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Leonard Silk

THE UNITED STATES AND THE WORLD ECONOMY

The year 1986 severely tested the ability of the United States to provide the leadership needed to prevent a threatened breakdown in the ever more closely integrated world economic and financial system. Dangers to the system have resulted from the high volatility of exchange rates, huge imbalances in trade and growing protectionism; these have been compounded by the inability of developing countries to meet their debt obligations, continuing fears of inflation in the midst of sharp declines in oil and commodity prices, sluggish growth in the industrial and developing countries alike, persistent overcapacity and unemployment. Aggravating the strains of clashing national interests were uncertainty and conflict among the major nations of the West over the right policies for solving this complicated set of problems.

If solutions are to be found, it is crucial that the leading industrial nations come to a common understanding of how to avoid repeating the mistakes that caused the Great Depression and the political disasters that flowed from it.

After World War I, and the inflations released by it, the major countries adopted highly restrictive monetary policies, which by the end of the 1920s choked off economic growth. The trend toward world deflation was reinforced by countries' mistaken foreign-exchange policies. In Britain the pound sterling had fallen to $3.44 in November 1920, but it was restored to its prewar dollar parity of $4.86 when Britain returned to the gold standard in 1925. Britain felt compelled to adopt excessively tight money to hold it there. The results were falling prices, economic slump, climbing unemployment and "the dole." In France, by contrast, the franc was undervalued after the war, and the large inflow of gold and foreign exchange put intense pressure on other countries, including the United States. In the United States restrictive tariff legislation was passed, especially the 1930 Smoot-Hawley Act, which hurt

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other countries and forced them to engage in severe deflation to maintain the exchange rates of their currencies. The Great Depression stemmed from the postwar boom—and from the deflationary measures some countries adopted to maintain their exchange rates.

Today there are some similarities to that earlier crisis, but there are important differences, including exchange-rate flexibility, an awareness of the danger of thrusting the world into a deflationary spiral, a recognition of the destructiveness to the system that unbridled protectionism would bring, and an understanding that fiscal and monetary policy can be used to stimulate the recovery of a national economy. But, despite some intellectual and political progress, divisions persist over how each nation can best pursue its self-interest—whether by holding down inflation and keeping its currency sound or by promoting economic expansion for the system as a whole. After the long post-World War II boom that lasted until the early 1970s and was followed by oil shocks, inflation and stagnation, the world economy is again suffering from overcapacity and high unemployment. Economists and politicians are searching for a way out of the dangerous bind—a way that can bring economic recovery without rekindling the inflation that compelled them to take the disinflationary steps that have led to the present unemployment. In a closely integrated world it is risky for any single nation, even the largest economy in the world, acting alone, to pursue a strongly stimulative policy without weakening its trade position and its financial structure—and without posing a threat to the international system.

II

The threat to the system was intensified by the United States' large and growing "twin" deficits in the federal budget and in foreign trade, and hence by the nation's growing foreign debt and dependence on the massive inflow of capital.

In fiscal year 1986 the U.S. budget deficit reached a record $221 billion, raising the national debt above $2 trillion, double its level in 1981 when President Reagan took office. The reasons for the vast increase in the public debt during the Reagan years are by now all too familiar: (1) the failed theory that so-called supply-side tax cuts would generate such an upsurge of national growth and tax revenues as to provide for expansion in both military and social expenditures; (2) the failed theory (or ideology) that curtailing the growth of federal

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revenues would force a curtailment of the nonmilitary activities of government (sometimes denominated "the Reagan Revolution"); (3) the rapid military buildup, and (4) the shortfall of revenues resulting from the unexpected and steep recession of 1981–82 and from the overall slow economic growth, with real gross national product increasing at an average rate of only 2.4 percent per annum during the first six years of the Reagan presidency.

While the budget deficits have been the focus of public and congressional anxiety, the strains on the American economy and the international system have been exacerbated by the less noticed growth of private debt. Business borrowing has grown rapidly, much of it to finance highly leveraged mergers and acquisitions, and so has borrowing by farmers, real-estate investors and consumers. Total American debt, private and public, has grown to nearly $9 trillion, more than twice its level at the start of the decade. Debt in recent years has grown much faster than the national economy. For two decades before 1982 total debt had held steady at 160 percent of the rising gross national product; in the past four years the ratio of total debt to GNP has leaped to 200 percent. This means that large numbers of business firms and individuals have put themselves in a more difficult position to repay debts if the economy turns down.

The rapid growth in private debt during the late 1970s and early 1980s was based on inflationary expectations; borrowers believed that the rising value of the assets they acquired and the declining value of the money they would use to repay their loans would more than justify the high interest rates they had to pay. Lenders and investors took big risks in the belief that inflation would bail out even unsound loans and investments. But the drop in inflation resulting from the sharp American and world recession of 1981–82 revealed the dangerous overborrowing that had gone on in the inflationary era.

The drop in inflation is doubtless the greatest achievement of the Reagan Administration. It resulted chiefly from the restrictive monetary policy pursued by the Federal Reserve under Paul A. Volcker, a policy which the Administration sometimes criticized as the cause of the recession but essentially supported. In 1986 the inflation rate as measured by the rise in consumer prices fell to 1.5 percent, its lowest rate since 1964, when the Vietnam military buildup was not yet in full sway. But the victory over inflation has been a costly one, and in 1986 the costs of both the inflation and stopping the inflation

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were still being paid. In the past year many farmers and oil producers were severely hurt or ruined when commodity and oil prices fell. Some 1,500 banks—about one out of every ten in the nation—were on the regulators' list of financially troubled institutions. One hundred and fifty banks failed in 1986, more than in any year since the Great Depression. Hundreds of technically insolvent savings and loan institutions were being kept afloat by regulators who did not want to exhaust the reserves of the Federal Savings and Loan Insurance Corporation.

Despite anxieties over the weakened financial structure in real estate, agriculture, energy, mining, manufacturing and banking, the wave of debt creation rolled on in 1986. What kept it rolling were the vast debts incurred, often through so-called junk bonds—high-interest, high-risk bonds—to finance mergers and acquisitions, as well as the debts incurred by corporate managements to fight off hostile mergers or acquisitions. As 1986 drew to a close, the revelation that the well-known arbitrager Ivan F. Boesky had agreed to pay $100 million in settlement of charges of insider trading brought by the Securities and Exchange Commission dealt a shock to Wall Street and the nation.

But "junk bonds" and such defensive devices as "poison pills" and "shark repellants" were only part of the reason total debt in the United States continued to grow rapidly in 1986; the growth was also fed by aggressive lending by financial institutions seeking to achieve a positive spread between their current rate of return and their current cost of money, by the drive of banks and thrift institutions to lend at floating or variable rates, pushing interest-rate risks onto borrowers, and by the interest-rate bargains or "buy downs" offered by auto companies and home builders seeking to make sales in a time of weakening consumer demand. Many businesses, unable to finance repairs, replacements or current operating costs, increased their debts simply to stay afloat. The drive to expand mortgage credit, much of it on a minimum down-payment basis, brought on a big increase in delinquencies and foreclosures on both homes and commercial properties as real-estate prices declined in many parts of the country, such as Texas and Oklahoma, which were hard hit by the slump in energy and farm prices.

A 1985 study by the New York Stock Exchange concluded that the health of American corporations had been endangered

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by excessive debt.[1] During 1986 nearly 70 percent of all corporate borrowing was short term; this is an extraordinarily high level. The "quick" ratio (liquid assets as a percentage of short-term corporate liabilities) fell to its lowest postwar level. The "interest coverage" ratio (pre-tax corporate profits to interest payments) was at a historically low level.

The danger is that if the United States' financial structure is further weakened by a worsening of the ratio of debt to gross national product, the outcome could be an increase in business failures (already at their highest postwar level), especially if the economy turned down. If, on the other hand, the monetary authorities were to go too far in trying to prevent a downturn, then inflation, high real interest rates and an overvalued dollar would continue to hurt American competitiveness in world markets.

III

The nation's internal and external economic problems are closely connected. The huge and growing public and private borrowing has pushed real interest rates above those in other competing countries. High interest rates, while essential to attract foreign capital given the inadequacy of saving by Americans, made the U.S. trade deficit worse. The capital inflow, by bidding up the value of the dollar, hurt American exports and import-competing industries, and caused the loss of many American jobs—some estimates run as high as two million—by forcing lay-offs and plant closings at home and shifts of production to foreign locations. The overvaluation of the dollar has not only helped to keep unemployment up but has also augmented the shift of jobs from goods to service industries, and in many cases to lower-paid jobs.

There are other factors involved in the job losses and job shifts, including the relatively high level of American wages, the spread of medium- and low-technology industries to other countries (including poor, developing countries) and the failure of American management to modernize as rapidly as foreign competitors, particularly Japan and the newly industrializing countries of Asia. Added to these problems are the low rate of national savings, the high cost of capital and the low return on

[1] "The Financial Health of U.S. Corporations: An Update," New York Stock Exchange Economic Research, July 1985.

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capital investment in the face of worldwide overcapacity in steel, chemicals, minerals and other basic industries.

Throughout the world the problems of sluggish growth, financial instability, Third World debt and trade imbalances are interlocked—and lie at the heart of America's problems. As Nobel laureate Lawrence R. Klein has put it, both the U.S. budget and trade deficits and the related problems of sluggish growth, overcapacity and unemployment are "endogenous" to the world economic system. It now appears that these problems cannot be solved by the United States alone but must be solved within the context of that wider system.

The orthodox solution for a nation's problems of insufficient growth, overcapacity and unemployment—orthodox, that is, since the Keynesian revolution—has been for the government to increase the demand for the goods and services that a nation has the capacity to produce, and hence increase the derived demand for labor. And the prescription for increasing demand has been to cut taxes, step up government spending and enlarge the budget deficit. This prescription, crowned by the enormous deficit-financed war effort in World War II, ended the depression of the 1930s; it has been used, in combination with an accommodative monetary policy, under both Republican and Democratic administrations in arresting and reversing all the postwar recessions—including the steep recession of 1981–82. Some economists still consider the Keynesian macroeconomic approach for combating the business cycle the right prescription.

But the huge buildup of budget deficits and total national debt, along with the nation's increased dependence on international capital inflow, makes it difficult and even dangerous, perhaps impossible, for the United States to escape its burdens simply by increasing total demand through still greater increases in public or private borrowing. The harvest could be heightened inflationary pressure, a slowing inflow or actual outflow of foreign capital, a decline in investment, a further loss of international competitiveness, more people out of work and a worsening of protectionism, with ominous implications for the world economy and polity.

What do these new conditions and dangers imply for economic policy? The greatest change required appears to be that the unit for policy thinking must become the world economy rather than the national economy, although this flies in the face of traditional national politics and economic pressures.

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National policymakers must be concerned with the wider community of interests, thinking not only about conflicts with adversaries but about mutually supportive relations with allies and trading partners as well. Whether or not the current U.S. Administration is able to tackle the problems facing the world economy, the challenge is of such magnitude that it will be with us for some years.

IV

Since the end of the Second World War the United States has assumed the leadership of the free world and the primary responsibility for rebuilding and integrating the world economy. But Charles F. Kindleberger, in his presidential address to the American Economic Association a year ago, said the United States has lost its appetite for providing the world with what he called "international economic public goods."[2] These are goods and services which benefit the entire international community but for which individual consumers, businesses or nations are not necessarily willing or able to pay, such as open markets for the goods of other countries in times of glut, supplies in times of acute shortage, steady flows of capital to developing countries, international money, the coordination of international economic policy, and a willingness to be the lender of last resort in times of financial crisis.

Without a nation strong enough and responsible enough to play the role of leader, the international financial system is in peril. The need for an international lender of last resort, a role played by Great Britain through most of the nineteenth and early twentieth centuries, is greater than ever today with more massive flows of capital and goods, instantaneous communications and shiftability of funds, a plethora of transnational banking and industrial organizations, and the buildup of Third World debt to the trillion-dollar level. Unless the United States regains its ability and willingness to sustain nations in danger of default or builds a collective defense with Japan and others, there could be a financial disaster comparable to those of 1873, 1890 and 1929, or an even greater one.

One reason for the current danger is that the United States, like Great Britain after 1890, has lost economic power relative to the rest of the world. Although it remains the largest and

[2] Charles F. Kindleberger, "International Public Goods Without International Government," *American Economic Review*, March 1986, pp. 1–13.

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most important economy in the world, a relative loss of power has been causing the United States to turn inward and focus on its own imperiled interests. "The contraction of concern from the world to the nation," said Mr. Kindleberger, "is general, and applies to economists as well as to politicians and the public."[3] While there had been a recent upsurge of interest in the international dimension, the focus of this interest, he maintained, had been almost exclusively on what the connections mean for U.S. interest rates, trade and industrial policy, growth and wealth.

Nevertheless, even within these economic constraints and the pressures of American interest groups that feel themselves adversely affected by foreign nations, the Reagan Administration, under the leadership of Treasury Secretary James A. Baker, has been struggling to play the role of leader and provide "international economic public goods." The Administration has sought open, or at least partially open, markets in a time of gluts; enhanced flows of capital to developing countries in a time of anxiety among banks about their existing overexposure; international money in a time when the dollar is overvalued and the American trade position and balance of payments are extremely weak; and policy coordination among the major industrial countries in a time when other governments, like the United States, are increasingly preoccupied with their own problems and, in some cases, have begun to regard "coordination" as inimical to their national interests. A critical concern for the future is to make sure that the United States, or some group of nations including the United States, is prepared to play the role of lender of last resort should an international financial crisis develop.

Secretary Baker's difficult task is to advance American interests by pressing other countries to share the responsibilities and burdens of providing international public goods. Since the Plaza meeting of September 22, 1985, of the Group of Five—at which Japan, West Germany, Britain and France agreed with the United States that the dollar needed to be lowered against their currencies—the U.S. Treasury has been pursuing a dollar-devaluation policy in order to cut the trade deficit, restrain congressional protectionist pressures and force monetary support for the United States on Germany and Japan.

The dollar did come down sharply, at least against the

[3] *Ibid.*, p. 9.

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German mark and the Japanese yen. But as 1986 wore on, it became less clear whether the U.S. dollar-devaluation policy would fit in with the aim of reviving stronger and more stable world economic growth or whether it might even be harmful—especially if it wound up sending the dollar into a free-fall.

After the middle of the year Japan and West Germany resisted further depreciation of the dollar: Japan feared the loss of export markets and Germany worried about the regeneration of domestic inflation. The United States urged both countries, if they wished to avoid further dollar depreciation against their currencies, to use fiscal and monetary policy, especially cuts in interest rates, to spur the growth of their domestic economies, to help increase the demand for American exports and sustain the debt-ridden developing countries.

On the eve of the September 1986 meetings in Washington of the International Monetary Fund and the World Bank, a dispute surfaced between Treasury Secretary Baker and Federal Reserve Chairman Volcker over the need for further dollar devaluation. In congressional testimony, Mr. Volcker said he thought the dollar had declined enough and that other policy measures were needed to reduce America's trade deficit, but Mr. Baker seemed to be threatening further dollar devaluation unless the Japanese, the Germans and their European partners did more to stimulate their economic growth. Mr. Baker's pressure evoked a heated response from the European finance ministers and central bankers, meeting in Gleneagles, Scotland, who warned that, to prevent a further dollar decline, they would intervene in the currency markets. At the IMF meeting in Washington, President Reagan reinforced Mr. Baker's warning that the dollar would sink further unless the other industrial countries took action to accelerate their growth. But the stalemate continued.

The Europeans insisted that the problem of global imbalance in trade and exchange rates was the United States' fault, a consequence of its huge and continuous budget deficits. They contended that the United States had failed to deliver on its part of the Plaza agreement—bringing down the budget deficit as the Europeans and Japanese accepted the further depreciation of the dollar. Indeed, the American budget deficit had swollen further in the year since the Plaza agreement, and the other governments blasted away at this failure.

President Reagan sought to deflect this criticism by declaring that he would act more strongly than ever to get rid of the

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budget deficit. His "highest task," he said, was "curbing the growth of our government's spending." "No nation," he declared, "can survive if Government becomes like the man who in winter began to burn the wall boards of his house to keep warm until he had no house to keep warm." His Administration had "made progress against those who would condemn future generations to pauperdom." His main weapon against them, he declared, was the Gramm-Rudman-Hollings law, which mandated a steady course to a balanced budget in 1991. "I pledge to you," he declared to the 151 nations assembled at the IMF meeting in Washington, "that I will do all in my power to stop this fiscal death march."

Yet, as the fiscal rhetoric escalated, foreign disbelief that the United States would act to cut its budget deficit deepened; it was believed that the United States was instead trying to put the burden of readjustment on other countries by urging them to reflate their economies and reduce their competitiveness.

The Germans were particularly adamant in refusing to play "locomotive" for the world economy; they maintained that they had taken on that role once before, in response to the blandishments of the Carter Administration, but had weakened their economy in the process and would not do so again. Chancellor Helmut Kohl and Finance Minister Gerhard Stoltenberg insisted that the German economy was already growing quite fast enough. They said that the problem of unemployment—the jobless rate was hovering close to nine percent—was mainly a structural, not a cyclical, problem; it needed to be solved from the supply side, through greater mobility of labor and flexibility of capital. The president of the Bundesbank, Karl Otto Pöhl, resisted American urgings that the German central bank cut its discount rate and step up the growth of the money supply, asserting that the money supply was already growing too fast in Germany.

The Japanese were more responsive to Secretary Baker's campaign for greater cooperation in the interests of world economic stability and growth. In late October, Mr. Baker and Finance Minister Kiichi Miyazawa worked out a bilateral agreement stating that action by the key industrial countries was "critical to promoting world economic growth, reducing imbalances, and resolving international debt problems." As part of the accord, the Japanese government agreed to cut the discount rate of its central bank and to submit a more stimulative budget to the Diet. But less than two months later, on

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December 25, 1986, the Japanese government approved the smallest spending increase in three decades. "It is hard to find revenue sources for more public works projects," said Miyazawa.

V

As the American initiatives vis-à-vis Japan and West Germany demonstrate, the United States in 1986 adopted a policy of "aggressive bilateralism," which was intended to promote its own economic interests but at the same time to forge coalitions that it hoped would keep the world economy stable and growing. In defending the pressure that the United States was putting on Japan and Germany to expand their economies more rapidly, Secretary Baker insisted that this policy was not aimed primarily at expanding the market for American goods but at preventing a breakdown in the world economy. "We feel that we are engaged in a life or death struggle here to preserve the world economy," he said. And, in the wake of the November congressional elections in which the Democrats gained control of the Senate, Mr. Baker said that the election outcome should prove to the Germans, the Japanese and America's other trading partners that "we were not crying wolf" in warning that a mood of populism, isolationism and protectionism in the United States posed an increasing danger to the world economy.

The effort to make bilateral deals with key partners represented a shift from the multilateralism that had characterized U.S. international economic policy during the period when it led the way in the construction of the great postwar international economic institutions, including the International Monetary Fund, the World Bank and the General Agreement on Tariffs and Trade. But aggressive bilateralism also marked a shift from the go-it-alone tendencies of the Reagan Administration during its first term, founded on an exaggerated view of America's economic strength. During his first term, President Reagan and his then secretary of the treasury, Donald T. Regan, hailed the capital inflow to the United States as a tremendous vote of foreign confidence in the American economy and regarded the rising dollar as evidence of the nation's vigor and the Administration's successful policies. In the second term, however, with Mr. Regan moving to the White House as chief of staff and Mr. Baker taking over as secretary of the treasury, dollar machismo gave way to a policy of dollar deval-

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uation. But the policy of dollar devaluation as a means of stabilizing and regenerating world economic growth ran into problems in 1986.

Mainly as a result of the 40-percent fall in the dollar against the yen, Japan suffered a severe slowdown. Its export industries lost profitability and sales, especially to its competitors in South Korea, Taiwan and other newly industrialized countries, which had prevented their currencies from falling significantly against the dollar. The Baker-Miyazawa agreement was achieved because Japan recognized that, to safeguard its export markets, it needed to halt further dollar devaluation against the yen. Germany, feeling less threatened by the loss of the American market (a minor part of its export sales) and relatively secure within the European Common Market (where the bulk of its exports go), rejected the American threat of further dollar devaluation.

Within the U.S. government there were differences of view, especially between the Federal Reserve on one side and the Treasury and the White House on the other, on how far to push dollar devaluation. The Fed tended to worry more about inflation and the danger that the dollar would fall out of control and cut off foreign capital inflow, while the Treasury and the White House pressed for what were known as "pro-growth" policies, fearing that recession posed a greater danger for the United States and the world economy than inflation. The world could live with inflation, they reasoned—it had done so through the 1970s and early 1980s—but serious recession could trigger a collapse of the world debt structure and bring on deflation and depression.

Another problem troubling policymakers last year was that the U.S. trade deficit continued to worsen despite the depreciating dollar and falling oil prices. It ran at about $175 billion in 1986 compared to $132 billion in 1985. Most economists thought the widening trade deficit reflected the normal lag in the so-called J-curve. During the initial period after a currency devaluation, according to this theory, import costs rise and export earnings decline as foreign competitors, determined to hold on to market shares, are slow to raise prices. But, as their profit margins are squeezed, they do eventually raise prices, causing a drop in their sales as cheaper domestic goods are substituted for imports, and the trade deficit shrinks. Late in 1986, following declines in the trade deficit in August, September and October, the consensus view of private and official

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economists was that the J-curve was at the turning point and that 1987 would see a marked improvement in the trade deficit, which would help keep the economy growing. But a huge jump in the trade deficit in November to a record monthly level of $19.2 billion shook confidence that a more favorable trend had begun.

At best, the improvement in the trade deficit was expected to be slow. Japan and other foreign competitors, despite the currency devaluations, were still holding down their export prices in a world suffering from unemployment and overcapacity. The outlook was for sluggish growth in the world economy to continue, thus limiting the demand for American exports; and other countries had invested heavily in facilities to serve the American market and would not readily give up. Major U.S. trading partners, including Canada, Mexico and other Latin American countries, had not allowed their currencies to rise much, if at all, against the dollar and were unlikely to swell the demand for American exports. A policy problem facing the United States was whether to press these other countries to accept dollar devaluation against their currencies; but their own unemployment and depressed industries and agriculture implied strong resistance and possibly worse political relations, increasing the risk that further dollar devaluation would be counterproductive.

There was the further risk that, unless the United States moved more decisively to eliminate the budget deficit, the trade deficit would persist anyhow. As Clayton K. Yeutter, the U.S. trade representative, put the problem at the Congressional Summit Conference on World Debt and Trade in New York in early December: "We have contributed mightily to the trade imbalance by allowing our Federal budget deficit to outgrow our total available savings." Warning that Congress might lack the "political patience" to await a trade turnaround, Mr. Yeutter warned: "We seem poised as a nation to shoot ourselves in the foot just as our trade situation is beginning to improve."

President Reagan, politically weakened by the Republicans' loss of the Senate and by the Iran/contra affair, could have greater difficulty in staving off protectionist legislation from the new Congress. Legislators, however, were looking for ways to avoid naked protectionism that would virtually force retaliation, and so were foreign governments. The hope was that ways could be found to reduce trade imbalances by a positive "market-opening" approach that would enable the United

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States and others to increase their exports of services, high technology, intellectual property, agricultural products, and trade-related investment.

Belief that this market-opening approach might be possible was encouraged by the meeting of the GATT contracting parties at Punta del Este this past fall, launching the Uruguay Round of Multilateral Trade Negotiations. Although the meeting at Punta was more successful than had been expected, it left two major issues unresolved—agriculture and services. Worries remain that it will be a long and hard struggle to contain and reverse protectionist forces.

In the strained world economic environment, many governments will be hesitant to rush into the Uruguay round and commit themselves to an extension of tougher trading rules on agricultural products and other goods and services. The United States itself is in an ambiguous position. In recent years at economic summit conferences and in other forums it has pushed hard for another GATT round; yet it has itself adopted protectionist measures and is resorting to an aggressive bilateralism toward its most important trading partners. At the end of the year, the Administration said it would impose a 200-percent tariff on a broad range of agricultural exports from the European Common Market; Mr. Yeutter said the purpose was to force the Europeans to settle American claims of $400 million resulting from losses on grain sales due to the entry of Spain and Portugal into the European Community.

Other countries are also trying to decide whether bilateral or multilateral approaches, or some mixture of both, are more likely to best serve their interests. Canada, for example, has sought to initiate bilateral negotiations with the United States to create a wider "free trade zone." But finding the Reagan Administration by turns inattentive, sharply critical of particular areas of Canadian protectionism, and more than ready to take countermeasures against them, Canada appears to be wavering between bilateral and multilateral approaches to the trade problems.

For the world system as a whole, multilateralism offers greater efficiency and equity and the prospect of policy coordination among the industrial countries, and between them and the developing countries. As Sylvia Ostry, Canada's ambassador for multilateral trade negotiations, has argued, coherent development of Secretary Baker's plan for increasing the flow of public and private capital to the developing countries

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requires not only enhanced cooperation between the IMF and the World Bank but also the contribution of GATT, so that trade in financial services can become a key element in the development process.

During 1986, its first full year in operation, the Baker plan made only slow progress, but enough to show the critical contribution that a coherent multilateral approach can make. A money package supported by the IMF, the World Bank and commercial banks was quickly put together to help Mexico, which was thrown back into economic crisis by a severe earthquake, falling oil prices and government mismanagement. The World Bank negotiated policy-oriented loans for eight major debtors for a total of about $3 billion, and discussions were under way with 11 countries for an additional $4.7 billion. The IMF negotiated standby programs and surveillance arrangements with 11 major debtors. The commercial banks, still reluctant to increase their exposure in the debtor countries, did make a few new loans, completed multiyear reschedulings with the Ivory Coast and Yugoslavia and launched rescheduling talks with Bolivia, Morocco, Nigeria and Uruguay. New money packages were under discussion with Mexico and Nigeria, and an oil facility loan for Ecuador was nearly completed. Colombia raised $40 million through an eight-year bond issue in the Japanese market. And a number of countries were moving to adopt debt-equity swaps with foreign lenders. Secretary Baker, while cautioning that it would take time to achieve lower debt service ratios for the debtor countries, noted that they had been helped significantly by the more than five-percentage-point decline in interest rates since 1984, which would save the major debtors $14 billion annually.

The most important change introduced by the Baker plan was its stress on growth rather than austerity as the crucial strategy for rescuing the debtor countries. But the Baker plan's critics insisted that, while this growth strategy represented a significant conceptual advance, it was not supported by enough new money from the industrial countries or by strong enough measures for bringing down interest rates, converting debt to equity and forgiving part of the Third World debt.

The United States, however, is not ready to go much beyond the original Baker plan, feeling strapped for funds to do more and unwilling—perhaps unable—to lean harder on the private banks and international agencies. Some American businessmen, led by James Robinson, chairman of American Express,

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have been urging Japan to do more to aid the developing countries; indeed, Mr. Robinson has proposed that Japan, now the world's biggest creditor, launch a "Marshall Plan" for the developing countries. At the start of the new year, Japan, after running a trade surplus in 1986 of nearly $90 billion, announced a multilateral aid program of about $9 billion over three years. But neither Japan nor any other country seems ready to shoulder the burden of aid-giver comparable to that which the United States assumed after World War II on behalf not only of its allies but also of its wartime enemies, Japan and Germany. Indeed, with memories of the Japanese and German bids for world dominance during World War II still very much alive, there is ambivalence in the United States and other Western countries over how large an international leadership role Japan and Germany should be urged to play. In any case, neither country wants to take on those international responsibilities. Forty years after the war, the United States is still having the leadership role thrust upon it.

VI

How can the United States best perform that international role?

To do the job in a world in which the line between domestic and international economic policy has been rubbed out, the United States must set its own financial affairs in order. This means, first of all, tackling the structural deficit in the federal budget that has aggravated the trade deficit and made the nation so dependent on capital flows from abroad.

How hard and how quickly to hit the budget deficit is both a political and an economic problem. To hit it too hard in the economy's current state, with the economy growing so slowly as to be on the verge of a recession, might be to plunge it into the unwanted recession; some economists warn that all-out efforts to reduce the budget deficit would repeat the mistakes of the Hoover Administration and the early Roosevelt Administration, which, in futile efforts to balance the budget, raised tax rates and aggravated the depression.

But to fail to deal with the budget deficit at all might be to worsen foreign and domestic fears about the American debt and the fiscal irresponsibility of its political system, and to heighten the risk that foreign capital inflow would become a massive capital outflow that would reduce savings available for

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investment, force up interest rates and intensify recessionary forces.

The inflow of foreign capital to finance the trade deficit has thus far helped to sustain American living standards by enabling Americans to consume more than they produced. But the cost of amortizing and servicing the growing foreign debt is steadily rising. If the United States is to halt that rise, it must eliminate the deficit in its current-account balance of payments and even achieve a surplus that will enable it to repay or at least service its foreign debt.

How much damage to the American standard of living would result from eliminating the trade deficit would depend on whether the deficit is eliminated chiefly by raising exports or cutting imports, and whether it is done within a pattern of economic growth or stagnation. Eliminating the U.S. trade deficit chiefly by expanding exports would mean higher employment and output, thereby offsetting some or all of the costs of consuming less than the nation produces. To achieve that goal requires that America's trade deficit be wiped out within a pattern of domestic and international economic growth; in fact, it is difficult to believe that the world economy will go on expanding if the United States falls into a slump.

This takes us back to the problem of the federal budget deficit. Solving the budgetary dilemma—and it is a genuine dilemma, with the danger of undesirable outcomes from trying to cut it too much or too little—requires widening the frame of the problem. Domestically, that means that steps taken to reduce the deficit by cutting government spending or by raising taxes need to be offset by a monetary policy aimed at bringing down interest rates to help keep the economy growing.

For the United States, with its heavy dependence on foreign capital, to shift to a tighter budget and an easier monetary policy, aimed at increasing national savings and reducing interest rates, will require international cooperation, especially a willingness on the part of America's major partners to stimulate their own economies and to sustain world economic growth, which the United States has spurred but can no longer sustain alone. Specifically, the other major countries ought to bring down their interest rates as the United States lowers its rates, to prevent the dollar from plunging and inflicting worse disorder on the world monetary system. The aim of convergent monetary policies, however, should not be to keep the dollar

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where it is but to move it significantly lower while also easing the world economy into a "soft landing."

Theoretically an overall redesign of the world monetary system might be desirable, but practically the United States is likely to try to work bilaterally or with small groups of countries to solve its own problems and strengthen the international system, much as it has done in the past year and a half, starting with the Plaza agreement among the Group of Five in September 1985. This was followed in March 1986 by a G-5 coordinated reduction in central bank discount rates; in April by a second round of discount-rate cuts by the G-5 minus Germany; in May at the Tokyo economic summit by an agreement among the G-7 (the United States, Japan, Germany, Britain and France plus Canada and Italy) on new arrangements for closer policy coordination; in September by an agreement of G-7 finance ministers for a multilateral surveillance exercise; and in October by the Baker-Miyazawa agreement. "These six steps," said Mr. Baker, "are only a start. We need to build on them while keeping our expectations within reasonable bounds."

All this is certainly "reasonable"; it may even be the best that can be done in the existing circumstances. But the question is whether it is good enough, given the dangers facing the American and world economies, the persistent trade and exchange-rate misalignment, the spreading protectionism and the precariousness of the debt-ridden developing countries.

VII

In sum, there are no "technical" solutions to the economic problems the world is facing. What is most needed is political will—the will of the United States to deal more effectively with its own problems and the will of all the major industrial countries to work together for a common end. It is easy enough to say that, with the lessening of American dominance and the diffusion of economic power, Japan and Germany must accept wider international responsibilities and join the United States in efforts to prevent a crack-up after the greatest period of growth the world economy has ever experienced.

But if that cooperative spirit is lacking, a crack-up could indeed come, with severe political as well as economic consequences. The political consequences could include a cut by the United States in its military support for Europe and Japan, if their investors were to start unloading dollar assets and building their own regional redoubts, and that would mean a weakening

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of the defenses against aggression. In a sense, we have been here before. It is the knowledge of what could lie ahead if we fail to work together that may be the main reason to hope that we will not let it happen again.

The most important aim of economic cooperation in the year ahead will be to keep the world economy moving forward. For within a pattern of growth the serious problems of world debt, trade and currency imbalances can be contained, and progress can be made toward their solution.

At the end of the 1920s it was the resort by individual nations to unduly restrictive monetary and fiscal policies and to "beggar-thy-neighbor" protectionism, in the presumed self-interest of each, that caused the Great Depression. That blunder must not be repeated. The greatest change needed to preserve stability and growth is for the world economy, rather than the national economy, to become the unit for policy thinking. Despite the resistance of traditional national politics and interest-group pressures, the development of internationally integrated monetary and fiscal policies has become vital to the economic well-being of every country.

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