KEEPING PACE

U.S. Policies and Global Economic Change

John Yochelson, Editor

Foreword by William E. Brock

A Center for Strategic and International Studies Book

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FOREWORD

The world economy of the 1990s will scarcely resemble the one in which this nation's current leaders have grown up. Most of those who will hold key responsibilities during the next decade, in both the public and the private sectors, were educated at a time when U.S. eocnomic and technological preeminence was taken for granted.

Now, largley as a result of the successes of U.S. policy since 1945, a number of the once unshakeable assumptions regarding America's position in the world economy are open to question. Even though the U.S. economy remains the world's most powerful, rapid gains elsewhere have significantly closed the gap. The U.S. lead in technological innovation has been narrowed and in some fields surpassed, and the dollar's future as the world's dominant currency looks less certain than it did a decade ago. Still, the United States is called upon to provide the vision and political energy to sustain global prosperity.

The challenges facing America's leaders in the years ahead are formidable. The revolution in information technology has not only integrated world markets but has sharply reduced decisionmaking time. Economic power promises to shift increasingly to the industries and nations that succeed in applying new technologies. The sharpening of competitive pressure has strained the multilateral institutions that have provided a foundation for U.S. international policies.

These challenges prompted the Center for Strategic and International Studies to organize a study group to examine the forces of change at work in the world economy and their implications for U.S. leadership. I had the pleasure of chairing this study group, whose deliberations began in Stowe, Vermont, during the summer of 1986 and have continued until the present.

The bipartisan CSIS study group brought together outstanding representatives from industry, labor, government, and the policy research community. We divided into three task forces: Robert Frederick, then-president of RCA, chaired a group on West-West relations; a task force on North-South issues was led by former Deputy U.S. Trade Representative William Walker and Westinghouse chairman John Marous; and Frank Carlucci, then-president of Sears World Trade, chaired our group on policy toward the Soviet bloc and China.

This book assembles the excellent working papers that served as a basis for discussion in our task forces meetings and plenary sessions. Some of these papers reflect sharply differing views over the definition and pursuit of U.S. interests, but all attempt to come to grips with the fundamental questions that must be addressed if the United States is to adjust to a new technological era while maintaining global leadership.

These papers, and the policy recommendations that will eventually flow from them, will be shared with the counterpart groups in Canada, Europe, and Japan that make up the Quadrangular Forum—a private collaborative effort that assesses the major challenges facing the industrial democracies. Our results will also be shared with the next U.S. administration.

The Center and the director of this project, John Yochelson, deserve the thanks of all of us for this timely and important effort.

—**William E. Brock**
Former Secretary of Labor and
U.S. Trade Representative

ACKNOWLEDGMENTS

This volume reflects not only the leadership of Senator William Brock and the insights of a superb group of contributors but the professionalism of outstanding colleagues at the Center for Strategic and International Studies.

Margaret Trimble, principal research assistant for this project, did an extraordinary job working with the authors and their manuscripts. Her diligence, energy, and creativity were indispensable. Her successor, Richard Schwartz, performed at the same high level in the final stages of this project.

INTRODUCTION

Although corporate America has been heavily criticized in recent years for its excessive focus on the short term, the pull of the immediate is accepted as all but inevitable in official U.S. economic policymaking. The pressures that limit policy horizons in Washington are clearly formidable. They stem from the two-year cycle of national elections, the diffusion of power in Congress as well as the executive branch, and the perennial crowding of agendas at the senior levels. The pull of the immediate is further reinforced by the sheer pace of economic change both domestically and internationally. A policy setting marked by sweeping innovation and unprecedented mobility of resources scarcely promotes the development of a long view.

The gearing of U.S. policy to the short term may be unavoidable, but its costs are nonetheless real. Three, in particular, stand out. First, the slant toward the short term fosters stop-and-go policies. Instability and unpredictability in the public sector inhibit and distort long-range business planning, reducing overall economic performance. Rapid shifts in U.S. priorities with respect to growth, inflation, and exchange rates during the 1970s provide a vivid case in point.

Second, short-term policies are ill suited to respond to the enduring, structural economic challenges faced by the United States. The kinds of challenges that arise from the application of new technology to the workplace, the internationalization of manufacturing, and the emergence of the newly industrializing countries will not yield to quick fixes.

Third, the U.S. policy process inhibits the development of a long-term vision of the U.S. role in the global economy. The transformations that have taken place in the postwar global economic order require such farsighted design to guide day-to-day decisions. In terms of leadership, a long-term vision is necessary to foster needed international support and cooperation.

This volume seeks to contribute to the shaping of a systematic view of interests and strategy in the international economic arena in the coming decade. Each chapter is, in the jargon of Washington, a "think piece" that analyzes a basic set of issues and assesses its policy implications. The chapters grouped in Part I examine the far-reaching impact of technological change on U.S. interests across the board. Part II focuses on the U.S. approach to global economic development. Part III looks at a series of underlying challenges to the international financial framework and the structure of the multilateral trading system.

In Part I, Harald B. Malmgren's opening chapter lays out a powerful argument that the world economy is being transformed by a technological revolution comparable to the industrial revolution of the eighteenth century. The driving forces of change are extraordinary advances in the creation of new materials, information technology, new manufacturing processes, transportation, and biotechnology. These advances are compressing time for decisionmaking; breaking linkages between labor, raw materials, and industrial output; blurring distinctions between commercial and defense technologies; and making possible the development and marketing of goods and services on a truly global basis.

The key challenge posed to the United States in this new technological era, according to Malmgren, is not loss of competitiveness but loss of autonomy. The forces at work are bound to erode the national sovereignty of all nations, even the world's preeminent economic power. He states:

> The pace of technological change and of the responses by private enterprises is overrunning the ability of governments to guide or manage structural adjustments. Existing regulatory regimes are rapidly being made obsolete, and traditional concepts of competition based on national markets are being made irrelevant by growing transborder competition spurred by the accelerated diffusion of technology on a global basis.

Malmgren argues that U.S. interests in this setting will best be served by a posture of maximal openness and receptivity to global economic transformation. On the domestic side, this requires stable macroeconomic policies to underpin growth and a priority effort in public education to prepare the United States politically, psychologically, and scientifically for the changes that are underway. Internationally, the United States must resist the cycle of defensiveness that is overtaking all of the advanced industrial economies as well as many of those in the developing world. Policies that seek U.S. competitive advantage at the expense of others will ultimately damage national economic interests, reduce growth in the world economy, and put the United States at odds with its most important allies.

Pat Choate and Juyne Linger make a strikingly different assessment. While concurring that a new technological era is at hand, they see a pervasive pattern of U.S. slippage and vulnerability. The United States is losing its edge in penetration of global markets, commercial applications of technology, and the process of innovation itself.

Choate and Linger attribute U.S. decline partly to domestic factors. U.S. industry failed to grasp the full extent of the international challenge that began to develop in the 1970s. Its record in commercializing and applying new technologies has been deficient. U.S. performance has been further handicapped by tax laws, an antitrust code, and technology transfer regulations that fail to take account of global competitive realities. At the same time, Choate and Linger hold the U.S. government even more accountable for underreacting to developments overseas that have damaged the U.S. position: restrictions to U.S. access of foreign markets, heavy subsidies to foreign competitors, violations of U.S. patent and other intellectual property rights, and a policy of scientific exchange that has left the U.S. scientific establishment readily accessible to others without providing reciprocal openness to U.S. researchers.

Against this background, Choate and Linger advocate much greater assertiveness in U.S. policy. Domestically, they argue for a concerted effort to strengthen the nation's technological base through wide-ranging measures to improve the allocation of capital, upgrade the labor force, and spur not only the research and development of new technologies but their commercial application as well. Internationally, they call for full-scale use of U.S. leverage—including restricted access to the U.S. market—to enable U.S. industry to compete on equal terms.

The contrasting perspectives of Malmgren and of Choate and Linger pose a fundamental question. How should the United States address the technology-driven issues that will continue to dominate the international agenda for the foreseeable future? For Choate and Linger, "the key point is that technology is a major national economic asset" to be aggressively nurtured. For Malmgren, technology is an increasingly shared asset to be developed cooperatively.

The discussion of East-West technology transfer by Stephen A. Merrill tilts, in the final analysis, toward Malmgren's thesis. Merrill suggests that the ebb and flow of pressures for restriction of sensitive technology to the Soviet bloc were once governed mainly by the state of East-West political relations. Now, however, such pressures are likely to be far less influenced by Soviet behavior than by "revolutionary technological and economic changes confined almost entirely to the West."

Merrill identifies several new technological realities that will affect U.S. policy toward technology transfer over the next decade: (1) the increasing availability of advanced, militarily sensitive technologies from non-U.S. sources—not just Japan and Western Europe but also the newly industrializing countries; (2) the increasing scope of commercial technologies that have military applications; (3) the growing dependence of the U.S. defense establishment on foreign components and allied collaboration in leading-edge research and development.

These new realities create crosscutting pressures. On the one hand, the increased scope and availability of strategically significant technologies make compelling incentives to control their flow to the Soviets. On the other hand, these same factors, together with the web of technological interdependence in the West, reduce the capacity of the United States to impose controls unilaterally without incurring increasingly high commercial and political costs. The perception of these rising costs has triggered an effort to ease restrictions put in place by the Reagan administration. Looking ahead, Merrill does not see the imposition of unilateral sanctions as a viable alternative but rather urges U.S. policymakers to reach out to an increasing number of Western and newly industrializing trading partners to create a control "common market" of militarily sensitive technologies.

Robert R. Bruce, in his discussion of telecommunications, illustrates dramatically how national governments have been overwhelmed by the pace of technological change. Bruce points out that the process of deregulation in telecommunications, both domestically and internationally, has been only one source of pressure. The profusion of information-based services being developed has further contributed to a tangle of unresolved problems ranging from basic definitions through the provision of market access. Despite the impact of the Reagan administration in setting an international agenda of privatization in telecommunications, Bruce maintains that U.S. policymakers have major responsibilities to help U.S. firms participate in overseas markets where national governments still exercise commanding influence. Simply to rely on U.S. technological leadership and the play of market forces will not suffice. Rather, the

United States has no choice but to engage in complex bilateral and multilateral negotiations in this sector of comparative U.S. advantage. Bruce draws the provocative conclusion that the mismatch between technological change and governmental response has damaged U.S. commercial interests because Washington has been unable to support them effectively on a global basis.

In Part II, Ernest H. Preeg and Alan J. Stoga offer penetrating but different appraisals of U.S. prospects vis-à-vis the developing countries. They concur on the central point that no single shorthand reference, such as "the Third World" or "South" captures the growing diversity of the developing countries. The differential in their economic performance as well as their importance to the United States have been reflected in U.S. policy. Preeg and Stoga agree further that Washington must confront development challenges from an economically constrained position. The federal budget deficit has reduced prospects for both bilateral and multilateral assistance. The interlocking of U.S. financial exposure to the developing world and debtor country dependence on U.S. export markets promise to limit the margin of U.S. maneuverability all the more.

Preeg nonetheless sketches a comparatively hopeful scenario based on the implementation of policies now in place, while Stoga concludes that a complete reassessment of U.S. strategy is needed including consideration of second and third best options. Preeg identifies a number of underlying trends in the developing world that augur well for U.S. policy. He sees a positive side to the austerity that has been imposed on middle-income debtors since the early 1980s: namely, their being forced into a more efficient, market-oriented allocation of resources that provides a solid foundation for future growth. Preeg also sees the breakup of the developing countries as a single negotiating block as a welcome sign of pragmatism, which enhances the likelihood of successfully integrating middle-income nations into the GATT and IMF structures. Looking ahead, Preeg sees two additional underlying factors that will draw many developing countries closer to the West—the impact of the information technology revolution and the displacement of authoritarian regimes by market-oriented democracies. Against this background, Preeg contends that there is a window of opportunity to work out of the international debt-austerity cycle along lines proposed by U.S. Secretary of the Treasury James Baker in 1985. Success will require much creative diplomacy and modest increases in resources but no new vision.

Stoga draws a much gloomier balance sheet. While granting that the international financial system has successfully muddled through since the debt crisis of 1982, Stoga points to high costs on all sides.

The debtors have suffered stunning losses in growth and per capita income that, over the long term threaten the recent transition toward democracy. The United States not only has lost overseas markets as a result of debtor country austerity but also has absorbed the brunt of the indebted nations' drive to service their obligations by increasing export earnings. This, in turn, has contributed to the rising tide of U.S. protectionism and corresponding disenchantment with the overall U.S. role in the world economy. Notwithstanding the recent improvement in U.S. commercial bank balance sheets, Stoga sees little prospect for implementing the Baker proposal to stimulate growth through fresh capital flows to the developing world.

In this setting, according to Stoga, the United States has no choice but to rethink its position. A U.S.-led revitalization of the world economy through a multilateral trading system, the World Bank, and the IMF would be a best solution, but the United States seems to lack both the will and the means to recapture the role it played in the 1950s and 1960s. A strategy of shifting more global economic responsibilities to Japan and West Germany has been attempted by several recent administrations, but progress has been disappointingly slow. Failing these preferred options, the United States should give more weight to its bilateral ties with developing world countries of major economic and political importance—even at the risk that such bilateralism will further erode multilateral institutions.

What balance should the United States strike between its stake in the multilateral framework that has underpinned the world economy since 1945 and its stake in bilateral ties with key countries? This vital question, raised by Preeg and Stoga in the context of global economic development, applies equally to U.S. international economic strategy overall.

Irving S. Friedman, drawing on four decades of experience with the IMF and the World Bank, contends that these institutions should remain the linchpin of U.S. policy toward the developing world. The premise for U.S. leadership in both the Bank and the Fund remains valid: namely, that global prosperity best serves the interests of the United States. Friedman is decidedly optimistic with respect to the future of the IMF. Already, the Fund has assumed important new responsibilities in managing the international debt problem. Its objectives, policy orientation, and lending procedures are clearly understood and universally applied. The Fund has the capacity to play an enhanced role in stabilizing international exchange rates and providing additional global liquidity should it be called on to do so.

Friedman has a more guarded prognosis for the World Bank, which, in his eyes, lacks a sense of mission and unifying general philosophy. The recent shift of the Bank's focus from long-term project lending to short-term policy lending has proven difficult. Even though the Bank has always been headed by an American, the U.S. government has not provided as much direction as it has to the Fund. Such direction is necessary to fill current gaps in the Bank's performance.

Looking outside the international financial institutions, Cynthia Day Wallace asks how much the United States can rely on foreign direct investment to advance its interests in the developing world. Wallace notes that the slowdown of growth and virtual halt of commercial bank lending to many developing countries has renewed their interest in foreign direct investment. However, constraints on such investment are still widespread, and the scale of private-sector resources available remains limited. Wallace sees favorable prospects but no *deus ex machina.* Moreover, following the reasoning of Robert R. Bruce, she concludes that there is no viable substitute for an internationally negotiated regime to allow market forces to operate smoothly.

In Part III, Lawrence Veit argues against the need for U.S.-led structural revision of the international monetary framework. He examines the breadth of national interests in the stability of the exchange-rate system, its capacity to reflect changes in economic fundamentals, and in the value of the dollar itself during any given interval. Veit sees no practical alternative to the current system of floating rates, yet he contends that U.S. interests demand a conscious, activist policy toward the dollar. Although the forces that determine its value are wide-ranging and at best partially understood, Washington can still have a controlling impact through the macroeconomic course it sets. In international matters, if not in trade, the United States retains wide latitude for action and should make use of it selectively.

Penelope Hartland-Thunberg sees severe structural deficiencies in the multilateral trading system that are being pointed up by China's application to join the GATT. While supporting the political rationale for bringing China more fully into the world economy, Hartland-Thunberg contends that the actual process of doing so raises two basic problems that have long been ignored or avoided: how to manage relations between market and centrally controlled economies; and how to adjust the responsibilities of the developing countries, which have thus far been relieved of GATT's most important obligations to provide open markets and reciprocal, nondiscriminatory treatment to trading partners. Despite its selective adoption of market-oriented policies, China remains a centrally directed economy with enormous potential to affect world markets in sectors in which it concentrates resources. Should China be admitted to the GATT with all of the prerogatives of a developing country, resulting economic disruptions could easily overshadow projected political gains.

The momentous issues posed by China's application, according to Hartland-Thunberg, should trigger a searching effort to readjust the GATT: first, by establishing more effective grounds than those now in place for dealing with nonmarket economies on bedrock questions of reciprocity, subsidies, and discrimination; second, by coming to grips with the problem of "graduating" developing countries to assume their full measure of responsibilities within the multilateral trading system. Hartland-Thunberg warns that adjustments of this magnitude may not be possible in a consensus-bound, one-nation one-vote organization. A redistribution of power within the GATT, giving more weight to those nations with a greater stake in trade, may be required.

Henry R. Nau sees an opportunity within the current GATT structure to accommodate the priority interests of the newly industrializing economies and the West. The United States and other OECD nations need developing world markets for the rich array of technology-based services they can provide. The NICs, in turn, need sustained access to Western markets in such politically sensitive industrial sectors as steel, textiles, and shoes if they are to generate the export earnings to sustain growth. It should be possible to negotiate a tradeoff along these lines in the current Uruguay round. Nau finds progress to date disappointingly slow, yet he attributes the lack of movement more to failings of political leadership than to structural flaws in the GATT itself.

Gary C. Hufbauer and Jeffrey J. Schott see little prospect that either multilateral or bilateral negotiating approaches will yield a dramatic improvement in the U.S. trade position between now and 1990. Even with the sharp decline of the dollar, Hufbauer and Schott forecast $100 billion plus merchandise trade deficits. In their view, the strongest surplus countries—Japan and West Germany—seem unwilling to relieve pressure on the U.S. market by serving as locomotives of global growth. The conclusion of a U.S.-Canada free-trade agreement notwithstanding, the contentious bilateral issues that dominate U.S. agendas with the European Community, Japan, and the NICs focus more on trade restriction than liberalization. The GATT round cannot be expected to produce concrete results on "traditional" trade problems (subsidies and import safeguards) or the "new issues" (services, investment, and intellectual property rights) for the next several years. At best, U.S. negotiators can only aim for preliminary agreements in the GATT to provide credibility for the negotiating process while seeking to contain protectionist pressures at home.

Robert L. Paarlberg reaches the provocative conclusion that U.S. international interests in agriculture will be advanced more quickly by restructuring domestic farm policies than by relying on protracted GATT negotiations. Paarlberg asserts that resistance to change is so great internationally that the United States cannot afford to hold itself hostage to a multilateral negotiating process in sectors where it retains significant advantages. Thus far, U.S. farm policies have helped support world prices by limiting production in wheat, corn, soybeans, and other cereals. If the United States liberalizes its own policies, it has the leverage in world markets to prompt adjustments by others.

It would be presumptuous to suggest that the contributions to this volume provide any more than a starting point to the development of international economic strategy. Beyond the insights they afford on specific issues, they indicate two essential guideposts:

First, the United States must face up to a demanding domestic agenda to sustain its capacity for international economic leadership. The federal government has a limited but essential role to play in this regard. Its most immediate requirement is to move the nation toward living within its means by producing a macroeconomic policy that reduces consumption, increases savings, and promotes growth. More broadly, domestic policies must be formulated to take account of the internationalization of the U.S. economy, whose exposure to outside forces has created demands for greater innovation, higher productivity, more mobility of resources, and a growing capacity to operate globally. A substantial consensus has emerged in recent years for the measures that are needed to improve the long-term performance of the U.S. economy. The bipartisan commitment needed to implement them is lacking.

Second, the widely shared defensiveness regarding the U.S. role in the world economy that has taken hold must be overcome. For many, the explosion of the trade deficit and of foreign indebtedness mark an adverse flow of global economic power that can only be checked if the United States makes full use of its ultimate leverage—access to its domestic market. The chapters in this volume suggest a more balanced interplay of global economic forces that, while posing some severe problems, has also left the United States with a number of gains and with more varied sources of influence than protectionist threats. Neither the economic balance sheet nor U.S. security objectives warrant the adoption of a neomercantilist view of U.S. interests. The rest of the world will take its cue from the tone as well as the substance of U.S. economic diplomacy. The call for U.S. leadership from other countries remains strong, and its prospects will be greatly enhanced by a forward-looking approach.

CONTENTS