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REVIEW & OUTLOOK

The Liberal Majority

With all the crying and moaning in Washington about trade, it sometimes seems as if no one's a free-trader anymore. Maybe the Silent Majority is beginning to speak up. A new study by some of America's business leaders argues that the postwar liberal trading system remains the best route to a prosperous U.S. future.

The study by the Committee for Economic Development, "Breaking New Ground in U.S. Trade Policy," is especially welcome because trade politics follows the Squeaky Wheel Rule: Producers demanding protection get the headlines. Yet the CED is composed of chief executives from some 250 companies spanning the breadth of the U.S., and for that matter the global, economy. Its trade subcommittee includes execs from Northern Telecom, Cargill, Pfizer, Citicorp, Emerson Electric, AT&T, Goodyear and Caterpillar, among others.

They aren't jumping on the mercantilist bandwagon. "Careful examination of both historical experience and current conditions has convinced us that open markets remain the best route to broad-based improvements in economic growth and prosperity, for both the United States and its trading partners," concludes the CED study. Someone ought to jetpack this over to Max Baucus, Dick Gephardt and the other neo-mercantilists on Capitol Hill.

Of course, the CED knows that a world of perfectly free trade doesn't exist. But rather than imitate trade offenders, the CED thinks U.S. interests lie in using a careful "stair-step strategy for opening markets." This means first using the multilateral GATT process, then negotiating with an offender and only as a last resort using the unilateral retaliation in the so-called Super 301 trade law. One such negotiation yielded results last week on supercomputers with Japan.

Even then, adds the report, we need to understand that the act of retaliation amounts to failure. The foreign market stays closed, "the U.S. consumer must pay higher prices, and the system of international trade which we have helped to craft has been weakened." In short, everyone loses and we ought to retaliate only very rarely and only in a "market-oriented" way (tariffs, not quotas).

The CED also stresses that a U.S. leadership role on trade is essential to maintaining this liberal order. By committing trade sins ourselves, the U.S. loses leverage needed to open markets in services, intellectual property and industries of the future. "The United States has, and will continue to have, global economic concerns and it is in our best interest to prevent fragmentation of the world economy," the report says.

We suspect these executives have reached their conclusions because they're in the forefront of the global economy. They understand that it's increasingly difficult to determine what is a "foreign" or "domestic" company. Edmund Fitzgerald, chairman of Northern Telecom and of the CED trade subcommittee, points out that his company has its "headquarters" in Canada, but most of its sales are in the U.S. It employs about as many Americans as Canadians. A big chunk of its shares are owned by Americans. Whose company is it anyway?

Or consider the protectionist applause line one so often hears that only one U.S. company, Zenith, still makes TV sets. Well, the nearby chart, adapted from an article by Robert Reich in the January-February Harvard Business Review, shows some of the others who were making TVs here in 1988. The list has grown since. The workers in Anaheim or Braselton figure that those are American TVs, even if the sets carry names like Sharp or Sony. Mr. Reich points out that an American now has a better chance of buying a U.S. car if he buys a Honda than a Pontiac Le Mans. When Honda reaches its goal of exporting 50,000 cars a year from Ohio to Japan, it'll make more cars here than in Japan.

The disconnect between politics and the real economy reached a comic high last week in Congress. Pennsylvania's Republican Senator John Heinz introduced into the Congressional Record a speech by a Caterpillar executive supporting open trade. Yet he somehow felt obliged to denounce the speech and the liberal trading system at the same time. Who has more credibility? A company that employs thousands and sells $5 billion a year outside the U.S.? Or a wealthy Senator who already made his fortune in ketchup pandering for protectionist votes?

The liberal trading system has served Americans well for 40 years. We hope more executives will follow the globally oriented lead of the CED and let our politicians know the way the world really works.

TVs–Made in the USA

COMPANY	PLANT	LOCATION	EMPLOYEES	ANNUAL PRODUCTION
Goldstar	Total	Huntsville, Ala.	400	1,000,000
Hitachi	Total	Anaheim, Calif.	900	360,000
JVC	Total	Elmwood Park, N.J.	100	480,000
Matsushita	Assembly	Franklin Park, Ill.	800	1,000,000
Mitsubishi	Assembly	Santa Ana, Calif.	550	400,000
Mitsubishi	Total	Braselton, Ga.	300	285,000
Philips	Total	Greenville, Tenn.	3,200	2,000,000+
Samsung	Total	Saddle Brook, N.J.	250	1,000,000
Sanyo	Assembly	Forrest City, Ark.	400	1,000,000
Sharp	Assembly	Memphis, Tenn.	770	1,100,000
Sony	Total	San Diego, Calif.	1,500	1,000,000
Thomson	Total	Bloomington, Ind.	1,766	3,000,000+
Toshiba	Assembly	Lebanon, Tenn.	600	900,000
Zenith	Total	Springfield, Mo.	2,500	N.A.

Total manufacturing involves more than the assembling of knocked-down kits.
Source: Electronic Industries Association, HDTV Information Center, Washington, D.C. 1988

'A Conventional Lobbying Group'

The American Bar Association's House of Delegates voted recently to support abortion on demand. The abortion issue itself aside, this particular vote revealed an awful lot about just what the ABA has become. It didn't matter that the president of the ABA had warned that "by no stretch of the imagination" did the abortion

rather than lawyers with corporate or government experience. "Litigators as a class are not disposed to value coherence in the law," he said. "After all, the more uncertain the law, the more litigation will take place."

The ABA has become so partisan, Judge Silberman said, that it may be "as improper for judges to belong to

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Pegging the Pound Was Where Lawson Erred

LONDON—Last week the British displayed unusual political immaturity. The Chancellor of the Exchequer, Nigel Lawson, resigned because Prime Minister Thatcher would not fire her trusted adviser, Sir Alan Walters. The opposition Labor Party leader, Neil Kinnock, in a display of the male chauvinism typical of the British lower class, denounced Mrs. Thatcher for having an independent mind and refusing to heed the men in her Cabinet. The British press, making a mountain out of a molehill, precipitated an unnecessary economic crisis by portraying Mrs. Thatcher as an autocrat who had thrown economic policy into confusion by driving a respected figure from her government.

Europe

By Paul Craig Roberts

Behind the silly posturing lies a real dispute. Mr. Lawson and his European-minded colleagues want the British pound formally tied to the West German mark. Sir Alan considers this an ill-advised and costly policy. As there is an effort to "anchor the dollar" either to gold or other currencies, the dispute is worth examining.

Until his resignation, Mr. Lawson had been conducting British monetary policy as if the pound were tied to the mark. When Mrs. Thatcher cut the top tax rate to 40%, Mr. Lawson flooded the country with money to prevent the pound from rising against the mark. As a result, he reignited the inflation that Mrs. Thatcher, through a long and costly effort, had subdued.

With inflation surging, the pound began falling against the mark. To keep the exchange rate pegged, Mr. Lawson tightened monetary policy and pushed interest rates up to 15%. This doubled the mortgage interest rates of the many new homeowners that Mrs. Thatcher's policies had created, producing widespread disaffection and pushing Labor ahead in the polls.

Instead of realizing his mistake in letting the exchange rate dominate both British economic policy and Mrs. Thatcher's political fortune, Mr. Lawson pushed for tying the pound formally to the mark by entering the European Monetary System, which subordinates all member currencies to German monetary policy. This put Mrs. Thatcher in a bind. The concept of European integration is one of those grand schemes that appeal to intellectuals, the media and the imagination, but are full of practical pitfalls.

If the pound had been tied to the mark, the British would have been unable to cut their exorbitant tax rates. The reason is simple. When a country cuts tax rates, it makes itself more attractive to investors and drives up the value of its currency.

It was fear of disturbing EMS exchange-rate relationships that caused the Chirac government in France to be timid about cutting tax rates. Edouard Balladur, the finance minister at the time, was sold on the tax-cut policy but was concerned that his government would be criticized as anti-European for disturbing the linked European currency relationship.

The price of attracting capital—whether one's own or that of foreigners—is a trade deficit. To avoid this deficit Mr. Lawson inflated the pound in order to prevent its rise. This misguided policy could not prevent a British trade deficit. Consequently, Mr. Lawson saddled Mrs. Thatcher with a record trade deficit, renewed inflation and high interest rates—three political failures in a row. Little wonder that Mrs. Thatcher's opponents were so anxious to keep Mr. Lawson in office.

It is extraordinary that the British Treasury thought it could prevent a trade deficit by inflating the pound. The British balance-of-payments statistics show that after the top tax rate was cut to 40%, the flow abroad of British capital slowed, to 50 billion pounds ($79 billion at the current rate) in 1988 from 93 billion pounds in 1986. This change in the British capital account required an offsetting change in the trade account, a change that could not be prevented by pegging the currency.

Nigel Lawson was a victim of the immense confusion in thought that has been characteristic of Western financial circles during the 1980s. The most important governments have ignored the role of low tax rates in attracting real capital investment, instead emphasizing financial flows in response to high interest rates. This has led them in a fruitless and destructive policy circle. First comes monetary expansion to drive down the currency's value that was pushed up by tax-rate reduction. Then, when the currency falls, interest rates are raised to attract financial flows in order to stabilize the exchange rate. This policy is totally mindless, and Sir Alan is correct to point out its deficiencies.

Britain and all of Europe need to reconsider the prospects for European integration in light of the possible reunification and neutralization of Germany. A unified Germany that remained within the Western alliance would give Germany such an overshadowing position that all other members of a unified Europe would become vassals of the German state. Unless the Soviet Union collapses, German reunification is likely to require Germany's neutralization. The implications for Britain, France and the rest of Europe of having their currencies tied to the economic policy of a neutral country need considering before we judge Mr. Lawson's resignation to be unfortunate.

In the least, we must recognize the futility of trying to use exchange-rate intervention to offset the effects of tax-rate reduction on capital flows.

Mr. Roberts was assistant Treasury secretary under President Reagan.

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REVIEW & OUTLOOK

The Lawson Legacy

We're sorry to see Nigel Lawson's departure from the British government. He is a politician with the courage of true conviction, as in summarily sacking exchange controls and in particular slashing the top rate of income taxation to 40%. But in the end his resignation as Chancellor of the Exchequer may be a good thing, especially if it works as he no doubt intends—by forcing Prime Minister Thatcher and her counterparts elsewhere to confront the genuine intellectual issues involved.

The early omens, we admit, scarcely suggest so wholesome an outcome. The Fleet Street reaction was captured in the Guardian headline, "Departure Reveals Thatcher Poison." British politicians divide into two groups of chickens, those with their necks cut and those screaming the sky is falling. So far as we can see only two persons are behaving with a dignity recognizing the seriousness of the issues: Mr. Lawson and Sir Alan Walters, the counterpoint of the Chancellor's difficulties, who also resigned as personal adviser to Mrs. Thatcher.

The problem is that on the vital issue of monetary policy and exchange rates, conservative, free-market economists divide into at least three incompatible camps. There are the strict monetarists, who believe that floating exchange rates free an economy to stabilize its price level by stabilizing the monetary aggregates. There are the supply-side globalists, who seek to spread the advantages of a common currency through fixed exchange rates. And there are the twin-deficit Keynesians, who predict/advocate devaluations to balance trade flows. This is a problem not only for Prime Minister Thatcher but for President Bush, as shown in the ongoing bickering over the dollar between the Federal Reserve and the Mulford Treasury.

In the British case, Mr. Lawson is the closest thing in London to a supply-side globalist. He not only slashed marginal tax rates, initially sparking fresh growth in Britain, but he wanted to regulate monetary policy by targeting exchange rates, indeed joining the European Monetary System. While no doubt agreeing with Mr. Lawson on everything else, Sir Alan is a dyed-in-the-wool monetarist, inclined to defend floating rates to the death.

To make matters even more confusing, the earlier U.S. experience made clear that Mr. Lawson's tax cuts would have profound effects on Britain's international accounts and the value of sterling. They increased the after-tax rate of return and made Britain a far more attractive place to invest, producing sudden capital inflows. By accounting definitions, this had to produce a sudden trade deficit. As in the U.S., it also produced a sudden burst in the demand for sterling, that is a surge in the sterling monetary aggregates, M-Whatever.

At this point the options were: Crunch money to stop the boost in the aggregates, as Sir Alan surely advised, and forget the soaring pound. To push the pound even lower trying to cure the trade deficit, a policy Britain has repeatedly proved disastrous. Or to supply enough money to meet the increased demand and stabilize the exchange rate, as the Chancellor argued, and ensure the permanence of this policy by joining the EMS.

Faced with a similar situation, Paul Volcker let the dollar soar, (though monetary aggregates also grew so rapidly monetarists issued egg-on-the-face warnings of inflation). But this devastated the U.S. manufacturing sector, laying the seeds of protectionism. Mr. Lawson, though not allowed to join the EMS, chose to "shadow" the deutsche mark. He reaped inflation along with rapid growth, no doubt validating Sir Alan's predictions in the Prime Minister's mind. But more recently, the pound has been falling, with high inflation, which has also seemed almost impervious to the high interest rates Mr. Lawson deployed to stop it.

So the British experience presents a genuine puzzle that reaches far beyond the shores of Albion. We had been soliciting opinions on it long before Mr. Lawson's resignation, and offer some of the collection for the benefit of his successor and one-time deputy, John Major. To begin with, we should note that in contrast to the U.S. deficit, Britain has been running largish budget surpluses. In pursuit of this mystery, Keynesian adepts and twin-deficit mavens need not apply.

We should also add Mr. Lawson's own explanation, as we understand it. Unlike the U.S., Britain never achieved even a momentary reduction in real wages. The wage stickiness, which OECD studies confirm is particularly high in Britain, gives its economy a structural bias toward inflation. Inflation is easier to spark and harder to control.

We should also concede that in the British experience the monetarist cause regains some of the credibility it lost in the U.S. experience. Nearby Paul Craig Roberts, a distinguished supply-sider with monetarist sympathies, argues the case for Sir Alan. Perhaps the fiscal shock of tax cuts is after all best absorbed by floating rates, though of course in the event Mr. Lawson resigned over whether to support a weak pound, not restrain a strong one. We recall that Mr. Roberts not only chides the Chancellor for being too easy because of a desire to constrain sterling, but also led the chorus saying that Mr. Volcker was too tight when he let the dollar rise. Somewhere in between there must be a golden mean, perhaps measured by M-Whatever, but perhaps measured by purchasing power parity.

The globalists tend to think Mr. Lawson ran onto technical reefs. In fixing rates the choice of initial parities is crucial, for example, and perhaps he picked the wrong pound-DM rate. For that matter, perhaps he fixed to the wrong currency. We sympathize with Mrs. Thatcher's reluctance to tie her currency to one governed by the domestic political imperatives of West Germany. Perhaps the shock would have been less if they'd fixed to another low-tax, deregulated, supply-side economy.

Alan Reynolds of Polyconomics adds his suspicion that the unrecognized inflationary culprit is the budget surplus. Those who can shake Keynesian ghosts out of their heads might recognize that the retirement of gilts for cash is equivalent to an expansionary open-market operation, indeed, it is the *definition* of an open market operation to expand the money supply. Mr. Reynolds also notes that since British banks have no reserve requirements, high interest rates are less likely to curb inflation than to cause recession.

We would add that in political terms Mrs. Thatcher's problem was failing to decide between the Chancellor and her adviser. In the end, neither policy was followed, and instead of learning anything we are left with a mystery. In particular, "shadowing" a currency is anything but fixing; it is an open announcement that the exchange rate target has no credibility. All the more so when strong voices are heard opposing the policy. Better to have a true monetarist policy, just for the experience.

So Mr. Lawson had to resign. In the end his move was sparked by remarks in excerpts from Sir Alan's autobiography in The American Economist, a 10,000-circulation academic journal. But it was the underlying situation that became intolerable.

What Mr. Major and Mrs. Thatcher will do now remains to be seen. They confront stubborn inflation and a sagging economy, that is to say, stagflation. This cannot be solved by provoking a further downturn; reducing the supply of goods does not solve inflation. Our advice is this: Immediately return the government surpluses to the economy through incentive-maximizing tax cuts, and find some monetary policy target that balances both supply and demand for money (which neither aggregates nor interest rates can do). This was the version of supply-side economics that, in the late 1970s and early '80s, worked in America and world-wide to solve a far more serious stagflation than afflicts Britain today.

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