ECONOMIC INTERACTION IN THE PACIFIC BASIN

LAWRENCE B. KRAUSE and SUEO SEKIGUCHI, editors

brookings

LAWRENCE B. KRAUSE AND SUEO SEKIGUCHI
Editors

Economic Interaction in the Pacific Basin

A study sponsored jointly by the Brookings Institution and the Japan Economic Research Center

THE BROOKINGS INSTITUTION
Washington, D.C.

Library of Congress Cataloging in Publication Data:

Main entry under title:

Economic interaction in the Pacific Basin.

Includes bibliographical references and index.
1. Pacific area—Foreign economic relations—Addresses, essays, lectures. 2. Monetary policy—Pacific area—Addresses, essays, lectures. 3. Pacific area—Economic policy—Addresses, essays, lectures. 4. Pacific area—Economic conditions—Addresses, essays, lectures. 5. Foreign trade promotion—Pacific area—Addresses, essays, lectures. I. Krause, Lawrence B. II. Sekiguchi, Sueo.
HF1411.E252 338.91'9 79-26006
ISBN 0-8157-5028-5
ISBN 0-8157-5027-7 pbk.

1 2 3 4 5 6 7 8 9

THE BROOKINGS INSTITUTION is an independent organization devoted to nonpartisan research, education, and publication in economics, government, foreign policy, and the social sciences generally. Its principal purposes are to aid in the development of sound public policies and to promote public understanding of issues of national importance.

The Institution was founded on December 8, 1927, to merge the activities of the Institute for Government Research, founded in 1916, the Institute of Economics, founded in 1922, and the Robert Brookings Graduate School of Economics and Government, founded in 1924.

The Board of Trustees is responsible for the general administration of the Institution, while the immediate direction of the policies, program, and staff is vested in the President, assisted by an advisory committee of the officers and staff. The by-laws of the Institution state: "It is the function of the Trustees to make possible the conduct of scientific research, and publication, under the most favorable conditions, and to safeguard the independence of the research staff in the pursuit of their studies and in the publication of the results of such studies. It is not a part of their function to determine, control, or influence the conduct of particular investigations or the conclusions reached."

The President bears final responsibility for the decision to publish a manuscript as a Brookings book. In reaching his judgment on the competence, accuracy, and objectivity of each study, the President is advised by the director of the appropriate research program and weighs the views of a panel of expert outside readers who report to him in confidence on the quality of the work. Publication of a work signifies that it is deemed a competent treatment worthy of public consideration but does not imply endorsement of conclusions or recommendations.

The Institution maintains its position of neutrality on issues of public policy in order to safeguard the intellectual freedom of the staff. Hence interpretations or conclusions in Brookings publications should be understood to be solely those of the authors and should not be attributed to the Institution, to its trustees, officers, or other staff members, or to the organizations that support its research.

Foreword

ECONOMIC INTERDEPENDENCE among countries of the Pacific basin has increased even faster than it has among nations generally. Most of the countries whose economies have grown most rapidly in the recent past, apart from those that produce oil, have Pacific shorelines; the same countries have also recorded the greatest increases in international trade. This fact suggests that the strengthened economic links among those countries have increased not only their prosperity but also their exposure to the unfavorable economic developments of the 1970s.

This study investigates the transmission of economic impulses among six countries chosen to be representative of the entire Pacific basin: Australia, Japan, the Republic of Korea, the Philippines, Thailand, and the United States. It compares their economic performance during the turbulent 1970s and examines the domestic and international effects of the economic policies pursued by individual governments.

The strength of the economic influence that Japan and the United States exert on each other has long been recognized. Its importance impressed Lawrence B. Krause, a Brookings senior fellow, and Sueo Sekiguchi, a senior economist of the Japan Economic Research Center, during their collaboration in 1973–75 as contributors to *Asia's New Giant: How the Japanese Economy Works,* edited by Hugh Patrick and Henry Rosovsky (Brookings, 1976). Krause further investigated the international transmission of economic impulses and its influence on the macroeconomic performance of individual countries in his contributions to *Worldwide Inflation: Theory and Recent Experience* (Brookings, 1977), of which he was coeditor (with Walter S. Salant). Research for the latter book stimulated Krause's desire to study the transmission of economic impulses among the countries of the Pacific basin and to put the bilateral relations between Japan and the United

States into better perspective. Krause thus found it natural to renew his collaboration with Sekiguchi, and the project culminating in the publication of this volume was undertaken jointly by Brookings and the Japan Economic Research Center.

The editors were fortunate in recruiting as contributors Ross Garnaut, professor of economics at the Australian National University; Hee-yhon Song, director of research for the Korea International Economic Institute; Romeo M. Bautista, professor of economics at the University of the Philippines; and Nimit Nontapunthawat, formerly of the economics faculty of Thammasat University and now senior economist and special assistant to the president of the Bangkok Bank.

A conference was held at the Japan Economic Research Center in June 1977, at which Yasukichi Yasuba and Chikashi Moriguchi of Kyoto University, Makoto Sakurai of the Japan Export Import Bank, and Masahiro Sakamoto of the National Institute for Research Advancement made substantial contributions that clarified issues and improved the manuscript. Parts of the manuscript were also reviewed by Yoichi Okita of the Economic Planning Agency and Ippei Yamazawa of Hitotsubashi University.

Professor Garnaut gratefully acknowledges the assistance he received from his discussions with his colleagues H. W. Arndt, W. M. Corden, P. D. Drysdale, and P. T. McCawley at the Australian National University and with the participants in a seminar in international economics at Hitotsubashi University. He also acknowledges the research assistance of Rod Sims and John Collis. Professor Bautista thanks John Power for reviewing a draft of the chapter on the Philippines.

Research assistance was also provided by Yasutoyo Shoda, Takahiko Mutoh, and Kumiko Mizutani of the Japan Economic Research Center and by Cynthia Nethercut, David Bates, and Stephen Smith of Brookings. The manuscript was edited by Alice M. Carroll, and the index was prepared by Florence Robinson.

The project was supported by grants from the National Institute for Research Advancement and the Sloan Foundation. The views expressed in this book are those of its contributors and should not be ascribed to the other staff members, officers, or trustees of the Brookings Institution, to the Japan Economic Research Center, to the National Institute for Research Advancement, or to the Sloan Foundation.

BRUCE K. MACLAURY
President, the Brookings Institution

HISAO KANAMORI
President, the Japan Economic Research Center

January 1980
Washington, D.C.

Economic Interaction in the Pacific Basin

Contents

Tables

CHAPTER ONE

Economic Disruption in the 1970s

THE WORLD ECONOMY in the 1970s became much more unstable than it had been in the preceding two decades. Indeed a new age of economic uncertainty seems to have commenced. Inflation has increased sharply. Economic growth has declined and unemployment has risen. Exchange rates have become much more unstable. Even international trade, the most reliable of all barometers of world economic health, has suffered a setback.

Practically all countries suffered inflation peaks in the first half of the 1970s, but some conquered inflation in the second half, while others made almost no dent at all in it. Oil exporting countries aside, many countries witnessed a sharp deceleration in their rates of economic growth, others a quite moderate decline. Exchange-rate instability by necessity affects everyone, but some countries tried for and achieved a degree of stability, while others accepted almost complete flexibility. With respect to international trade, some countries managed extremely high rates of export growth, while others suffered stagnation.

Differences in economic performance among countries can be traced to the peculiar circumstances in which each found itself and to the economic policies it adopted. As usual, policy differences reflect a host of political as well as economic factors. However, to an unusual extent, countries felt that their problems, particularly with respect to inflation, were more the consequence of disturbances arising abroad than of their own actions. For instance, in the early 1970s the United States witnessed its price and wage controls undermined by increases in world agricultural and commodity prices and then suffered along with everyone else the historic rise in oil prices. Japan had a similar experience but also found its inflation moderated by the rise in the exchange value of the yen which it could not control. In smaller countries such as Norway and Sweden the belief became widespread that these economies were incapable of affecting their own price performance and thus were totally at the mercy of external forces.[1]

The world economy seems to have reached a kind of watershed in 1973–74. Obviously the change was brought on by the oil crisis. It was a time of testing for all countries. The size of the disturbance was so great, its complications so far-reaching, that the adjustment capabilities of all countries were severely challenged. Some countries proved to be quite adaptable, but others were hardly able to cope. The world instability and the inability of individual countries to control their economies have focused attention on the international transmission of economic impulses. The tendency of impulses that originate in one country or in world markets to have an impact on other countries may well be an inevitable consequence of greater economic interdependence.

The Political Context of Economic Policy

Particular national policies are chosen of course for political as well as economic reasons.[2] Economic interdependence may lead to increased real national incomes, but it has also created problems for government and certain segments of society and heightened tension in international relations. Tension has been created because governments have lost some ability to control their economies. Their short-term policies are threatened by fluctuations from abroad that are both hard to predict and difficult to recognize (in part because of lags in statistical reporting). Their medium-term policies aimed at industrial development may be frustrated or vitiated by technological or other developments abroad. Even long-term policies governing such matters as the distribution of income and wealth in their societies may be complicated by foreign involvement. For instance, the perceptions of equity and efficiency on which their policies are founded may change. When change is

1. For theoretical models and econometric tests demonstrating this external dependence, see Odd Aukrust, "Inflation in the Open Economy: A Norwegian Model," and Lars Calmfors, "Inflation in Sweden," in Lawrence B. Krause and Walter S. Salant, eds., *Worldwide Inflation: Theory and Recent Experience* (Brookings Institution, 1977).

2. See Robert O. Keohane and Joseph S. Nye, "World Politics and the International Economic System," in C. Fred Bergsten, *The Future of the International Economic Order: An Agenda For Research* (Heath, 1973).

rapid, current events are hard to comprehend and the future difficult to envision. Though governments retain political sovereignty over their own lands, their economies are affected by a wide range of events over which they have little control.[3]

Yet governments now are held responsible in the public mind for good times and bad. Inflation, unemployment, low growth, poverty, all are the fault of the government. Even natural disasters can cause people to blame the government for not taking proper precautions or failing to respond rapidly or effectively. No regime, whether democratically elected or not, can ignore public reaction to economic conditions. Governments are quick to claim credit when the economy goes well. But they are held responsible also when things go badly, even though they may attempt to place the blame elsewhere.

Governments so frequently blame foreigners for their economic troubles that when inflation is imported, their argument is not believed. Yet the domestic economy may be faced with a problem the government had not predicted or a solution whose costs in unemployment it cannot justify. Some people blame the government, which in turn becomes unhappy with its foreign economic ties. Others blame foreigners directly, adding more tension to international relations.

The complexity of economic issues increases the difficulties. In responding to the fourfold increase in oil prices in early 1974, for instance, how could a government, assuming it had the instruments to deal with domestic consequences, sort out the domestic from the international factors? The oil price rise had all of the following effects on oil importing countries: it increased domestic inflation through its effects on costs; it caused a decline in real income by deteriorating the international terms of trade as import prices rose more than export prices; it caused a substantial decline in the balance of trade; it caused a windfall to domestic energy producers (if there were any); it increased the demand for capital and labor that could substitute for energy or could be used in energy production; and it increased the prices of energy-intensive goods and services relative to other goods. In such circumstances should the government cushion the shock on the economy by slowing down the adjustment but risk misallocation of resources, or should it reinforce the price change, speeding up the adjustment but aggravating the short-run disruption? Should the government encourage saving to fight the inflation and provide the real resources to match the higher need for capital but thereby intensify the depressing effects of the decline in real incomes already suffered, or should it offset the real decline by stimulating the economy to maintain

3. Ralph C. Bryant describes the problem as a "mismatch of domains." *Money and Monetary Policy in Interdependent Nations* (Brookings Institution, 1980).

current levels of activity but run the risk of greater inflation and the worsening of the country's trade position? Should it levy increased taxes on domestic energy producers in order to capture for society some of the windfall gains but run the risk of discouraging present and future levels of domestic energy production, or should it encourage domestic energy production to increase self-sufficiency and obtain greater economic security but thereby make domestic income distribution less equal and run the risk of long-run commitment to high-cost energy and faster exhaustion of domestic energy resources?

Difficult as it may be to identify what is good for the country as a whole, choices must be made. Those choices will differ among countries as their economic and political structures differ. Natural endowments, product markets, labor markets, and financial markets affect economic responses. Though governments cannot expect other governments to behave as they do, most tend to evaluate other countries' policies in a framework relevant to their own economies. The more difficult problem of governments is not doing what is right, but knowing what is right.

Assembling a coherent national policy is not a simple matter. Most governments are organized so that different agencies represent particular constituencies and thus express different points of view in the formulation of national policies. The compromises necessary in shaping policies may well produce inconsistencies. Energy conservation as a principal instrument to fight an oil crisis, for example, might require a rise in the prices of all energy-intensive products. To offset the rise in the price of fertilizer, farmers might be given subsidies that encourage its use and therefore run counter to conservation goals.

But even assuming that a coherent and reasonably consistent policy can be determined, it will be subjected to a plethora of implementing decisions at the operating level that generally will weaken its direction and often will be at cross purposes. Top political leaders will perceive themselves to be frustrated by their bureaucracy, but the real culprit is the complexity of the issues. Those issues are made more complex by the foreign influences that impinge at many points and make policy coherence even more difficult to obtain. No wonder that governments are frustrated and political leaders ambivalent about economic interdependence.

Transmission of Economic Impulses

This study examines the questions of why inflation rates differ between countries, how much inflation is imported, what accounts for differences in growth rates, and how cyclical instability is transmitted from one country to another. It reviews the responses of six countries in the Pacific basin to a series of economic upheavals in the 1970s and analyzes the effects on their economies.[4] In a comparison of the analytical results, it indicates how disruptive particular kinds of international links may be. Finally, in considering the economic policies adopted in response to external impulses, it suggests national and regional actions that may help to spread economic benefits rather than increasing international instability.

Economic impulses are transmitted between countries through many channels.[5] The balance of payments, the accounting framework for international transactions, contains and reflects information on some of the most powerful forces in the transmission mechanism: prices of exports and imports, trade volumes, goods and services balances, capital flows, direct investment, and overall monetary balances.[6] These records of world trade and financial flows offer a means of calculating and comparing the impact of international economic fluctuations on national economies.

Each of these factors is heavily influenced by the exchange rate. It is the most important factor governing economic relations between countries. It is also the single most important price in an economy because it links all domestic prices to those in the rest of the world. A change in the exchange rate between two currencies, for instance, changes the prices of goods and services in one country relative to the other and creates expectations of further changes which may ignite capital flows. The change is seen as a rise in the value of one currency and a fall in the other. Hence it produces dissimilar economic effects. Appreciations in the exchange rate can be used to moderate increases in import prices or to restrain increases in demand for exports. Changes in goods and services balances can be restrained by appropriate exchange-rate changes.

4. An eclectic approach to macroeconomics is incorporated using Keynesian and monetary analysis, with econometric elaborations introduced occasionally. For a discussion of the mainline theories of market economies, see Alexander K. Swoboda, "Monetary Approaches to Worldwide Inflation," and William H. Branson, "A 'Keynesian' Approach to Worldwide Inflation," in Krause and Salant, *Worldwide Inflation*. Econometric investigations are described in Robert James Ball, ed., *The International Linkage of National Economic Models* (Amsterdam: North Holland, 1973).

5. For an analytical discussion of the transmission of inflation, see Walter S. Salant, "The International Transmission of Inflation," in Krause and Salant, *Worldwide Inflation*.

6. Some economists would confine balance-of-payments analysis to the overall monetary effect. See Harry G. Johnson, "Money, Balance-of-Payments Theory, and the International Monetary Problem," *Essays in International Finance*, no. 124 (November 1977).

The effects of changes in exchange rates on the domestic economy are far-reaching, and some of them occur after long lags. An appreciation, for example, will discourage exports and encourage imports, reducing profits and therefore investment in export and import-competing industries; it will also encourage investment abroad by domestic firms. The consequences of exchange-rate changes are an important factor in analyzing any economic phenomenon under a floating-exchange-rate system.

Four World Crises

Serious economic disruptions in the 1970s repeatedly outstripped the capacity of economists to describe the devastation the disruptions caused. In rapid succession, the breakdown in the Bretton Woods monetary system, the rise in raw material prices, the oil crisis, and the deep worldwide recession and weak recovery deteriorated economic performance and caused massive increases in worldwide inflation. Governments became progressively more timid because of their concern to counteract the inflation. Even in 1978 when Japan had conquered inflation and wholesale prices were falling, the government was reluctant to increase its stimulus for fear that a rise in the fiscal deficit would rekindle inflation. Other countries that tried aggressive demand-stimulating measures found that financial markets anticipated the inflationary consequences and that the result was more inflation rather than real growth. The disruptions affected not only single countries but all countries and led to structural changes of varying importance.

The Breakdown of the Bretton Woods System

From the end of World War II until March 1973 the international monetary system was governed by a set of rules and understandings designed to prevent a return of the monetary chaos of the 1930s.[7] Under the Bretton Woods agreement, countries were obliged to establish par values for their currencies (in terms of either gold or the U.S. dollar) and to defend those values by intervening in the foreign-exchange market. To prevent the exhaustion of international reserves, the International Monetary Fund stood ready to help deficit countries. But the heart of the system was the obligation of countries—both deficit and surplus—to make internal economic adjust-

7. See Lawrence B. Krause, *Sequel to Bretton Woods* (Brookings Institution, 1971); Robert Solomon, *The International Monetary System 1945–1976: An Insider's View* (Harper and Row, 1977); and Thomas D. Willet, *Floating Exchange Rates and International Monetary Reform* (Washington: American Enterprise Institute, 1977).