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A DOMESTIC APPROACH TO WORLD ECONOMY:
INTERNATIONAL ECONOMIC POLICY UNDER THE REAGAN ADMINISTRATION

BY

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The world economy is only as good as the national economies that comprise it. If the major national economies are sound, it is highly unlikely that international interactions will be perverse. On the other hand, if national economies are weak, it is doubtful that economic ties among them will produce anything but a weak world economy.

As self-evident as this proposition is, it was lost from view in the international economic discussions of the 1970s. In that decade, the problems of the world economy were traced to the malfunctioning of the international economic system itself. The increasingly sensitive and complex interactions at the global level, it was argued, overwhelmed national markets and eluded the understanding and, for sure, the control of national policymakers. Economic interdependence undermined national independence in economic policymaking, and national decision-makers could be forgiven for whatever policies they pursued nationally while they sought their salvation in the reform or even radical restructuring of the international economic system.

Surprisingly, this globalist view has received little critical analysis. The preoccupation with international solutions to remedy national policy dilemmas continues. The international economy, we are told, can no longer be defined as, or limited to, the mere intersections among national economies. For all practical purposes the international economy has absorbed national economies and "it is now the national economies which must be looked upon as an extension of a global and integrated system with a logic of its own."¹ 'Worldeconomy' dominates, and global policymaking has to lay the foundation for sound domestic policymaking.

¹See Foreign Affairs, Spring 1983. Albert Bressand, "Mastering the 'Worldeconomy',"

There is another point of view. It reverses the globalist logic and looks at the world economy from a domestic perspective. It regards sound domestic policies as the foundation of world economy, and effective national policymaking as a prerequisite of stable and mutually beneficial global policymaking. It emphasizes the need for convergence of domestic economic performance among major countries around a few fundamental indicators--low inflation, flexibility of markets and open international boundaries. If these conditions exist, interdependence flourishes and global policymaking reinforces national decisionmaking and domestic economic growth.

No one questions the growth in the role and importance of the world economy. World exports in 1960 comprised about 2.5% of total world output; by 1980 that ratio had grown to almost 17%. Even the latter figure understates the significance of international exchanges since traded goods in almost all countries exert a pervasive impact on national output, including that produced on an exclusively local basis. And these trade numbers say nothing about the explosion in capital and currency transactions in world markets that has taken place over the past twenty years.

Nevertheless, while the expansion of the world economy is unquestioned, the relative weight of national and international policies in influencing world economic relations is an issue of some moment. This issue goes to the heart of the political economy of international interdependence.

Those who view world economy as the dominant influence on domestic policy base their case on two fundamental arguments. First, a diagnosis of contemporary economic problems, they argue, suggests that these problems derive from the complex interaction and feedback of national policies upon one another in an open world economic system. These problems further

derive from the unmanaged and often inappropriate feedback and interrelationship among various elements of the world economy itself, e.g., a mismatch of trade and monetary relationships. Since the problems are exogenous to any national system, they can only be dealt with on a basis going beyond national policy. Second, it is argued, even if the problems were to a greater extent within the scope of national action, national decision-making processes are increasingly pluralized and fragmented and unable to produce timely and decisive actions to influence international economic problems. The loss of national control, a central theme of the globalist school of thought, is a consequence of internal atomisation as well as external absorption. National authorities face increasing paralysis and loss of legitimacy at home, even as they confront mounting uncertainties abroad.

Finding national decision making capabilities increasingly ineffective, globalists turn to international institutions, both existing and especially new ones, to put the pieces back together again. Paradoxically, they turn to international sources of power and authority which are even weaker than national institutions. The 1970s witnessed a never ending series of international conferences and proposals for new international organizations, from the Economic Summits of the Industrialized Countries to the U.N. special sessions and world conferences on food, population, environment habitat, science and technology, and ultimately Global negotiations, and from the Common Fund of UNCTAD to an International Seabed Authority and a World Development Fund. Somehow these fragile and discordant global "town meetings and offices" were going to muster the resolve and consensus to solve problems that defied the strongest national government authorities

around the world. Even if they failed, we were told, they would generate a more desirable atmosphere of cooperation and participation, moving away from the confrontation inspired by national actions.

The globalist case has dominated practical as well as academic discussions of international economic issues, so much so that a revival of national authority and a shift in focus from international to national policy solutions to the world's economic ills under the present U.S. Administration has been branded disdainfully, by critics at home as well as abroad, as economic nationalism or even worse, economic isolationism. Yet the thrust of economic events in the early 1980s, as well as the initial, though still uninsured, benefits of the present Administration's policies for the U.S. and world economies is making the case for a different approach to influencing world economic interdependence.

This approach, which for lack of better terms I will call a domestic or domesticist approach, differs from the globalist solution in at least three important respects.² First, it rejects the notion that national authority is obsolete or in decline and concentrates on reviving consensus and capacity to act at the national level. Instead of advocating international solutions, it seeks to buy time internationally to allow national authorities to discern the direction of international developments and then to develop the necessary political consensus at home to revitalize domestic economic conditions in line with perceived international trends. Second, while it agrees with much of the globalist's diagnosis of the complexities of the international system, it is mindful of the open market policies that created interdependence in the first place and that are hardly

²The terms here are arbitrary. The reader can substitute others if he or she wishes. Domestic and global, however, seem less emotionally charged than other dichotomies that have been used such as internationalist and nationalist or unilateralist and multilateralist.

irrelevant to the preservation and further promotion of such interdependence. Interdependence is not to be taken for granted as inevitable or inexorable. It is no more so today, the domesticist argues, than it was in the 1930s. Third, it sees international meetings and institutions, not as functional arenas for directly attacking world economic problems, but as political fora for exchanging basic views about domestic economy and defining the range of possible agreement on the interactive aspects of world economy. International meetings should facilitate national policymaking not substitute for it. If disagreements are too great, the issues should be elevated to the most general level or taken up in smaller groups where the prospects of arriving at a consensus are better. For the domesticist, world economy starts not in the logic of an integrated international system but in the logic of domestic politics and economic policy, extending to interactions among domestic economies but rarely to the unified globalist, institutional focus championed by world economy advocates.

The domesticist approach to world economy has much to offer, but its conceptual underpinnings are all but non-existent in the professional and public policy literature.³ This approach would seem to be on much more solid ground politically than its globalist alternative. The reliance on national rather than international authority is realistic. To seek refuge from national diversity in still greater international diversity makes little sense and, in time, making more concrete decisions at the international level will only redirect national divisions to international

³ A rare exception, which however was applied only to so-called global issues, not world trade and financial relations, was Robert L. Paarlberg. "Domesticating Global Management," Foreign Affairs, April 1976.

fora, further weakening the capacity for response. Can anyone image the immobilisme that would quickly afflict the Industrialized Country Economic Summits, if they increasingly made important economic decisions and the Congress and national parliaments, not to mention special interest groups, began to insist on a greater role in these decisions. After all, in a political sense, who do the seven leaders at these meetings represent? None of them represents the industrialized community of the Seven, let alone the industrialized countries as a whole. Running the world economy through Economic Summits or an Economic Security Council⁴ would be the equivalent of running the United States economy through a locally or state elected Congress without a national Presidency. In the absence of a global constituency, no international decision-making body that could be effective would be viewed as representative and any body that was representative would undoubtedly be ineffective, at least from the point of view of the health of the world economy. No, national authority remains the bedrock of international life, and any proposal to institutionalize global economic policymaking will be ineffective if it is representative (the fear for example with Global Negotiations) and unacceptable if it is unrepresentative, especially in a formal institutionalized sense.

The world economic community is neither ready for a global economic Presidency nor capable of surmounting national differences by end-running them through international meetings. The best we can hope for in the foreseeable future is to rely on national authority and an informal (i.e., non-institutionalized) international process of shaping consensus on how this national authority should be applied. International institutions

⁴ For this suggestion, see Robert D. Muldoon, "Ground Rules for an Open World Economy," Foreign Affairs, Summer 1973.

can follow from the prior existence of such a consensus among national policymakers, but they cannot force this consensus. Moreover, what remains critical is the nature of the consensus. The kinds of policies to be pursued at home as well as in the world economy are more important than the process or institutions by which these policies are arrived at. If these policies are conducive to an open world economy, interdependence and hence world economy will flourish and international institutions can be built on a solid foundation. If these policies are antithetical to an open world market, economic interdependence will shrink, even if international institutions are built.

Thus, a minimum of consensus on what economic policy objectives national authorities choose to pursue remains a prerequisite of an open international economy. No world economy can accommodate unlimited national differences on basic economic policy choices and still remain open. Here the domesticist is optimistic that, despite conservative, socialist, and all shades of intermediate approaches to economic choices at the national level, it is still possible to shape a minimum international consensus on fundamental economic objectives and performance. As I discuss below, these objectives and performance criteria are general enough to preserve the freedom and independence of national decision-making, while specific enough to constrain the global consequences and instabilities that would result without them.

Before leaving this initial discussion of domesticist and globalist alternatives it is essential to note that neither is exclusively domestic or global in its orientation. Hence, epithets such as unilateralist or

world order type are inappropriate to this discussion. The domesticist arrives at international imperatives through an analysis of the convergence or divergence of national policy choices. The globalist arrives at domestic imperatives through an analysis of international exigencies. Both care intensively about the world economy. Both believe that a sound world economy and a sound U.S. economy go hand in hand. Both are activist in seeking this objective. But they differ in how to reach this state of affairs. The domesticist believes more of the answer lies in sound domestic choices, the globalist in mastering the independent logic of an integrated "worldeconomy."

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The domesticist view is rooted in an evaluation of the success and shortcomings of the postwar international economic system. This system, for all of its faults, is credited with the achievement of higher, sustained rates of growth and development than in any comparable period in history. Briefly, world trade and output from 1948 to 1973 grew at average annual rates of 7 per cent and 5 per cent respectively, almost triple the average annual rates for the thirty-five years prior to 1948. In the process world output tripled and income per capita in the world as a whole doubled, despite a 50 per cent increase in the world's population.

The benefits of this unprecedented growth were more widely spread than is commonly recognized. According to recent World Bank statistics, average annual real growth of GNP from 1950 to 1980 was approximately the same in some sixty (60) middle-income developing countries (per capita income greater than \$370 in 1979) as in the industrial countries--3.1 per cent versus 3.2 per cent respectively. Real per capita incomes in these

two groups of countries also increased by the same amount--some two and a half times from 1950 to 1980. And, when comparative purchasing power is taken into account, real per capita income in the middle income developing countries actually grew five times or twice as fast as that in the industrial countries.

These are scarcely trivial or ho-hum outcomes, even if they did not preclude an increase in the gap between absolute incomes in these two groups of countries. The absurdity, of course, of expecting the absolute gap to close at this stage of development, is illustrated by some simple mathematics. If, to take some hypothetical numbers, per capital income in the industrial countries averaged \$10,000 and in the middle income countries \$500, it would require a growth rate in the middle income countries twenty times that in the industrial countries to close the absolute gap. Such a growth rate is simply unachievable. The important point is that, even at a real growth rate in terms of purchasing power of only two times that of industrial countries, the middle income countries can eventually close the absolute gap if this rate is sustained. The proper conclusion, therefore, the domesticist contends, is not to despair over the shortcomings of the postwar system but to seek a better understanding of how to sustain and improve this system.

From 1950 to 1980, the low income (per capita income less than \$370 in 1979) developing countries, comprising some 90 remaining third world nations, did not fare as well as the industrial or middle income countries. For them, real per capita incomes rose by less than one-half or less than one-fifth the increase in the industrial and middle income developing countries. Even after adjustment for purchasing power, these rates show

a relative decline in the fortunes of these countries. Yet these results are tempered somewhat by the significant gains made by many low income countries in areas of basic human needs. From 1950 to 1979, literacy rates in these countries increased from 20 to 51 percent, life expectancy went up from 41 to 57 years, and child mortality declined from 28 to 12 deaths per thousand. Again these achievements are unprecedented by historical standards. Nevertheless, the continued plight of the world's poor leads the domesticist back to a careful examination of what was right about the postwar system, why the poor make relatively fewer gains, and how that system can be improved.

Growth rates in the postwar period were greatest in the 1950's and 1960's, slowing in the 1970's by half in the industrial countries, by a quarter in the middle income developing countries, and by two thirds in the poorest African developing countries. It is customary to attribute the high growth in the earlier period to postwar reconstruction and the existence of enormous unused resources and capacity. But, in almost all war-torn countries, prewar levels of output had already been achieved by the mid-1950's. Moreover, the existence of unused resources is by no means a guarantee these resources will be used. Look at the devastating record of the 1930's. Policies established under the postwar international economic system, the domesticist concludes, must have had something to do with the vastly superior record of this period.

The domesticist is unwilling to assume that the growth of the world economy and its contribution to unprecedented prosperity in the postwar period was simply a matter of historical inevitability, a product of ineluctable modernization and the march of modern technology.⁵ Rather, the

⁵ For an alternative view, see Edward L. Morse, Modernization and the Transformation of International Relations, The Free Press, 1976.

domesticist argues, it was a consequence of deliberate policies. Three basic policy directions, in particular, were crucial. Indeed alterations in these policy directions in the 1970's led to the slower growth of this later decade. Thus according to the domesticist analysis of postwar world economy, the problems and complexities of the 1970's, rather than suggesting the need for totally new policy directions, confirm the wisdom of earlier directions and the imperative need to refit these directions to a different and admittedly more complex political universe of the 1980's.

First, the postwar system gave pride of place to the role of sound domestic policies in world economic growth and stability. This priority was reflected in two sets of commitments -- the commitment by all other countries besides the United States to a fixed exchange rate vis-a-vis the dollar, and a commitment by the United States to maintain the value of the dollar in terms of gold. The fundamental commitment underlying the entire system, therefore, was the U.S. commitment to price stability, especially after the dollar acquired in the course of the 1950's and early 1960's the uncontested role of principal international reserve currency. Until roughly 1960, the United States held gold reserves sufficient to cover outstanding liabilities against the dollar. During the 1960's, however, these liabilities grew to many times the value of U.S. gold reserves, and the willingness to hold dollars depended increasingly on the price competitiveness of U.S. goods and capital assets. From the domesticist's point of view, it was the loss of this competitiveness as perceived from abroad, due to the inflationary "guns and butter" policies of the U.S. government in the late 1960's, that eventually led to the collapse of confidence in the U.S. dollar and the end of the fixed exchange rate system.

But we are getting ahead of our domesticist's analysis of postwar economic successes and shortcomings. The second fundamental policy commitment in the postwar system was the commitment to liberalize trade, at least in manufactured goods. The decision to allow comparative advantage to work at the margins, as governments moved toward lower trade barriers, was decisive in terms of enhancing efficiency in the allocation of national and world resources in the postwar period. This commitment made the difference between the postwar and prewar systems, since the latter avoided price inflation, albeit at the expense of prosperity. The commitment to freer (and I stress freer rather than free because the commitment was never to eliminate all government influences on trade or even to extend the practice of freer trade to certain sectors such as agriculture) trade was also a necessary corollary of the commitment to price stability, fixed exchange rates, and domestic policy discipline. The idea was that countries, when faced with balance of payments deficits or surpluses, would not be allowed, in the main, to alter their exchange rate (except in circumstances of fundamental disequilibrium) or to impose new barriers on trade at the border (except under limited escape clause provisions of the GATT). This meant they would either have to finance deficits or absorb surpluses through reserve losses or accumulations, or eventually (since reserves were limited) alter the domestic policies that were contributing to loss of export competitiveness or to insufficient domestic demand and, hence, lagging imports. (An often noted imbalance, of course, existed between the pressures on a deficit country to adjust and those on a surplus country, which could accumulate reserves indefinitely.)

The commitments to price stability and liberalized trade in manufactured goods also embraced indirectly a third commitment. That was to preserve a relatively flexible domestic economy, tilting at the margins toward market forces and market pricing to facilitate the movement of resources from one sector to another and from the domestic or non-traded goods sector to the international or traded goods sector. Under the system, domestic adjustment would have to be fairly continuous given the fact that the international means of adjustments -- available reserves and exchange rate or trade controls -- were relatively constrained. The primary role of government was to facilitate this adjustment by preserving and enhancing the market environment through appropriate macroeconomic policies. The commitment was less to limit direct government participation, which could be expected to vary depending on domestic political choices, than to promote market forces and flexibility, whether applied to private or public actors.

As the domesticist sees it, the commitments to price stability, freer trade and market forces worked together to ensure sound domestic policies. That was the essence of the postwar system and thus the secret of unprecedented postwar growth and development.

What went wrong in the 1970's? The most common explanation is that offered by the globalists. The unique conditions of the early postwar period, they argue, disappeared. The U.S. economic position inevitably declined, as postwar allies and erstwhile enemies benefited from a new and more efficient capital stock, a more organized government-led approach to technological and industrial development and restructuring, and fewer defense and other foreign policy obligations and costs which

fell disproportionately on the shoulders of the superpower. U.S. competitiveness was bound to suffer. Despite heroic U.S. efforts to persuade other, specifically surplus, countries to revalue their currencies, stable agreements could not be achieved. Differences on fundamental economic policy objectives, such as acceptable levels of inflation, unemployment, and government intervention, were now too great among the highly competitive economies of the industrialized North; and these differences, which could not be resolved at the bargaining table (where the U.S. was no longer dominant) would have to be accommodated by greater flexibility in the marketplace. Domestic flexibility, which ensured adjustment under the old system, would have to give way to greater international flexibility, which would now absorb some of the requirements for domestic adjustment. Floating exchange rates were the obvious answer.

Further, it is argued, the move to floating exchange rates was not only logical but timely. No sooner had it been taken than the world experienced the first of two serious and also historically unprecedented oil shocks. Varying national responses to these shocks only exacerbated the differences in fundamental policy objectives and preferred policy mechanisms. Massive petrodollar flows and the accompanying growth of international financial and currency markets could have never been accommodated without a shift to floating exchange rates. Indeed, as the argument continues, while protectionism also grew and was unavoidable to some extent, as nations wrestled with massive and rapid current account movements, protectionism would have grown much more if exchange rates and capital flows had not accommodated more of the differences in national priorities.

The globalist explanation of the malaise of world economy in the 1970s

has much to recommend it. But, for the domesticist, it overlooks and indeed perhaps excuses the central reason for the loss of U.S. competitiveness and more broadly the collapse of domestic discipline in domestic economic policymaking around the world. The culprit was U.S. domestic economic policies, specifically the growing budget deficits and accelerating money growth in the U.S. beginning in the late 1960's. In 1968, the federal deficit swelled to \$25 billion compared to \$8.7 billion in 1967 and an average of \$4.4 billion per year from 1961-1966. After a small surplus in 1969, it never saw black ink again for the next decade, increasing to \$23 billion per year in 1971-72 and \$60 billion in the subsequent business cycles of 1976 and 1980. Money growth meanwhile showed similar expansion. MI exploded in 1967 and 1968 by 6.6 and 7.7 percent respectively, compared to an average of 3.4 percent per year from 1961-1966. After 1968, MI fell below the average for the early 1960's only once and overall from 1969-1979 averaged 6.3 percent per year.

This disintegration of the cornerstone of the postwar international economic system, namely domestic discipline in the world's leading economic and currency country, was clearly evident in U.S. performance. U.S. average annual inflation increased from 1.8 percent in 1960-1967 to 4.5 percent in 1967-1973 and to 7.9 percent in 1973-1980. Over the same period, U.S. unemployment accelerated from an average of 4.4 percent per year in the 1960's to an average of 6.1 percent per year in the 1970's.

According to the domesticist, this decline in U.S. policy discipline and performance did not result so much from a decline in U.S. power vis-a-vis its competitors as it contributed to inflation and instability in the international system which also strongly impacted U.S. competitors. Contrary to the decline argument, the role of the U.S. economy in the world economy was not significantly different in 1970 than in the middle

to late 1950's. In 1955, U.S. GNP represented 36.2 percent of total world output; in 1970, this figure was 30.2 percent. In 1960, U.S. exports represented 14.9 percent of total world exports and in 1970 12.8 percent. In 1971, the United States still accounted for 52 percent of the stock of all foreign direct investment, and the dollar's share of total world reserves actually increased from 1955 to 1970. In light of these facts, it is difficult to account for U.S. decline beginning in the 1970's primarily in terms of external forces outside U.S. control? Much more likely, the domesticist argues, U.S. domestic policies badly managed by U.S. policymakers bear an important part of the responsibility for the decline in world economic performance during the period.

Indeed, these policies in turn negatively impacted the world economy. Inflation was exported and then compounded by the two world oil price shocks. For the 1970s as a whole, average annual inflation rates in both the developed and developing worlds tripled, in comparison to the 1960s, to levels of 8.5 per cent and 26.5 per cent respectively. Unemployment in the Group 10 industrial countries steadily increased from 1974 to 1982 from 3.7 to 8.1 per cent.

The breakdown of price stability made it harder to resist the creeping tide of protectionism. As it became clear that floating exchange rates did not provide for the insulation from policy differences they were initially expected to provide, and as daily movements of capital in financial and currency markets reached elephantine proportions, many countries, including the United States, found ready excuses to reestablish new barriers to trade. Tariff barriers continued to decline under the agreements of the Tokyo Round, but non-tariff measures, including quotas and especially more pervasive domestic policy measures aimed at subsidizing

declining industries and developing new high technology industries, began to spread across the anatomy of international trade relations. New doctrines emerged, declaring free trade an anachronism and ordering up generous doses of government stimulus and direct intervention to expand production in certain sectors critical for national employment (e.g., steel), or to create comparative advantage in high technology areas where none existed, or to carve up international trade according to new static principles of managed markets. Little wonder, the domesticist concludes, that at the margins trade patterns no longer contributed to greater efficiency in the allocation of national and world resources.

The collapse of price stability and the erosion of free trade commitments both facilitated and reflected the loss of an implied commitment to market forces and flexibility. Through the 1970s the expansion in the role of government, as citizens demanded more and more from their public authorities, was phenomenal. In the industrialized countries, public expenditures grew inexorably, while tax revenues, given slower growth lagged. In 1973, a third of the industrial countries ran budget surpluses, by 1982, all of them were in deficit. The combined magnitude of these deficits was twice as large in relation to GNP as it was in 1973. For the seven major industrial countries, the ratio of total public expenditures to GDP rose from 29 per cent in 1967 to around 37 per cent by the early 1980s. In individual countries, such as Canada, Germany, Italy, Japan, Spain and the United Kingdom this ratio increased by more than 10 percentage points; in Belgium, the Netherlands, Norway, Portugal, Sweden, Luxembourg, and Ireland, it rose more than 15 percentage points. In developing countries, whose governments might be expected to play a larger role, the expansion was nevertheless equally dramatic. Central government revenue as a percentage of GDP grew in the middle income developing countries from 18 per cent in 1970 to 26 per cent in 1980. State-owned enterprises, frequently required to pursue

public policy as well as market objectives, swelled -- in Brazil from fewer than 150 to almost 500, in Mexico from under 200 to over 500, in Tanzania from under 100 to 400. By 1980, the budgets of these enterprises in Tanzania, for example, consumed 4% of GDP, up from about .5% in 1969. In Brazil, the operating deficits of state-owned enterprises accounted in 1979 and 1980 for 76 and 66 per cent respectively of the federal budget deficit. All of these developments, as seen by the domesticist, weakened the role of market forces and market pricing, reducing further the ability of the national and world economies in the 1970s to use resources more efficiently at the margins.

To the domesticist, the future is not so much a consequence of the past as a construction of the present informed by the past. The postwar economic experience was unprecedented. About that, there could be no doubt. But was it unique? Did it follow from the unusual political conditions of the period, particularly the political dominance of the United States? After all, the globalist might retort, was it not, for all practical purposes, the United States and Great Britain that ruled at Bretton Woods? And ultimately, was it not the United States that won out against the British on the provision of limited international reserves, which together with fixed exchange rates ensured that adjustment would have to be achieved largely through the maintenance of sustainable domestic policies? Moreover, was it not the United States which also succeeded in overriding imperial Britain with its Commonwealth preferences on the key principle of most-favored-nation trade liberalization?

In the 1980's, the United States does not exercise such preponderant political power in the world economy, even while it continues to exercise a disproportionate economic influence due to the size of its economy,

share of world trade, and especially the role of the dollar. How then might it reestablish and sustain consensus on the principal economic ingredients of postwar success -- sound domestic policies, freer trade and, at the margins, a bias toward market forces? The question is particularly acute given the much greater political diversity and complexity of the international system.

For the domesticist, the answer lies partly in the disjuncture between U.S. economic and political power. U.S. power in the international marketplace remains much greater than its power at the bargaining table (a fact which frequently irritates our allies). Even in 1980, the U.S. economy continues to account for 35 per cent of free world GNP, 20 per cent of OECD trade, and 85 percent of international reserves held in dollar assets. If the U.S. economy therefore could be revitalized and put on a course that reestablished the premises of price stability, market incentives, and freer trade, the world economy might be induced in a similar direction. At some point, the altered economic conditions might make it easier for the United States to apply its reduced political influence to secure renewed formal commitments to a reconstituted international economic system.

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The domesticist approach underlies many of the perceptions and policies pursued in the United States since 1981 by the Reagan Administration. This is not to say that the premises of this approach are shared consciously or in full by individual Reagan Administration officials or even by the President himself. This Administration has been particularly remiss in developing a consistent intellectual framework for most of its policies,

including international economic policy. Its domestic economic program was eclectic and even, some believed, contradictory. And most of its officials, by temperament and training, are not inclined to explain policy in a broad historical or conceptual framework.

Yet it is also hyperbole to argue that this Administration has had no international economic policy. The fact that some critics make this charge repeatedly and get away with it reflects the dominance of the globalist approach in our thinking about international economic policy. This approach, as we noted earlier, tends to view domestic reactions to world economy as essentially counterproductive. Such reactions are quickly labeled nationalist, neomercantilist, unilateralist, or ideological. By definition, they cannot be helpful in dealing with the world economy because the problems lie outside the nation-state and the fragmentation of national authority within the nation-state ensures either that there will be no response or that the most reactionary forces will determine domestic policies. Thus, an emphasis on domestic policies must inevitably reflect a repudiation of international policies, if not of the world economy itself.

Yet the Administration's policy has consistently emphasized the primary importance and role of domestic economic policies as the key to stable and prosperous international economic relations, not as an end in themselves. In this respect, restoring sound U.S. domestic policies was the fulcrum for restoring the proper emphasis on price stability and market incentives in the world economy as a whole. Almost immediately, at the Ottawa and Cancun Summits, the Administration made clear that the focus on domestic policies was not intended as an "America First" strategy, but as a reminder to all countries that the world economy could only be as good as its members' economies. As domestic economic performance improved,

it argued, international economic relationships would stabilize and begin once again, if organized round the concept of freer trade, to produce positive feedback for domestic growth and development. Above all, it was policies that mattered, not just process. The issue was not interdependence or international cooperation for its own sake. If policies were wrong, as they had been, for example, in the 1930's, interdependence produced negative feedback; and international cooperation, such as the ill-fated London Economic Conference in 1933, could actually make matters worse.

If the Administration shares, unknowingly in part, many of the premises of a domesticist's approach to world economy, how do its policies fare against a critique from the domesticist perspective? Such an evaluation could be particularly useful, because while this Administration has achieved remarkable success in revitalizing U.S. and, to a lesser extent, world recovery and growth, its policies fall short in a number of important ways of its own standards and certainly those of a domesticist. This evaluation is also likely to be more enlightening than the internationalist critique, which by denying the existence of an international economic policy under this Administration, essentially ends the argument.

In its first year, the Administration concentrated on its domestic economic program to restore price stability (stable, moderate growth of the money supply) and to renew growth incentives (reducing taxes, expenditures, and excessive regulation). It also conducted, however, an active year of international economic diplomacy, albeit of a domesticist rather than globalist variety. At the Ottawa Summit in Canada in July and the Cancun Summit in Mexico in October, it urged all countries, in the wake of the excessive inflation and growth of government intervention in the 1970's, also to consider policies to lower inflation, liberalize trade,

restore market incentives and pay more attention to the private sector. While globalist critics dismissed these early exhortations as ideology or exported Reagonomics and indeed as interference in domestic sovereignty, the appeal for domestic policies to reconverge, at least at the margins, around the essential premises of an expanding, open world economy betrayed an underlying premise of the domesticist approach. Seen from the domesticist perspective, there is a limit to the divergence of domestic economic performance among countries in areas such as inflation, deficit spending, etc., if international markets are to be kept open and if stability and growth are to be achieved under these circumstances.

The fight against inflation which was subsequently identified with tight U.S. money policies and resulting high interest rates, was not original with the Reagan Administration. Jimmy Carter and Margaret Thatcher had already taken up this fight. What was unique to the Reagan Administration was the idea that growth could take place simultaneously with disinflation and that, for this reason, there would be no need to buffer the impact of disinflation either on the domestic economy or on the world economy.

Moreover, this program was now to be pursued in a more flexible international economic environment involving floating exchange rates. Even if both aspects of this program -- disinflation and growth -- had succeeded, there may have been more volatile international repercussions than in earlier periods. The transition from a fixed to a floating rate system in the early 1970's had been partially buffered, at least until March 1973, by the requirement to negotiate exchange rate changes. Now, a transition back to more predictable price performance and stable exchange rates would be attempted in an international environment which, because

it was more flexible, did not automatically require similar intergovernmental coordination at the bargaining table. The Reagan Administration may not have sufficiently appreciated this difference, although it it had, it may have made little difference since the Administration was determined to let its policies work their way out in the marketplace rather than be the subject of international negotiations at the bargaining table. Ironically, it was the flexibility of the floating rate system that permitted the United States to pursue anti-inflation policies that ultimately contributed to a sharp appreciation of the dollar.

Nevertheless, had growth accompanied disinflation in the U.S. economy, the international repercussions may have been quite tolerable. This was the expectation of many Reagan officials, at least through the first part of 1981. Under these assumptions, it was reasonable and appropriate to discontinue daily and sustained exchange market intervention. There was no desire to buffer the impact of U.S. disinflation on the world economy since the United States was emphasizing the need for other countries also to disinflate, reducing the sharp divergence of domestic performance in this area during the 1970's. If U.S. economic changes, acting through the marketplace, put pressure on other countries to disinflate, this made the task of reestablishing an international consensus on the importance of price stability somewhat easier. It would have been much more difficult to make the case for disinflation politically at the bargaining table. Moreover, to intervene to buffer the decline of foreign currencies being devalued by inflationary policies would have contradicted U.S. domestic policy objectives and signaled a lack of resolve on the part of the U.S. Administration, for foreign policy reasons, to lead the fight against the inflationary tendencies of the 1970's.

On the basis of a return to sound domestic policies, the Administration

also championed the second key principle of the domesticist's approach to world economy, free or more accurately, freer trade. In freer trade, the Administration saw the chief economic rationale for having a world economy. Lowering trade barriers at the margins (not necessarily eliminating them) made possible greater efficiency and growth. Without that possibility, trade created no new growth, and pursuing it for non-economic reasons risked doing little more than dividing up existing growth. International finance and investment also made less economic sense if trade were increasingly restricted at the margins. Under such circumstances, capital transfers could not be secured with the prospect of more cost effective transfers of real goods and services. Thus, freer trade was the cornerstone of the world economic system. Finance was there to facilitate it, and even non-trade related finance ultimately depended on freer trade to contribute to new growth.⁶

The concern with inflation and improved market incentives for growth were also at the heart of the Administration's policy toward the International Monetary Fund (IMF) and the international development institutions. The IMF was perceived as drifting away from its primary role as lender of last resort. By making longer-term financing available to countries experiencing early problems of disequilibrium, it was weakening its leverage and recipient country incentives to promote domestic policy adjustment. There was a need, especially in the inherited world of the 1970s of high

⁶ Thus, when foreign concern about non-trade related capital flows led to suggestions for less open trade and financial markets, Administration officials saw a contradiction. The remedy for speculative capital flows was more efficient, meaning more open, world trade and capital markets.

inflation and debt, to preserve an institution whose role in the area of domestic policy adjustment was far more indispensable than its role in international financing. For the Administration, which had doubts about the policy directions of the IMF in the late 1970s, it made good sense to reserve on financing issues until a new policy course had been struck.

The emphasis on improved market incentives became the leading theme of the Administration's position on development issues at Cancun.⁷ It underlay the skepticism the Administration expressed about the policies of the international development institutions. An early evaluation of these institutions by the Administration confirmed their value for American foreign policy interests but also urged a more complementary view of the relationship between private and public finance and the needs of some countries at higher stages of development for less of the lowest cost concessional finance available through these institutions. Public funds should not substitute for private funds, as it was feared in the case of the then proposed World Bank Energy Affiliate; and the resources of the World Bank's soft loan window, the International Development Association (IDA), should be reserved for the poorest countries of the world, while middle income and more advanced developing countries met their needs increasingly through hard window loans (closer to market rates) and eventually through commercial financing in world private capital markets.

⁷ The emphasis on the private sector drew useful attention to the 50 percent or more of production in developing countries generated in the nongovernmental sector. It has led to improved analysis, for example in recent World Bank Development Reports, of how public and private sector activities can more effectively complement one another and how market incentives can be applied irrespective of whether ownership is private, public, or parastatal.

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By domesticist standards, early Administration views of the world economy were on target. Objectives of domestic adjustment and freer trade took precedence over international aid and finance. Informal discussions of policy took precedence over the formalized procedures of global institutions, especially new ones. (An ad hoc limited Cancun Summit was a better alternative than Global negotiations.) And the United States would use its weight in the international market place to alter conditions and gradually facilitate bargaining and consensus at the negotiating table. The approach was activist toward resolving international economic ills of the 1970s, but from a domestic starting point in the U.S. as well as other partner countries.

How did these views fare in practice? The assessments of Reagan Administration economic policies are already numerous and conflicting, and the argument has probably only begun. Given the passions that afflict this debate, it is unreasonable to expect it to be resolved soon. The important point to keep in mind is that this Administration, like all others, has adapted its policies as it has gone along, and it would seem more useful to review the key choices it has made at each point along the way and to assess the general direction of its international economic policy against domesticist standards. These standards, as I argued, come closest to this Administration's economic instincts, yet they too are exacting and may therefore be the most appropriate means for holding this Administration accountable in international economic policy. Let's look at the Administration's approach to domestic economic policy coordination, trade and financial issues through the domesticist prism.

In 1981 Reagonomics over-succeeded in one of its objectives -- controlling money -- succeeded in two other objectives, cutting taxes and regulations -- and failed in a fourth -- cutting expenditures sufficiently to meet its preferred level of tax rates (or as the critics might put it, also over-succeeded in cutting taxes). The result in late 1981 and 1982, through whatever causal sequence (let the debate continue!), was large current and projected budget deficits, high nominal and real interest rates, a high dollar, a decline in exports and general economic activity, and lower inflation at the cost of sharply increased unemployment.

The issue for the Administration in 1982 was whether, now that it was clear disinflation would hurt, disinflation should have been stretched out or discontinued. The issue, of course, was foremost a domestic one. If the answer was no and the Administration was prepared to accept the economic pain and potential political risk at home (incurred eventually in the 1982 Congressional elections), it had little reason to intervene to alleviate these costs abroad. Doing so would have weakened the impact of U.S. market power, slowed the process of disinflation abroad and ultimately retarded this process in the United States. In early 1982, inflation was still at double digit levels in several advanced countries and continuing to accelerate in many developing countries. Intervening in exchange markets to bolster currencies suffering from comparatively over-inflated domestic economics would have permitted policies of inflation in these countries to persist. Moreover, doing something about the witch's brew of tight money and loose fiscal policy, seen by many as the source of voodoo economics, was both economically risky for the U.S. and world economy (if it involved primarily higher taxes and delayed recovery indefinitely and politically difficult if not duplicitous (as it was, the tax legislation

in 1982 walked back at the margins the Administration's budget gains in 1981). Ultimately, the Administration concluded, disinflation without growth is either accomplished quickly in the United States and politically active societies or not at all.

If growth could not be achieved with disinflation, as was hoped in 1981, it would now be achieved through disinflation. The lack of early success through the impact of a revitalized U.S. market on the world economy led to an acceleration of Administration diplomacy. At the Versailles Summit in June 1982, the Administration participated in substantive and significant discussions, unlike the more genial, public relations - oriented encounter of Reaganomics and French socialism at the Ottawa Summit (where little else was possible given an American Administration that was six months old and a French Administration only six weeks old). It elaborated its concept of sound domestic economic policies in the major currency countries converging around common performance indicators of low inflation and greater market flexibility over the medium term (a 2-3 year time perspective). As a coordination vehicle, it recommended the new process of multilateral surveillance bringing together the five major currency or SDR countries -- United States, United Kingdom, France, Japan and West Germany -- and on an informal basis, the Managing Director of the IMF. Under a monetary agreement reached at the first Economic Summit in Rambouillet, France in 1975, the IMF had initiated on an annual basis a process of bilateral surveillance of the economic policies of member countries. This one-on-one consultative mechanism between each country individually and an international institution had done relatively little, however, to impress upon the major industrial countries the disproportionate effects of their domestic economic policies on one another and on world economic conditions as a whole. The multila-

teral surveillance process, to be conducted initially on a semi-annual basis, was designed to supplement this bilateral process for the major currency countries. The relationships among domestic economic conditions in these countries, which account for 65 per cent of the free world's GNP and the three principal international reserve currencies, are especially critical for world economic well-being. These countries lacked a direct, multilateral consultative mechanism at the highest political levels to appraise the likely impact of their existing policies on the other countries and to assess the international feedback of trade, capital and currency flows, which might, if international markets were kept open, undermine or at at least significantly affect their own domestic economic programs. Organizing this process under the broad auspices of the informal Economic Summits gave it more political significance than existing Finance Minister meetings in the G5, G-10 or the OECD. And including the IMF Director informally with the responsibility to present the initial assessment of member country policies and their interrelated impact insured the presence in the discussions of an impartial yet aggressive referee, without incurring the disadvantages of formal institutional involvement on the part of the IMF.

The multilateral surveillance or, as it was also called, convergence exercise represented an important, incremental step in the reform of the international monetary system begun at Rambouillet. It balanced the pre-occupation in the floating rate system with exchange market intervention and gave practical expression to the view that convergence of domestic economic performance among the major currency countries was the best way to achieve fundamental and lasting exchange rate stability. Indeed, it recognized that, whatever exchange rate system existed, a necessary condition

for exchange rate stability was price stability! It differed from earlier globalist prescriptions for active coordination of economic policies (e.g., the Bonn Summit model⁸) by focusing on mediumterm domestic objectives and outcomes of policy rather than on short-term fine-tuning of the policies themselves.

In this respect, the proposal conformed to the domesticist view of how to manage world economy. Summits were not for policymaking, since these meetings did not represent any truly international constituency. Indeed, from the perspective of the world community, the leaders present at the Summit were self-elected and had no real political mandate from their own domestic constituencies or a larger international constituency to make policy at the Summits.⁹ The best that could be achieved at these meetings was the education of domestically-accountable leaders to the international consequences of their economic actions. If these meetings succeeded, domestic leaders, over time and by a series of successive approximations in domestic policymaking, would modify their actions and close the gap in domestic economic objectives and performance that produced undesired instabilities in international economic relationships. Industrial countries did not necessarily have to achieve these objectives by the

8 See George de Menil and Anthony Solomon, Economic Summitry, Council on Foreign Relations, 1983.

9 To acquire such a mandate, Congress and Parliaments would have to become much more involved in Economic Summits than they are currently as Congress is for example in arms control and other international conferences. That would of course defeat the original and only real purpose of the meetings in providing the leaders with a relatively free and unconstrained environment for a frank exchange of views.

same policies. Hence, at Versailles, the famous confrontation of conservative and socialist economic policies that produced so much drama at Ottawa was resolved in the common recognition by France, the U.S. and other Summit countries that, regardless of their ideological or institutional preferences, they all had an interest in converging domestic economic outcomes of low inflation, greater flexibility in their economies, and maintenance of open market.¹⁰

Has the multilateral surveillance initiative mattered? Initially, it was lost amidst the furor of controversy over high U.S. interest rates, intervention in exchange markets and especially, in the aftermath of Versailles, the Soviet gas pipeline and the debt crisis of summer and fall 1982. Nevertheless, after Versailles, U.S. policy adjusted in one important respect, albeit in a way that seemed to contradict Administration priorities. The Federal Reserve sharply accelerated the growth of the money supply, largely in response to domestic and international credit pressures. U.S. interest rates declined, and the immediate international financial crisis was weathered. But the fundamental fiscal imbalance in the U.S. remained, threatening over time the ability to sustain an easier monetary policy without reigniting inflation. Following Versailles, French policy also adjusted. In March 1983, the Mitterrand government introduced austerity measures to end the long French love affair with inflation. In addition, during the winter of 1982-1983, more conservative governments came to power in Germany and Japan

¹⁰ Some Administration officials foresaw an eventual association of the GATT Director with the multilateral surveillance process to integrate trade and domestic policy considerations more effectively.

The result was to narrow fundamental differences in basic economic objectives among the major currency countries and set the stage for the large degree of consensus on objectives and, to the surprise of many, also specific policies (such as reducing government expenditures) that emerged at the Williamsburg Summit. The nascent recovery in the United States added further lubricant for consensus. Obviously, larger political and economic forces were driving the Western countries toward improved economic relations after their sometimes acrimonious exchanges in 1981-82.

In 1984, the process of recovery advanced, with a stronger recovery than anyone expected in the United States and the long-awaited resumption of growth in Europe. Whether the recovery in the United States was keynesian, supplyside or both (it still seems worthwhile to distinguish between deficits created by cutting taxes and those by increasing expenditures), the Administration gets credit for it. It also takes responsibility, of course, for persisting imbalances. While the effects of the latter continue at the moment to be favorable -- through recent increases once again in U.S. interest rates cloud the picture -- the effects in terms of medium-term outcomes for relationships among the major currency countries, precisely the focus of the Administration initiated multilateral surveillance exercise, are much more worrisome. U.S. fiscal policy cannot be sustained indefinitely without either deleterious consequences for growth here and elsewhere or a sharp resurgence of inflation and rapid decline of the U.S. dollar. French inflation performance, which has shown some but not enough improvement, also cannot be sustained without implications for the franc or for inflation in France's trading partners.

Obviously, the multilateral surveillance process cannot claim credit for any of these achievements. But it does seem to address the right issues in the right time frame and in a more realistic political perspective. It compels the key currency countries, especially the United States, to confront the international consequences of its domestic policies. It creates a peer pressure group at the highest political level to achieve this, which is about as far as one can go in a world based on national sovereignty. If it works, as contemplated, by successive, albeit slow, domestic policy adjustments, it accomplishes the same thing as direct coordination of monetary policies, which some have advocated. And it does so without the enormous political and institutional difficulties that would beset a formal global mechanism for monetary policymaking in the key industrial countries. (How, for example, would the developing countries regard such a mechanism?) By focusing on the medium-term, it promises more than the fits and starts of short-term fine-tuning of international economic policies; and by operating in a more realistic political perspective, it does not try to force international solutions before domestic political changes can be brought about to alter individual country's policies.

The domesticist would certainly urge that the multilateral process be continued and strengthened. To be more effective, it needs to be broadened and given greater professional and public visibility without losing the confidential character of its discussions. The meetings might become more frequent and commission serious studies of other countries' policies and their consequences by the participating countries themselves. Currently, the IMF Director, assisted informally by his staff, prepares the only analytical paper for the discussions. Having one member country prepare a paper on another member's economic program and its consequences

may be a delicate task to manage, but it would certainly be educational. The level of sophistication in the G-5 countries about the economies of the other countries is not as great as one might assume. Too often, views of other economies are mere projections of how things work within one's own economy. In addition, Treasury officials, which represent the United States in these meetings, need to conduct wider and more detailed briefings on the broad outlines of these discussions. Perhaps the IMF Director can be authorized to brief the economic press after each session. Finally, Treasury and its counterparts in foreign governments need to support discussions and even parallel "multilateral surveillance" seminars among non-governmental groups from the five countries to include business, labor, academic and political party officials. The more these groups learn about the policies and functioning of the other economies and their impact on their own economy, the more rapidly and smoothly the process of converging domestic economic adjustments around common performance indicators can proceed, even with changes in official governing parties.

To achieve this degree of pervasiveness and effect, however, the multilateral surveillance process will have to be cultivated and reinforced over a period of ten years or more. What do we do in the meantime? The economic clock of the business cycle seldom awaits the calendar of domestic political change or elections. Doesn't politics make the medium-term irrelevant? Will the elections in the United States come in time to make the needed macroeconomic policy adjustments? Will they crystallize the political situation sufficiently to permit these changes to be made? Or will the political deadlock of the past two and a half years persist?

Clearly, if the elections come too late or fail to create a political

coalition for responsible change, the opportunity to reestablish the world economy on the domesticist premises of price stability and greater reliance on market forces will have been lost. The Reagan Administration can then be held responsible, not for failing to identify the right directions and begin the process of world recovery but for being unable to follow through politically. For an Administration that prides itself on its political, more so than intellectual, prowess, that would be a serious indictment.

One might agree with the Administration that it matters greatly, not only to reduce the deficit, but also how this is done. Reverting back to indiscriminate and, through de-indexing, automatic tax increases, coupled once again with special interest, long-rolling, politics increasing budget expenditures, could do as much to return us to the era of inflation and economic rigidity as continuing large budget deficits. But however one looks at these deficits, the test of this Administration is whether it can bring off its preferred approach to reducing the deficit. If it cannot, it has failed. The present deficit, in terms of the medium-term consequences it entails for the U.S. as well as the world economy, looks no different than the U.S. budget deficits of the late 1960s and early 1970s which contributed to the world economic disaster of the 1970s. While the Administration has forcefully rejected the policies of this earlier era, it continues in at least the one important area of fiscal responsibility to pursue them.

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Given the prolonged struggle since 1981 over domestic economic priorities and their management internationally, the Administration has

until recently given less attention to open international trade and capital markets. In a theoretical sense, this may be consistent with the domesticist's view that a country's policies toward international trade and capital flows can at best supplement domestic economic policies or at worst be irrelevant to them. In a practical sense, however, the Administrative's belated and not always consistent devotion to open market principles is due to the serious recession of 1981-82, the continuing slow pace of recovery in Europe, and the draconian cutbacks in imports by many developing countries in managing their debt burdens. Without growth at home and abroad, trade policies quickly become victims of expediency. When confronted by high unemployment, no government can long hold out against the appeals of import-competing interests for protectionism. In these circumstances, the natural allies of free trading governments, exporters who benefit from access to foreign markets, are dormant, especially when foreign markets appear to be shrinking rather than opening up. In an important sense, therefore, growth -- and that means in the domesticist view, domestic policy adjustment -- is a prerequisite of freer trade.

Here we encounter a catch-22, however. If a country is stagnating, the more protectionism it accepts, the less able it may be to overcome this stagnation, even while the magnitude of the domestic policy adjustments needed to grow again may increase because the country is now pursuing very inefficient trade policies. There is no economic excuse for protectionism even under conditions of stagnation. The Reagan Administration succumbed to protectionism in 1981-1982 -- multi-fiber agreement, steel imports, motorcycles, etc. -- not because it was unaware that this would retard recovery but because it was politically weakened by recession. Again an Administration that sees itself as a master of politics was unable to follow through

politically to achieve its preferred policies.

While the Administration struggled in the domestic trap of stagnation and protectionism, it pressed the case for freer trade internationally. At the Versailles Summit and then the GATT Ministerial meeting in November 1982, the Administration pushed proposals for new liberalization in trade that went far beyond anything any other government was ready to accept. Not only were these other governments caught in similar domestic traps of stagnation and protectionism, but many of them reflected new attitudes toward the trading system that had gained prominence in the 1970s.

These attitudes embraced three broad schools of thought. The first school of thought, entertained by many developing countries, saw the postwar trading system as unjust and inequitable. Not having participated in its creation or its successive trade rounds, these countries insisted on new rules (e.g., preferences rather than the most favored nation principle) and new institutions (e.g., UNCTAD in place of GATT). They generally doubted the value of unregulated international trade, having pursued development policies of import substitutions, and tended to treat trade largely as another form of foreign aid (advocating one-way preferences which essentially transfer a portion of tariff revenues to developing countries).

A second school of thought, represented by some European governments and industrial policy advocates in the United States, argued that the basic nature of trade and comparative advantage had changed. Competitiveness was no longer a consequence chiefly of comparative factor endowments but now of organizational and technological capabilities that included the country's ability to decide where it wanted to have a comparative advantage and to integrate government, industry and research organizations to create

this advantage. Competitive industrial strategies, new machinations of global corporations, and above all leading roles for governments in establishing competitive capabilities made the old rules of non-intervention and quasi-judicial settlement of disputes under GATT obsolete. At the very least, governments had to negotiate more directly to establish a level playing field and at times to be an active player on that field in bargaining for market shares.

A third school of thought reflected the growing influence of capital and exchange markets on trade flows. This school, strong particularly in France where it merged with a traditional preoccupation with the international monetary system, argued that prices of internationally traded goods and services no longer reflected comparative advantage, even comparative advantage determined by government policies. Rather these prices were increasingly influenced by massive and often speculative capital flows which overwhelmed currency exchange markets and produced unprecedented volatility and uncertainties in exchange rates and hence trading patterns. Until something was done to alter fundamentally the exchange rate system, there was little point, these countries argued, in pursuing liberalized policies or market-based prices in world trade.

Attitudes toward the trading system, therefore, reflected fundamentally different views toward the role of international institutions, the role of governments in domestic economic and industrial policy and the link between trade, money and capital flows.

The debt crisis of 1982 gave rise to still another, this time longer term, perception of the link between trade and debt in future international economic relations. Debt servicing obligations now added to already large import requirements in many developing countries, necessitating

substantial increases in the exports of these countries if they were going to successfully manage their debts and redeem financial obligations through the transfer of real resources. Alternatively, of course, these countries could drastically reduce imports, as many of them had done in the short-term adjustment phase. But if carried out over the longer term this approach meant the shrinkage of developing country import markets, a corresponding decline in developed country exports, and increasing resistance in developed countries to granting developing countries new or even existing access to their markets. The debt problem in the longer-term seemed to suggest that markets would have to open up, whatever specific attitudes were toward international institutions, government targeting or the monetary system.

In this more differentiated and politicized world of international trade, is there any hope for the domesticist's view of freer trade as a complement to domestic adjustment policies? To his credit, the President has continued to make the domesticist case, even while the Administration has reflected the disparate views on the trading system within its own ranks. Agreement at the international level will certainly not be swift or unambiguous. Despite the strong recovery, only halting progress has been made since Williamsburg where the Summit leaders placed a new round of trade negotiations on the agenda of the world community. This May, a significant procedural breakthrough occurred when the so-called Quadri-lateral group consisting of the United States, Canada, the European Community and Japan, which had been meeting alone on a sporadic basis since the GATT Ministerial, met together for the first time with key developing countries, including Brazil, India, South Korea, Mexico and the Philippines. In early June, the London Summit moved another step forward by calling

for "an early date" for new negotiations, and Administration officials are beginning to talk more openly and explicitly about the purposes, content and politics of a new trade round.¹¹

The obstacles to freer trade are fed by cynicism about the divorce between what governments say in the trade area and what they do. A time of testing awaits the Reagan Administration this September when it must decide trade cases in steel, copper and other products which directly and significantly affect the exports of its industrial country partners and those of debt-ridden developing countries (e.g., Brazil and South Korea in steel). The President has to recognize that each of these individual decisions to provide relief, particularly now that unemployment is substantially reduced, can drive another nail into the coffin of renewed free trade negotiations. Even more telling, each such decision reflects a lack of confidence on the part of the Administration in its own domestic economic program and a concession that these policies are not yet in proper balance.

The prospect for freer trade, therefore, is ultimately linked with the prospect for reducing the domestic economic imbalances that persist in the United States and among its industrial country partners. If one can assume responsible and hopefully still timely action to reduce the deficit, the outlook for freer trade becomes much brighter than that for its alternatives.

¹¹ See U.S. Trade Representative William Brock's "Trade and Debt: The Vital Linkage," Foreign Affairs, Summer 1984; and Dennis Lamb, Deputy Assistant of State for Trade Policy, "The Logic and Politics of a New Trade Round" Address before the World Trade Conference, Chicago, Illinois, April 25, 1984.

New global institutions to make world trade more just and equitable are likely to do just the opposite. The developing countries, particularly the heavily-indebted ones, are showing less and less interest in such institutional solutions. So are the industrial countries. At the London Summit this year, the Western countries, in contrast to their enthusiasm at the Ottawa and Cancun Summits for Global Negotiations, urged that North-South discussions be conducted in the smaller, more manageable arena of the IMF/World Bank Development Committee. In its last two sessions, this Committee, with limited membership, has given special and, for it, somewhat unprecedented attention to trade issues. None of this is to say that the developing countries are now convinced of the virtues of new trade negotiations, especially ones in which reciprocal reductions can be made and the gains in mutual access to markets can go well beyond what might be possible on the basis of one-way preferences. Nor have some of them lost their hostility toward the GATT or their affection for UNCTAD. But informal talks on a new trade round are going forward on a flexible basis. It should not be beyond the imagination of the participants to find at some point an agreeable institutional umbrella, perhaps the GATT or perhaps the GATT and the IMF/World Bank bringing together domestic adjustment programs and trade liberalization measures.

The industrial policy advocates, it would seem, face a tougher road in pressing their view of trade policy, unless the bottom drops out of world economic recovery. Their call for more direct government involvement in deciding comparative advantage and managing markets actively is simply impractical. This approach will politicize all, rather than just major, aspects of commercial relations between countries, severely straining good will and political ties among these countries. Can one

imagine healthy political relations between the United States and Europe if governments had to negotiate continuously tough trade disputes such as steel quotas or shares of wheat flour markets? Moreover, the roles of government and more importantly, institutional structures and political traditions in individual countries are so vastly different that it will be impossible to define meaningful common limits on government domestic policy actions for trade purposes. How does one establish equivalence between U.S. government tax policies that affect the allocation of credit in U.S. venture capital markets and the administrative procedures of Japanese bureaucracies that funnel credit for commercialization of technology to Japanese industry? A rule of reason may suggest that policies with effects on industry in general and those with effects on specific industry may be distinguished. But in a more politicized universe, these legal refinements are not likely to be workable. Similarly how does one get around the fact that an important contributor to U.S. commercial and technological development is U.S. space and defense programs, which far exceed anything that exists in any of its trading partners and therefore must, if taken by itself and even if spin-off is modest, disadvantage our trading partners in competitive relation with the United States?

We need a more sophisticated way to evaluate single-factor explorations of comparative advantage in a complex trading environment. Perhaps we need to look more at how equivalent functions are performed in each of our economies (such as the allocation of capital), seek some general agreement on broad parameters for handling these functions (such as no discrimination whatsoever between foreign and domestic capital in our respective markets), and pay less attention to whether public or private institutions are performing these functions. There is more common ground in this approach,

as the Reagan Administration has found in seeking to open up Japanese capital markets or in negotiating bilateral investment treaties with developing countries.

Finally, those who advocate monetary policy reform before initiating trade liberalization are likely to be won over eventually to new trade talks by progress on the stabilization of exchange rates through domestic policy convergence. No exchange rate system, whether fixed or flexible, can work well without underlying price stability in relations among the major currencies. Domestic policy convergence therefore is a prerequisite for either system and makes the eventual choice of the exchange rate system a less weighty matter. As some high level U.S. officials have stated privately, once we have achieved greater exchange rate stability through lower inflation, we might throw a blanket of broad exchange rate zones over the system to help us stay there.

All of this assumes of course that massive capital flows in the new era of global banking, currency and investment markets will also become less troublesome once basic economic and political (as they affect safe-haven investment flows) parameters in the major currency countries converge. It is a good premise of policy to assume that markets will behave rationally but that does not guarantee it. Continuing efforts in two directions would help. As a result of the summit study on intervention in exchange markets commissioned at Versailles, a consensus emerged that significant effects on exchange rates can be achieved only if underlying monetary policy is allowed to change as a consequence of intervention. What is still at issue is whether intervention, which can affect rates in the short-term even without basic monetary policy changes (though at a possible cost to Finance Ministries) is necessary to smooth overshooting and undershooting of exchange rates caused by large and volatile capital

flows which have little to do with, or at least tend to overcompensate for shifts in current account positions. It could be useful, as a follow-up to the Versailles study and the continuing effort to shape a more stable consensus on the role of government intervention in exchange markets, to undertake a second study of the influence of international capital flows on exchange rates. A second useful direction to pursue, as a part of this same study, would be to examine the effect of national controls and other policies on capital markets and thus also on international capital movements and exchange rates. The domesticist bias is to assume that distorting international capital movements may be as much the consequence of national policies, and specifically policies toward capital markets and investments assets, as the result of unspecified speculative motivations. Thus, removing national obstacles to the free flow of capital may help over the medium-term to stabilize exchange markets. The Reagan Administration has adopted this premise in its efforts to open Japanese capital markets. Although some have noted that, in the short-term, liberalization may have a perverse effect by encouraging borrowing in yen for immediate conversion into dollars, fewer analysts have noted that this need not be the case if borrowed yen could be freely invested in yen assets, such as Japanese companies. The opening of capital markets must include markets for real as well as financial assets. In the end, liberalizing financial markets can be effective only to the extent that trade and investment markets are also liberalized.

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By comparison with its alternatives, therefore, the case for freer trade will become increasingly more convincingly, if the United States and other major currency countries succeed in sustaining world growth.

The twin pillars of growth and freer trade are also, in the domesticist perspective, the key to managing the world debt problem. Unlike the globalist, who sees the sources of the debt problem in a shortage of liquidity and foreign exchange, the domesticist traces the problem back to the domestic and trade policies of both the creditor and debtor countries, impeding the efficient allocation and use of resources. The leading edge and hence solution to the debt problem is not finance but policy.

The Reagan Administration's approach to the debt problem betrayed the domesticist bias. From the beginning, its approach to the IMF and World Bank was addressed to the policies of these institutions, rather than their immediate or projected needs for finance. As the policies of the institutions adapted at the margins in domesticist directions of urging tougher macroeconomic policy adjustments and greater reliance on market forces, the Administration responded with support for their financial needs. The Administration's approach was essentially the same in opting for a case-by-case handling of individual indebted country situation. The objective was domestic adjustment and freer trade policies, and since these policies were unique to each country, a case-by-case approach was recommended. Rather than putting all developing countries into the procrustian bed of equally tough conditionality or, at the other extreme, easily available finance, the case-by-case approach actually allowed more flexibility. It ensured that no country would be pushed beyond its political or social capacity to adjust, even while it avoided creating precedents by pursuing individual cases as part of a more comprehensive approach. Moreover the case-by-case method need not be limited only to the short-term. It can be applied also to achieve longer term solutions. As individual developing countries achieve their goals in the short-term,

their debt situations can be renegotiated and extended over the longer-term. Doing so avoids confusing the terms appropriate to these countries with the terms applying to other countries that have not made the same initial progress.

The domesticist is no less concerned about the debt problem. Globalist critics who charge that the Administration turned a blind eye to the debt problem until the problem smacked it in the face in mid-1982 are making a debater's point, not evaluating Administration statements and actions prior to mid-1982. On the other hand, the Administration did underestimate the extent to which its fiscal policy, given very restrictive Federal policies in 1981-82, would rebound via open financial markets to bring about a much more precipitous appearance of the debt crisis that might have otherwise occurred.

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For this Administration, alas, its success in practically every other field of international economic policy - trade, monetary and debt - hinges critically on its own domestic economic policies and the struggle to complete the budget program it embarked upon in 1981. The stakes are high for the Administration as well as for its domesticist intellectual roots. If it fails, the domesticist's world will be turned on its head. Rather than domestic policies and freer trade standing as the cornerstones of the world economy, the financial crisis will come to dominate all else; and government aid will be needed, either in the form of inflationary monetary policies in the industrial countries or through legislative appropriations, to hold a faltering world economy and political community together.

No one could welcome this sequence of events. Higher U.S. interest rates, either because of crowding out or because of higher monetary growth and subsequent inflation, will increasingly make debt management impossible and politically antagonize the developing countries. The latter will rally, as they have already begun to do this past June at Cartagena, to force more direct involvement in debt renegotiations by the industrial country governments. The involvement of industrial country governments would threaten a revival of North-South confrontation and a sterile, radicalized global conferencing type of dialogue and negotiation, such as we experienced at times in the 1970s.

In the end, three prospects are likely, none of which will help solve the problems of adjustment and further opening of international markets which the debt problem and world economic health require. Confrontation may intensify with exclusively negative consequences. North-South debt talks may go on long enough and earnestly enough to avoid serious confrontation, but no significant substantive results will emerge - as was the case, for all practical purposes with the conference on International Economic Cooperation (CIEC) in the mid-1970s. Or industrial country governments will be obliged, either through inflationary monetary policies or legislative appropriations, to come up with significant aid to help the commercial banks and developing country governments adjust their debt obligations on a longer term basis and reduce the short-term pressure for continuing policy adjustment in the indebted countries. This outcome, to the extent that economic adjustment remains incomplete, only postpones a later day of reckoning. Admittedly, such delays may be necessary in certain cases to stave off political and social upheaval. But then it makes more sense to do this on a country-by-country basis

rather than a comprehensive plan that will benefit most those who are already better off.

The debt problem is not financial but economic. No one should believe that more credit, without the right policies, will even revive world trade and growth. It may for a while as we saw in both developed and developing countries in the 1970s. But eventually the demand for credit to finance inefficient policies becomes insatiable, and the postponed adjustments come home to roost.

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The domesticist perspective, which is enjoying a revival under the present U.S. Administration, offers a different outlook for the 1980s than the globalist perspective of the 1970s. It seeks to exploit, rather than reject, national authority and to develop a consensus on key domestic economic performance indicators -- low inflation, market incentives and freer trade -- which national authority should seek to achieve over the medium-term. On this basis, it seeks to build informal international relationships -Economic Summits, multilateral surveillance, Trade Minister Meetings, etc., -- that help leaders accountable only to their domestic publics better comprehend the world context in which they are operating. Most of all, these international deliberations, rather than governing in some mechanistic or indeed almost fatalistic sense, serve to remind the leaders that interdependence and the open world economy are constructs of their own choosing. It is their willingness and ability to preserve and enhance the basic agreement on more open markets to promote comparative advantage, on price stability to encourage predictable currency and capital

flows, and on market flexibility to accommodate inevitable adjustments that provides the logic of the world economy. An open world economy cannot accommodate unlimited diversity on these key fundamentals. That, the domesticist would argue, is the lesson of the 1970s.

To shape and maintain consensus in the increasingly complex political universe of the 1980s is, to be sure, a very tall order. The Reagan Administration has rightfully reasserted U.S. leadership to direct attention back to the domestic roots of world economic prosperity. But now that it has done so, it cannot get off the hook with respect to its own unbalanced domestic policies. It has painted itself into a corner, and the world awaits to see if, over the medium-term, it will practice what it preaches. While the political capacity to act to resolve the budget problem remains the key, the Administration could help itself politically by recognizing the basic intellectual challenge it is posing to the globalist perspective of the previous decade. A huge gap remains between the Administration's tendency to deal with policy, issue by issue, as if no one cared about a comprehensive overall logic or strategy, and the critics' tendency to dismiss ad hocery as no policy at all and to forego a search for larger patterns of explanation. The domesticist perspective offers a useful template for discerning larger pattern behind this Administration's international economic policy and for holding this Administration accountable for its own domestic policies.

The Magic of Hard Work: Foreign
Assistance and the Private
Sector Under the Reagan Administration*

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The Reagan Administration has sought better balance in international development and U.S. aid programs. This has meant an incremental shift in emphasis from:

- economic to security assistance
- multilateral to bilateral and regional assistance
- international policy to LDC domestic policies
- aid to commercial trade, investment and finance
- public to the private or market sector

This approach is strategic, not ideological. It stresses complementarity, not trade-offs between the various activities listed above. Indeed, in all cases, there is an effort to look at the second area of activity as a means to reinforce and leverage the first activity, rather than to diminish it. Let me explain and then focus on the shift in emphasis to the private or market sector, which is the subject of this conference.

The Overall Emphasis

The previous Administration believed that America's political and economic advantages could substitute for military power and security

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assistance in the third world. There is much to this outlook but it entails an extraordinarily benign view of the world in which developing countries exist. The Reagan Administration sees more turbulence and instability in this world. It stresses security assistance and arrangements to counter this instability and to preserve or restore the necessary environment for economic development. If provided early and effectively, small amounts of security assistance can yield big dividends in improved prospects for economic development. This is the rationale behind the Administration's Caribbean Basin program where security assistance is a small fraction of economic assistance.

Bilateral and regional assistance can be targeted more directly to countries and areas where an integration of economic and security goals is essential. The multilateral development institutions operate best where security can be assumed. Moreover, the advantage of multilateral institutions lies less in their financing capabilities than in their capability to exert economic policy leverage. In 1981, the Reagan Administration reminded the World Bank and the International Monetary Fund (IMF) that conditionality was the essence of their ability to catalyze much larger private funds (as in the case of commercial bank financing following in the wake of IMF adjustment programs) or, where such funds may not be forthcoming, to ensure sound infrastructure development policies. How fortunate it was that the IMF got this message in 1981. When the debt crisis hit in summer 1982, the IMF was in position to play the critical role it has exerted over the past 18 months. With more attention to policy, financing followed. The eighth quota increase for the IMF was approved in February 1983 and ratified last month. I would expect this same sequence to apply to larger funding for the

World Bank and its soft loan affiliate, the International Development Association (IDA).

The emphasis on domestic policies of LDCs themselves is a long-overdue corrective to the preoccupation of the 1970s with the new international economic order and international policies. Domestic policies, after all, are the foundation of the international system. If they are wrong, international policy cannot compensate. If they are right, international policy will be that much more effective. Hence, the Reagan Administration stressed sound domestic policies first in the United States, then other industrial countries and finally the LDCs. Industrial country policies were subjected to a new process of multilateral surveillance in which the IMF Managing Director participates. And developing country policies have come under closer scrutiny in the IMF and in broader development studies, such as the 1983 World Bank Development Report devoted exclusively to the economic management policies of the LDCs.

Aid has become the smaller part of the international development process. For non-oil LDCs, whose exports grew at an annual rate of 21 percent in the 1970s, trade earnings dwarf aid flows. Moreover, while two-thirds of total capital flows to LDCs in 1960 was government funds, two-thirds today is commercial financing. Any country that wants to develop today cannot ignore the international economy. What is more, participating in this economy makes the use of aid more effective, as South Korea, Taiwan and other successful developing countries have shown.

The Private Sector Emphasis

When Ronald Reagan mentioned in 1981 that the private sector accounted

for over 50 percent of the gross national product of the LDCs, he was called ideological. Since then, this figure has become part of the conventional wisdom. I was pleased to note that, in the health sector, anywhere from 50-80 percent of total health services in developing countries is provided for by the private sector. The ideologues are those who would have us to ignore this element of development and who encourage LDCs to strangle their private sectors with massive regulations and a shortage of investment capital.

Let's get one thing straight. We're talking about the market sector when we say private. In the end, who owns the business is a political issue for each country to decide. Public enterprises can operate on market principles no less than private ones. Of course, if asked, I do not think we should apologize for private ownership. In my view, the right of an individual to own property provides that individual with an important means to defend his or her political and human rights.

Proposals

Now, how do we achieve greater emphasis on market-based development policies and programs, both in the U.S. and in developing countries?

First, we take the issue aggressively to the development community, as this Conference is doing in the health sector. We have a lot of ground to make up. In the 1970s, government budget deficits ballooned everywhere, in both developed and developing countries. Parastatals abounded, and public international development institutions grew exponentially. Inevitably the development dialogue emphasized public institutions and

policies. The market sector was lost from view. Foreign direct investment in LDCs, for example, declined as a share of total capital flows from over 20 percent to less than 14 percent. It will take a decade of persistent discussion to restore a better balance.

Second, it is a balance we seek. As in the other areas I've discussed, more attention to the market sector will actually reinforce and enhance, not diminish, the efforts of the public sector. We need not only to recognize this complementarity but deliberately to cultivate it. Over the past decade, U.S. aid programs focused increasingly and exclusively on basic human needs (BHN) or infrastructure activities -- health, education, population, etc. These programs are absolutely essential, especially in the poorest countries, where for example people are not healthy enough to work even if there are jobs. But such programs are not sufficient. Their purpose is to put people in a position to work in productive jobs. To create the productive jobs, A.I.D. and developing countries need innovative programs that harness private sector resources to broader public sector macroeconomic and political objectives.

The Reagan Administration has made a start by creating the new Bureau for Private Sector Enterprise in A.I.D. and establishing this spring the President's Task Force on International Private Enterprise. But it has a long way to go. The Bureau of Private Sector Enterprise is a small enclave in A.I.D. which institutionally still resists a complementary role for the market sector. The President's Task Force could make an important contribution but it needs new ideas and energies.

These ideas have to come, in my view, from the market sector. The U.S. government has no expertise in this area and even less incentive.

Let me make a suggestion. Why doesn't this conference come up with specific ideas for the President's Task Force? Let me stretch my own specific knowledge of the health sector by suggesting two possibilities.

Three years ago, in a piece I wrote for the Council of the Americas, I suggested that A.I.D. fund private, non-profit activities established by professional or trade associations to mobilize market sector ideas and energies within the United States. One problem we face is simply a lack of knowledge in Washington about what businesses around the country, especially small businesses, are doing or not doing in development areas. The point was brought home to me personally in the last few weeks. I am acquainted with a small center for research and innovation in southern Mississippi which has recently developed an emergency medical service and remote cardiac monitoring system which could be applicable in many developing countries, especially in the Caribbean. I called to inform them about this conference. Distant from Washington and not dependent on government funds, they knew nothing about the meeting. How many times is this example repeated throughout the country? Could the National Council for International Health (NCIH) itself create an ongoing (rather than ad hoc, as in the case of this conference) activity or affiliate to reach more of these groups and to mobilize them to influence A.I.D., Congress and developing country policies? Initially, A.I.D. might provide seed money but eventually the organization could operate on a non-profit basis for modest membership fees. Today, in Washington, very few non-profit or, as they are often called in the aid business, private voluntary organizations exist to promote the role and contribution of businesses, especially small businesses, in development assistance programs.

What sorts of ideas might come out of such groups? Let me offer my second possibility as an example. The most serious obstacle to more market based activities and cooperation in the developing world is attitudes. Whether justified or not, many developing country officials, as well as aid officials, feel scarred by private sector ventures that failed or, more importantly, by the vicious ideological attack in the 1970s on multinational companies. They know little about how market based organizations operate. Hence, like aid officials, they are unlikely to take the initiative on their own. Market organizations will have to do so, if any real change is going to occur.

So what if this new mythical non-profit organization that NCIH has just established decided to approach a specific developing country with a plan put together by its business members, those exporting to or operating in this country or seeking to do so? The plan calls for establishing a facility in the country funded and staffed collectively by U.S. health industry firms to provide sector-wide services to the indigenous health industry -- suppliers, operators, marketers and educators. These services would not involve proprietary activities associated with any one U.S. firm but rather general industry services, such as basic and refresher training in quality control, hygiene techniques, etc. appropriate to health industry suppliers, or similar training programs in new medical research findings appropriate to health industry providers, or in general management techniques for hospital management companies and so on. Such a facility might also arrange trips by local official and businessmen to the United States to observe how the market sector works in this country. None of these activities interfere with the profit-based activities of

individual firms, yet they enhance the general quality of indigenous skills available to run a cost effective, high quality health industry in that country. Most importantly, they offer a presence of foreign health industries in the developing country that expresses a collective concern for local development and not just an interest in providing services or supplies for a profit. This kind of presence could go a long way toward altering the prejudice against profit and market based activity in developing countries as well as in our own aid agency. It fosters a better corporate image by separating the foreign business involvement from a direct relationship with the individual firm's bottom line, yet indirectly improves that bottom line by lowering the cost of externalities associated with doing business in a less developed environment. Indeed, it might not cost foreign businesses that are already involved in the country anything at all. Many of them already fund good citizenship activities in these countries and could simply divert these resources to collective efforts with other U.S. (and perhaps other foreign) businesses. Private industry has to present a new face in developing countries. Earlier corporate image could be built by firms acting individually: such as Ford building schools in Mexico. Today it is the corporate community that must show its concern.

Conclusions

Well, I have exhausted my knowledge of the health sector. So let me turn it over now to the experts. Keep in mind, however, my major points. The Reagan Administration has started to open new doors to viewing development as a broad-based activity requiring the complementarity

of many efforts -- economic and security, multilateral and bilateral, international and domestic, aid and the commercial economy, and the public and private sectors. In the case of the latter, the market sector will have to take the lead. This conference has a chance to do so in the health sector. I hope you seize the opportunity and submit your suggestions formally to A.I.D., the President's Task Force, and interested international or foreign organizations represented at this meeting.