter of the Rome Treaty submitted in 1986 for ratification by the member states. The EMS is a guarantee of monetary stability and predictability in Europe. It is therefore essential to strengthen this system which, with the help of an ever wider consensus on economic policies, has made possible a high degree of economic convergence.

The declared objective of the member states—recently restated by the Governor of the Bundesbank—remains the establishment of a monetary union that includes a common currency and a European central bank. To achieve this objective requires, however, a gradual strengthening of monetary cooperation among the Community's member states, and a growing convergence of their economic performances.

1985 has made it possible to deepen, in practice, this monetary cooperation. Even though it may not amount to a spectacular "breakthrough," such progress is important. Meanwhile the spontaneous extension of private uses of the ECU, notably in connection with trade, has been particularly pronounced and should continue in 1986. Bond issues denominated in ECU on the international market amounted to 1.9 billion ECU in 1983, 3.4 in 1984, and 9.4 in 1985. The ECU thus became the fifth international currency of bond denomination after the U.S. dollar, the Swiss franc, the Japanese yen and the German mark. On the Eurocurrencies market, the ECU is in third place. Paper denominated in ECU in the portfolios of banks also continues to increase: it amounted to $46.6 billion, or 38.5 billion ECU, at the end of the third quarter of 1985.

Given this progress, and thanks to the role of the EMS in the convergence of the member states' economic performances and the coordination of their policies, the liberalization of capital markets should make great strides in 1986, thus reinforcing in turn the cohesion of the EMS.

To be complete, this cohesion will require the participation of the pound sterling in the exchange mechanism. Such participation is looked upon more and more favorably by the financial and industrial community of the United Kingdom, because of the noticeable contrast between the negative impact of the pound's instability (especially on British interest rates) and the positive advantages which Britain's partners derive from their membership in a zone of relative exchange-rate stability. The last word on the subject remains to be said—and it is, as usual, the most difficult one.
Although the outlook is good, one should not forget that, in international monetary affairs, the Community as such is conspicuously absent. The Group of Five has accomplished much, yet nobody believes it could become the Group of Three in the foreseeable future. The recent Tokyo Summit was not helpful for strengthening monetary cooperation in the Community. Indeed, if its lack of monetary competence strictly speaking can justify the European Commission’s absence from the Group of Five, its exclusion from the Group of Seven is worrisome: it diminishes the Commission’s credibility as a promoter of macroeconomic convergence; it underlines the difference in status between the “Big” Europeans and the “Small” Europeans; and it also reduces the significance of the Group of Ten’s work. Here, as on so many other subjects, the European paradox is blinding: because of its vulnerability and its peculiar mode of operation, the Community needs—more than the United States, of course, and even more than Japan—the best possible management of interdependence and its repercussions; and yet, it is the Community that does the least to acquire the means of promoting, and taking part in, such management! Such modesty action-wise also increases the disenchantment—justified or not—of the United States with its partners. This mood also helps explain the popularity of protectionist tendencies in the United States.

To conclude, the ship of the Community has regained a sufficient cruising speed to respond to the rudder. The course is set—but the pilot hasn’t yet come aboard.
V. CONCLUSION:
A RETURN TO SYSTEMATIC COOPERATION

Our overarching concern as we have prepared this report is the need to return to a more systematic approach to international cooperation. Skillful crisis management and a healthy pragmatism have helped prevent the worst over the past 15 years, but this is not enough. One day a crisis might overwhelm us. Moreover, we pay a heavy price as untended imbalances—such as the present American deficit and Japanese surplus, the results of almost five years of policy inattention—grow to dangerous proportions and threaten to disrupt the entire world economy. And we are not taking advantage of the opportunities which international cooperation can demonstrably provide for the prosperity of our peoples and overall harmony among our nations.

We do not propose greater international economic cooperation from any “soft-hearted” desire to be nice to each other nor to improve overall relations between our countries, though greater cooperation would have such a result. We do so, to the contrary, from a conviction that each individual nation will gain substantially from more effective policy collaboration with its major trading and financial partners. The reason is simple: in today’s interdependent world, any national policy which long remains incompatible with those of other major countries will inevitably become unsustainable, and thus levy severe costs on the country initiating such a policy—in addition to the costs to other countries and the increased vulnerability of the entire system. Chapter II demonstrates that this conclusion applies even to the largest trilateral country, the United States, and has indeed done so spectacularly over the past year as its trade deficit hit $150 billion and protectionist pressures erupted with a vengeance.

The goal of greater international economic cooperation is to tilt national economic policies in the direction of greater compatibility among nations, and thus greater sustainability. Policy decisions within all our trilateral countries emerge from an extensive and ongoing interplay of contending forces, with the outcome affected to greater or lesser degrees by external circumstances and pressures. We believe that well-conceived, effective international regimes can promote more sound results from such debates, with positive effects for both individual countries and the community of nations.
As noted in our introduction, the foundations for a leap forward in the extent of cooperation have strengthened considerably. Across the three regions, inflation has declined dramatically, philosophical orientations have converged around an emphasis on market orientation, and some growth is underway. The G-5 meeting in September 1985 and subsequent events have given a fresh impulse to multilateral action. Ideology and skepticism are no longer the primary attitudes of the participants. Joint action is needed and can improve matters. The message is clear but are the partners ready to listen?

The essays on individual partners present a mixed picture of readiness and ability to move forward:

- C. Fred Bergsten sees the 1985-86 shift of the Reagan Administration resembling similar shifts in preceding Administrations "from an initial international macro/monetary stance with a substantially unilateralist character (passive or active) to a much greater degree of international cooperation." With past history as a guide, this shift to a more cooperative mode is likely to be retained for the remainder of Reagan's term. But future Administrations need to be cognizant of the folly of rejecting such cooperation, and more effective international regimes are essential to help tilt U.S. policy decisions in this direction on a sustained basis. GATT has helped in this respect regarding trade policy, though it too needs substantial improvement. A more effective regime on macro/monetary policy is a "key requirement for promoting less American unilateralism."

- Isamu Miyazaki finds that "Japan has become aware, finally, that its chronic surpluses are due principally to structural factors of the Japanese economy." He argues for the "international cooperation" option for Japanese economic policy in 1986-90 (lower interest rates, increased public investment, significant tax cuts, more market opening, and increased official development assistance and direct investment overseas), which adopts the "Japan-as-a-locomotive" thesis and would bring the current account surplus down to a more reasonable level. The choice of this policy path, however, is subject to further policy debate.

- Etienne Davignon sees the European Community still "intensely absorbed by its own internal problems." There are hopeful aspects of the current situation, however—improved growth, convergence of national economic performances, deep restructuring already underway, greater de facto coordination. And while grounds for skepticism remain, a new European relance is taking shape around three objectives, endorsed by governments: completion of the in-
ternal market, increased monetary cooperation (refigured by the EMS and widening use of the ECU), and an emphasis on the capacity for innovation of European companies. The “European paradox” remains: the Community needs the best possible management of interdependence—more than the United States, more than Japan—but it does not do enough to create the conditions for this management, and its members do not wish to participate as an “entity.”

R. William Lawson finds some recent indications that “Canada’s relatively passive approach to international economic management may have run its course.” But these indications are concentrated in the trade field, and within that on freer bilateral arrangements with the United States, more than on multilateral free trade. We should “not expect to see much enthusiasm in Canada for any international initiative that looked towards commitments in the exchange-rate or balance of payments fields. The belief in Canada that freedom from such commitments gives valuable freedom of maneuver to domestic financial policy is too strong for that”—however shortsighted the belief may be.

The leap forward needed to achieve a level of cooperation compatible with the dimensions of the problems is particularly critical in three areas: macroeconomic policy and exchange rates, trade, and Third World debt.

Macroeconomic and Monetary Policy
The far-reaching implications of the current trade imbalance between the United States and other key trilateral countries indicate the folly of conducting economic policies within a purely national framework:

- The American deficit of $150 billion, produced primarily by the enormous rise of the dollar during 1980-85, has unleashed strong pressures for protectionism in the United States, which could disrupt the entire world trading system including a new explosion of the Third World debt problem. Even the substantial decline of the dollar to mid-1986 will leave the deficit near $100 billion, and may be inadequate to halt the erosion of U.S. trade policy.
- Japan’s surplus of $50-70 billion, coupled with widespread perceptions that Japan’s internal market is largely closed to competitive imports, has generated a proliferation of limitations on its exports which further erodes the trading system.
- The largest surplus countries, notably Japan and Germany, have relied on export expansion for a substantial portion of their total
economic growth and are hence extremely vulnerable to the inevitable reversal of their trade accounts. Indeed, severe problems were already being experienced by exporters in these countries (especially Japan) by early 1986, even though the adjustment to that time was far from complete, due to the need to correct in a few months an imbalance permitted to fester for almost five years.

The current situation is only the latest, if undoubtedly the most extreme, result of uncoordinated national economic policies. America decided in the early 1980s to sharply increase its budget deficits and, with a responsible monetary policy, to accept very high real interest rates. Japan and most of Western Europe chose to reduce their budget deficits sharply and hence promote lower interest rates. The results included a sharp rise in American demand for imports of both goods and capital; a sharp rise in the willingness of other trilateral countries to supply those goods and funds; a huge flow of capital into the United States and the sharp rise of the dollar against most other major currencies.

We believe that the massive problems which resulted could have been avoided, or at least substantially reduced, if the leading trilateral countries had conducted their policies during this period in concert rather than in isolation. The absence of any effective international arrangements to promote such coordination enabled them to largely ignore the international consequences of their actions, and in turn the eventual impact on their own economies. Hence America became overdependent on foreign products and money, and other trilateral countries (especially Japan) became overdependent on markets and investments abroad—particularly in a single country, the United States.

It is clear that such imbalances cannot last. Indeed, adjustment to the current misalignment has been underway since early 1985—with particular speed since the G-5 acted in September 1985. But that adjustment can occur in enormously different ways, some constructive and some highly destructive of both internal economic prosperity and international harmony.

Our central conclusion is that every effort should be made to avoid the creation of such imbalances in the first place. This is the only way to avoid economic and political disruption in all countries involved, and to assure that crises will not occur. Failing this admits counsel of perfection, a second goal is to address incipient disequilibria as quickly as possible to limit the damage caused and the risk of extensive deterioration. The minimum objective is to contain such damage and avert systemic breakdown.
In our view, all three goals can be effectively pursued only through the creation, and steady implementation, of an effective international regime within which the major trilateral countries accept obligations to carry out their internal economic policies in a mutually compatible manner. There are several ways to do so:

• a return to fixed exchange rates, as under Bretton Woods or the European Monetary System, within which countries pledge to either alter their macroeconomic policies as necessary to preserve agreed parities or to negotiate mutually supportive changes in those parities.
• a system of “target zones,” in which countries adopt wider (perhaps about 20%) ranges for currency relationships and less binding obligations to alter policy but nonetheless incorporate external factors consistently into their decision-making processes.
• multilateral surveillance by the community of participating countries of each other’s economic developments and policies, in a constant effort to achieve international compatibility of national efforts and hence avoid the buildup or escalation of damaging imbalances.

We would urge that the essential breakthrough to effective policy cooperation not be thwarted by excessive debate over the technicalities of alternative proposals. The key is to set up a system with full will to participate by all major countries, to implement it as effectively as possible and to learn over time how to do so more effectively. We believe, however, that surveillance alone, without an agreement on reference points of some sort, will prove insufficient. Thus, in our opinion, some form of “target zones” will need to emerge for successful collaboration in this area.

In that context, we are greatly encouraged by the agreement at the Tokyo Summit to launch a more systematic approach to surveillance with the assistance of specific indicators for each country. We believe that the framework suggested there, if implemented faithfully and consistently, would lead to substantial achievement of the objectives enumerated above. We believe that the International Monetary Fund can play a major role in promoting such an outcome, by assessing the international compatibility of the national indicators and calling attention to national deviation from agreed targets. A first step forward would be for the trilateral countries to instruct the Fund to act in this fashion.

Finally, we believe that the institution of such a system is a matter of high urgency. The continuing imbalance described above, between the
United States and other trilateral countries, remains severe and threatens the stability of both the financial and trading systems. The coming American trade balance improvement will, perforce, require substantial deterioration in the trade balances of partner countries whose distribution and impact will also need to be managed carefully. Domestic demand within each country, both in the United States as it cuts its trade deficit and in other countries as they reduce their trade surpluses, will need to be managed in a compatible manner to avoid creating substantial new problems.

The Tokyo Summit has set up several groups. It is not our intent to discuss procedure, but two observations need to be made: (a) effective monetary cooperation depends primarily on an appropriate relationship between the U.S. dollar, the Japanese yen, and the German mark; and (b) the close relationship between monetary, economic and trade aspects of the relevant issues requires real involvement and participation by those states and organizations whose commitments are key to the credibility of the choices to be made, and—in each country—by those who are responsible for the different sectors.

The lesson of the past is that effective international regimes for policy cooperation can substantially reduce, or even avoid, severe imbalances which harm all countries. We believe it is imperative that the trilateral countries learn this lesson to avoid suffering repeatedly from the failure to do so.

Trade
Opening markets, maintaining a stable international trading system and revitalizing GATT are indispensable conditions for more systematic economic cooperation—and for reversing the steady adoption of new trade barriers by several key trilateral countries and the consequent erosion of the existing regime. This will be achieved only if the new trade negotiations scheduled to take place in the framework of GATT focus on the real problems.

• Some of the most acute problems have not been handled effectively, or at all, within the framework of GATT. The Multi-Fiber Arrangement, the various agreements to limit steel trade, and other bilateral accords of all kinds have been ad hoc attempts to surmount the tensions resulting from the huge imbalances cited in the previous section and from the need to reconcile structural adjustment with existing political and social constraints. No major party has turned to GATT to seek multilateral agreement on temporary safeguard measures. It is through bilateral channels that the United
States and the European Community have each tried to achieve a better balance of trade with Japan, and with each other. The international trading system embodied in GATT has thereby been severely damaged. In such circumstances, at the same time we are assigning new tasks to GATT, we need to agree on what competences we entrust it with. The balance to be found probably lies in the recognition that more flexibility is needed (safeguard clauses), but that such flexibility must be coupled with a strengthening of GATT's role in surveillance and enforcement. It is unthinkable to grant exceptions and safeguards without simultaneously agreeing on the measures required to guarantee a return to the common rules, within an agreed timeframe. Without a referee, without surveillance, freedom becomes anarchy—or, at least, inequity. It is dangerous for us to continue to behave as if GATT still were as effective as it was originally. It is preferable to propose a certain number of adjustments rather than hide behind empty appeals in the name of "orthodoxy." Calls for a return to basics seem to us at times ambiguous, since, after having taken note that reality no longer corresponds to our initial hopes, everyone thinks he is free to act on his own—at a time when the international context must bear increasingly on national decisions.

• Customs duties are no longer the main focus of the negotiation. In a world where exchange rates can change by as much as 30% in six months, the impact of, say, a 6% reduction of tariffs spread out over five years can be swamped. This underlines the relation between open trade and equilibrium exchange rates. A competitive devaluation can give undue advantages to a given country, just as procrastination by a state in bringing its exchange rate into line with its economic performance can have similar results. Thus, the monetary and trade debates must proceed in parallel, and procedures must be established to deal institutionally with this interrelationship.

• No sector reveals better than agriculture the ambiguity which reigns at present over preparations for the new GATT round, especially among the trilateral partners. Clearly, no comprehensive negotiation can exclude agriculture; but it is just as obvious that social, regional and political constraints do limit the margin for

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negotiation. It is essential to determine: (a) whether the United States, in the case of a meaningful negotiation, will renounce its waiver of Article XI obligations; (b) within what time frame a genuine trade "normalization" will actually take place; and (c) what will be the rules of behavior during the transition period? In the absence of clarification on these points, the negotiation will not really be ignited, and current disagreements will undermine its overall credibility.

- In a world that is changing rapidly, some central areas are left without rules and structures for cooperation: e.g., services, the protection of ownership rights, high technology where it has become so hard to distinguish between "hardware" and "software," trade in enzymes and molecules, and at least the trade implications of national rules and policies which govern international investment flows. These areas raise a fundamental question: is it possible to devise and agree on common guidelines for these fields on a global basis, when levels of development vary so much from state to state? The developing countries' reluctance to negotiate on "classic" services is a good reminder of the depth of the question. Our recommendation is to analyze what can now reasonably lend itself to a global approach, and what requires in the first stage agreements among parties that have comparable levels of development. Unless the specific nature of some issues is recognized, the bilateral approach will win out over the multilateral approach.

As far as procedure is concerned, if we believe it is essential to agree at the Punta del Este meeting this fall on the opening of the new round of negotiations, plenipotentiary representatives of the main countries should also meet in parallel to make concrete progress in the four areas we have identified above. Without such political clarification, we would be deluding ourselves if we thought we were giving the international trading system the kind of credibility that can carry weight in each country's internal debates and put a halt to the protectionist wave, a wave most immediately evident as this report was completed in the trade bill passed by the U.S. House of Representatives in late May 1986 and the series of actions taken by the American Administration in an apparent effort to counter that initiative.

**Third World Debt**

Third World debt can be addressed effectively only with active trilateral cooperation. Fundamental resolution of the problem—including a
return to market creditworthiness for the borrowers and voluntary lending by the banks — will take considerably longer than originally thought. Reactive measures—as practiced since the crisis erupted in August 1982—are no longer adequate; preemptive and more far-reaching strategies are required. The "Baker plan" launched by the United States in October 1985 is an initial step in the right direction.

An economically effective and politically realistic set of policy steps is now required of each debtor country, fostering simultaneously a renewal of self-sustaining growth and continued responsible adjustment to the debt problem. A joint response to such policies by the trilateral countries is imperative, in at least four areas:

• A reversal of the current slide toward protectionism, and a further opening of markets, through the new round of trade negotiations discussed above. Developing countries can earn the foreign exchange needed to service their external debt only by expanding their exports, which requires increased access for their products to the markets of the trilateral countries.

• Liberalized lending policies by official institutions, notably export credit agencies and the multilateral development banks, so that they can make longer and more quickly disbursing loans to the debtor countries. This will require *inter alia* early agreement on sizable General Capital Increases for both the World Bank (perhaps $40 billion) and the Inter-American Development Bank (perhaps $20 billion), and substantial expansion of both the co-financing and guarantee programs of these institutions. The expansion of structural adjustment lending by the World Bank should be encouraged, and it is essential that the eighth replenishment of IDA reach at least $12 billion for the next four years.

• Adequate packages of new credits by commercial banks in the trilateral countries, probably of magnitudes substantially larger than envisaged in the Baker plan (but still considerably smaller than the annual reflows of interest payments by the debtors), encouraged by an expanded use of partial guarantees (through the IBRD and national export credit agencies).

• A series of further institutional innovations to add to the current financial packages and protect against renewed disruptions: extension of the Compensatory Financing Facility (CFF) at the IMF to offset future increases in interest rates, use of the existing CFF to compensate oil-exporting LDCs for their export losses due to lower oil prices, use of a substantial portion of the World Bank's $20 billion in liquid assets to speed up disbursements of loan commit-
ments to debtor countries with approved Bank programs, and a
sizable new creation of Special Drawing Rights (SDRs) at the IMF.²

In addition to such steps, which should be made available on a case-
by-case basis to all participating debtor countries, a special emergency
package will have to be constructed for Mexico (and perhaps a few
other oil-exporting countries). It would obviously be a mistake to deny
the world the benefit of lower oil prices due to their adverse distribu-
tional impact on a few countries (and individual companies and finan-
cial institutions). However, in addition to the inevitable further
adjustment of the oil-exporting countries themselves, direct financial
help may need to be organized promptly to avoid disruption to the
entire process. Mexico exhibits the greatest need for such help, which
could be fashioned from the elements mentioned above plus a few
others—such as long-term purchases of its oil by the United States (and
perhaps other industrial countries) for strategic stockpiling purposes,
and loans geared to future oil prices.

* * *

An effective return to systematic cooperation depends on both a
correct definition of the objectives of such a policy and a judgment by
each participant that such a policy is feasible. To meet these two key
criteria, it is necessary to concentrate on all three major areas which we
have analyzed—macroeconomic policy and exchange rates, trade and
Third World debt—and to choose a system of cooperation which
entails real commitments on each.

Interdependence among the trilateral countries is a reality. Such an
acknowledgement can today be complemented by a dynamic policy
that substitutes a collaborative framework for the unilateral, or at least
disparate, policies of the recent past. Both necessity and the current
economic context make this fundamental choice possible.

To provide political impetus toward the achievement of such a frame-
work, and overcome bureaucratic compartmentalization, action at the
highest level is required. Systematic cooperation will become a political
reality only if a personal and overt commitment is made at the highest
political level. We therefore call on heads of state and governments to
devote the highest priority to this endeavor, in their pursuit of
prosperity for all our peoples and harmony among all our countries.

1984) demonstrates that the continuing debt problem of the developing countries constitutes a
"shortage of international liquidity" and thus justifies SDR creation under the IMF Articles of
Agreement. All IMF members would receive their normal allocation, though the trilateral countries
could enhance the benefit for debtor developing countries by relending their shares to those
countries.
VI. A CANADIAN VIEW

R. William Lawson

I am very pleased to respond to an invitation from the authors of this report to provide some comments on the subject from a Canadian perspective. My comments will focus primarily on those considerations which seem to me to affect the participation of Canada in international economic management, but they will also include some discussion of the subject in more general terms. The views expressed are my own and are not offered as representative of Canadian opinion.

For reasons of history and geography Canadian attitudes and policies have always had a strong underlying international orientation. Canada's economic history is primarily the story of the development of its natural resources to supply external markets. A large part of its population is still made up of first-generation immigrants from many countries. Its British and French origins have left it with strong ties to Europe, and the intimate associations of Canadians and Americans across their long undefended border have created what is often called a special relationship.

On occasion policy in Canada has turned towards economic nationalism to moderate the openness of the economy in an effort to encourage a more broadly-based development, but the nationalism has been neither extreme nor sustained, and the importance to Canada of its international trade has continued to be very great. More than one-quarter of what it produces is sold abroad and more than one-quarter of what it consumes is produced abroad. Canada's welfare is thus heavily dependent on the external economic climate.

During the Second World War Canadians became very concerned about the kind of international economic system that would follow the war. How was the world to avoid the restrictions and disorder that characterized the pre-war system? At that time there were not many countries with which this question could be explored, and Canadians joined very actively in the discussions between the United Kingdom and the United States that led to the creation of the Bretton Woods institutions and, later, the GATT.
Whatever else might be said of the immediate post-war years, the conditions then were ideal for Canadian partnership in international economic management. The need for international economic initiatives was obvious and urgent, and very few countries were in a position to help in planning and implementing them. Some of Canada’s best economic minds were devoted to international economic matters, and the government of the day gave strong support. Canadians are proud of the contribution that Canada made in the immediate post-war years. Some of the feeling in Canada that the country now has too little influence in international economic matters is probably due to nostalgic memories of those days.

That early post-war experience stands in considerable contrast with much of what has happened since. For many years now both public discussion and government in Canada have given much lower priority to participating actively in international economic management. There are a number of reasons for this.

One obvious reason is that Canada now makes up a very much smaller proportion of the international economic system than it did in the immediate post-war years. The enormous increase in Canada’s relative international weight during the war involved both opportunity and responsibility for leadership while it lasted, but that situation was accidental and temporary, and as it changed Canada’s role in international economic management declined.

Another reason is that the international economic system worked very well in the years after the war. While the spectacular recovery of Europe and Japan reduced Canada’s relative economic weight, that recovery was of great benefit to Canada. In the general prosperity of the last 40 years Canada has prospered exceedingly. While Canada’s prosperity has continued to be heavily dependent upon developments abroad, it nevertheless seems, paradoxically, to have contributed to a decline of interest in Canada in international economic management. Sustained prosperity seems to have made Canadians confident enough about the future to feel able to shift their interest from the conditions necessary for Canadian prosperity to ways of redistributing the income that prosperity generates. Taking a growing pool of national income for granted, Canadians became preoccupied with initiatives to provide basic economic security and greater equality of opportunity to Canadians in all parts of the country by transferring income directly or indirectly between regions of the country and between individual Canadians. These issues have been so absorbing that they have diverted Canadian attention from external matters, including the management of the international economic system.
Another internal matter that has absorbed a great deal of the attention of Canadians in recent years is the relationship between French-speaking and English-speaking Canadians. The very strong movement in favor of separation from Canada that developed within the province of Quebec in the 1960s and the 1970s threatened the future of the country, and the search for ways of easing the concerns of French-Canadians, and of modifying to that end the constitutional fabric of the Canadian federation, was given high priority by government in Canada for many years.

These preoccupations have not resulted in Canada consciously turning its back on partnership in international economic management. Canada's dependence on international trade would never allow it to do that. Canada continues to attach great importance to its membership in a wide range of international economic institutions, and it has almost invariably been cooperative in the initiatives that these institutions have taken. Canadians have wanted to be good world citizens. But for many years Canada has been in an inward-looking mood in matters of public economic policy, surprisingly inward-looking for a country so exposed to external economic developments. When from time to time problems in the international economic system have emerged, Canadians have tended to regard them as originating elsewhere and as primarily the responsibility of others, especially the United States, to deal with.

Indications have recently appeared that Canada's relatively passive approach to international economic management may have run its course. These indications are in the trade field. In the last three years or so there has been a dramatic outburst of debate on the merits of Canada seeking freer trade with the United States on a bilateral basis. Some Ministers in the previous Liberal government had started to show interest in this idea, many spokesmen for the business community have recently given strong support to it, and in August 1985 a Royal Commission appointed in 1982 to inquire into a range of economic matters reported in favor of it. The present Conservative government (elected in September 1984) had already declared itself in favor of the idea, and it is now giving high priority to exploring the possibilities with the United States.

The idea of free (or freer) trade with the United States has surfaced several times in Canadian history, but this is the first time that it has attracted the serious attention of government since shortly after the end of the Second World War. Since the general theoretical arguments for free trade have not changed, one naturally asks why the issue has now re-emerged so suddenly and in such a lively way.
A Canadian View

A large part of the answer appears to lie in the way that the international trading system has developed. Canada has participated in the tariff reductions under the various GATT rounds, and these have made the Canadian market increasingly open and have exposed Canadian suppliers of the domestic market to increasingly severe foreign competition. It now appears to be the view of many Canadian businessmen that the best way for many Canadian suppliers to react is to turn away from their traditional reliance on a protected home market, to become more specialized in their product lines and to seek enough sales abroad to achieve an efficient scale of output. The prospects of this approach would be greatly improved by assured access free of both tariff and non-tariff barriers to suitable foreign markets. Free trade on a multilateral basis might be the ideal way of getting such access, but the possibility of achieving that in the relatively near future is seen as very remote. A large part of the market to which Canadian businessmen would like assured access is in the United States, and since there seems to be much more likelihood of being able to get a bilateral arrangement with the United States, this is where the interest has centered. The interest is enormously strengthened by the strong protectionist pressures that have emerged recently in the United States.

I shall not try to assess the chances of anything significant coming out of the current initiative of Canada to explore a free trade arrangement with the United States. There will be many problems on both sides. Many people in Canada object to the whole idea. Perhaps the most general objection is a fear that free trade with the United States will, in one way or another, erode Canada's political independence. Some who fear this see the bilateral character of the proposed arrangement as the problem; they would support free trade on a multilateral basis. Others who fear it see free trade as the problem; they think that it would involve unnecessary and painful economic adjustments and that it would limit excessively Canada's freedom of action in industrial, social and cultural policy. As is often the case in debates on economic policy, the participants tend to have quite different views of what will happen if no action is taken. By and large those who support free trade believe that it is imperative that, if Canada is to maintain or increase its present standard of living, it recognize its waning primacy as a supplier and processor of primary products and take advantage of the pressures of international competition to help it to become efficient enough in other areas of production to compete effectively in the world market.

The relevance for this report of the trade debate in Canada is that it shows a degree of interest in international trading arrangements that has not been seen in Canada for a long time. The inward-looking
character of Canadian debate on economic policy is being relieved, for
the time being at least, by fundamental questions about the changing
nature of world trade and what Canada should do about it. Canada's
economic interdependence is showing through.

The Canadian debate on trade is also relevant to this report in that it
is about a bilateral rather than a multilateral initiative. Little attention is
being paid to multilateral free trade because even those who express a
strong preference for it do not seem at all optimistic about what can be
accomplished in that direction in the near future. Some Canadians
have expressed concern that a bilateral arrangement with the United
States will erode Canada's historical attachment to multilateralism. The
other side of this argument is that the economic adjustments that will
be necessary to enable Canada to compete on an open basis with the
United States will increase its ability to join in free trade on a
multilateral basis if and when that becomes possible.

The renewed interest in Canada in the world's trading arrangements
has not so far been matched by a renewed interest in the world's
financial arrangements. There is little evidence in Canada of the
dissatisfaction that has emerged elsewhere with floating exchange
rates.

One reason for this may be that exchange-rate floating works better
for some currencies than for others. Canada's move in 1950 and again in
1970 to exchange-rate floating was based on the special features of the
Canadian situation and was not offered as a model for other countries.
But one might nevertheless have expected more questioning of floating
in Canada in view of what has happened to the Canadian exchange rate
over the last ten years. During that period the value of the Canadian
dollar has fallen from around US$1.02 to around US$.72 (April 1986).
The reason that this result has raised so few questions seems to be the
widespread belief in Canada that a floating exchange rate provides
significantly more freedom for domestic economic policy than would
otherwise be possible and that Canada has benefitted from this
freedom. According to this view acceptance of exchange depreciation
in recent years has allowed interest rates in Canada to be lower than
would otherwise have been possible. Since interest rates in the United
States in recent years have been regarded by many Canadians as being
unreasonably high, the idea that Canadian interest rates can be
sheltered by exchange depreciation has been an attractive one. This
benefit is seen as being reinforced by the encouragement that exchange
depreciation has given to exports. Since these arguments have at-
tracted little dissent there is not much debate in Canada about the
floating exchange-rate system. I shall return later to this question.
On another aspect of the international financial system, the international debt problem, Canada's larger banks are much involved because they have been very large players in the Euro-currency markets through which much of the credit was supplied. But apart from them and from a relatively few Canadians in financial circles and in the public service little attention is given to the problem in Canada. Insofar as the problem receives discussion, the fact that the capital flows involved were external to Canada and were expressed in foreign currencies contributes to the view that the matter is not one in which Canada is well-placed to generate initiatives.

I shall now turn to some general comments on the nature of the international economic system and its management.

The international system envisaged at Bretton Woods worked well for the first 25 years. There were problems that at the time seemed difficult enough, but they were not nearly as widespread or deep-rooted as those that we have since encountered. During those years the international economic arrangements encouraged a secular growth in world output and trade, and in human welfare, on a scale far greater than anybody would have dared to forecast at the end of the war. Then, around 1970, the system began to show signs of serious trouble. Since then we have observed volatile and errant exchange rates, massive aberrations in countries' international payments positions, a threatening growth in international debt, a strong resurgence of protectionism, and a serious inadequacy in the flow of development aid. What went wrong? Why? What can be done about it?

These are the questions that underly this report, and I am pleased to see them explored in this international framework. I greatly welcome the emphasis given by the authors to the fact that good management by the principal trading nations of their domestic economic affairs is essential for the good functioning of the international system.

Almost everybody interested in these matters looks back on Bretton Woods as an imaginative and wise initiative to escape the post-war return of the disorder that had increasingly pervaded the international field in the 1930s. The central purpose of the IMF was to encourage national states to pursue their economic goals by practices that would at the same time promote foreign trade and international financial order. A fundamental test to apply to national policies was that they not be disruptive to the trade and payments of other countries. The commitments that countries undertook when they joined the IMF were written largely in terms of external variables, that is, exchange rates and international payments positions, but what Bretton Woods really
sought was national policies at home that would make expanding world trade and exchange-rate stability possible. The architects of Bretton Woods knew very well that international economic order depended upon appropriate domestic policies.

What has happened, of course, is that the major trading nations have not conducted their own affairs in ways that were compatible with international economic order. Their greatest failure has been that they have not maintained internal financial stability. The surge of inflation that ricocheted around the world in the 1970s was fuelled by bad national policies. In reacting to events at home and abroad many countries made serious mistakes in economic policy at more or less the same time, and thereby sacrificed in varying degrees the internal values of their own currencies. One of the casualties of widespread inflation was the IMF system of pegged exchange rates. Without confidence in the internal values of individual currencies exchange-rate stability was impossible.

There was little that the IMF could do about this. The IMF is run by its members; it is essentially a group of countries who meet together to encourage each other to act responsibly in accordance with certain agreed rules. If, for whatever reasons, the economically stronger members of the group fail to act in accordance with the rules, about all that the other members can do is point their failures out to them. When many countries failed at the same time, what they did was to relax the rules.

What can be done about this? How? There would not be much point in tightening the rules of the IMF unless the principal members expected to be able to meet the requirements. However the rules were phrased, they would necessarily call, either explicitly or implicitly, for countries to achieve and maintain internal financial balance, to avoid a domestic economic climate that was either inflationary or deflationary, and to do it by means that were not disruptive to their trading partners. To the extent that countries do that, we shall have more exchange-rate stability no matter what the exchange-rate system is; to the extent they don’t, we won’t.

Perhaps the most cheering feature of the international economic scene in the last few years is the evidence of a growing recognition in many countries that a restoration of internal financial balance is necessary to their welfare for both internal and external economic reasons. The lessons of the last 15 or so years have not gone entirely unheeded. But in most countries the road back is proving to be very difficult in both political and economic terms. It may be, as has been suggested in this report, that in the present climate some strengthening of the
political will of countries to get their houses in order could come through international discussions and renewed international commitments. It certainly seems that the success of efforts to mobilize enough internal support for good economic policies is tenuous at best in most countries, and no means of strengthening that support should be overlooked.

I would not expect to see much enthusiasm in Canada for any international initiative that looked towards commitments in the exchange-rate or balance of payments fields. The belief in Canada that freedom from such commitments gives valuable freedom of maneuver to domestic economic policy is too strong for that. It may be that this belief will be reconsidered, and I hope that it will because I think that the case for it is much more doubtful than is commonly supposed. It is hard to challenge the idea that, for a country like Canada, freedom from external financial rules gives some short-term room for maneuver in domestic policy, but it is far from certain that that freedom is worth its price. Part of the price is the damage that it does to the evolution of an effective set of international rules for supporting international financial order, and no country has a greater interest in that objective than Canada. Another part of the price is the risk that the short-term room for maneuver in domestic policy will not be used wisely. If it is used to postpone needed internal economic adjustment—if, that is, it is used to delay doing uncomfortable things that ought to be done—it is not an advantage. I think that this is how much of the room has been used in Canada. Much of the exchange-rate depreciation that Canada has experienced over the last decade seems in retrospect to have been used to avoid dealing with a considerable range of domestic policies and practices that need adjustment.

The impression of many Canadians that exchange-rate depreciation is the right road to lower interest rates is an illusion. The way to achieve lower interest rates in Canada is to strengthen public confidence in the future internal value of the Canadian dollar. If Canada had been more effective than the United States over the last decade in the pursuit of domestic financial stability, interest rates in Canada would not now be higher than in the United States but lower, as they are in Germany and Japan. They would still tend to move from day to day with U.S. rates, but around a lower trend line. One consequence of exchange-rate depreciation is that it puts upward pressure on Canadian costs and prices, thereby exacerbating the problem of restoring confidence in the future internal value of the currency. Expectations at home and abroad about the future rate of inflation in Canada are a more important
determinant of the level of interest rates in Canada than are interest rates in the United States.

Canadians often seem more critical of the failure of the United States to deal with its unsustainable fiscal position than of Canada's failure to deal with a worse fiscal position. The explanation given is that the performance of the United States is far more important because of its size and the international role of its currency. It is certainly true that the failure of the United States to achieve domestic financial balance is very much more important to the world than the failure of Canada, but it is not more important to Canada. If Canada had managed its own affairs better over the past ten years it would be in a stronger economic position today; it would have a more flexible economy and better prospects for realizing its great potential. How effective in the future new international financial commitments by Canada could be in calling forth better economic management in Canada is an open question, but I think it almost certain that such influence as they had would be in the right direction. I would therefore like to see Canada become once again an active partner in international financial management, and to see it stand ready to undertake, along with others, such external commitments as may from time to time seem most likely to contribute to the good functioning of the international system.
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