Entangling Alliances (2)

THE COSTS OF REAGANOMICS

by C. Fred Bergsten

The economic goals of the Reagan administration would appear to provide strong support for a more assertive U.S. foreign policy. Lower U.S. inflation would help restore global price stability and general economic calm. Renewed U.S. economic expansion would provide an engine of growth for the world economy and reduce the risks of protectionism at home and abroad. A more secure economic base would be laid for the defense build-up, which aims to assure allies and deter the Soviets.

The actual impact of the Reagan program, however, is already creating major economic problems for the industrialized nations, the developing countries, and especially the United States itself. Probably by the end of 1981, and certainly in 1982, severe economic difficulties will result with profound implications for overall U.S. foreign policy.

How could such laudable goals produce such negative results? The extremely high costs of the Reagan program stem from its strange combination of expansionary, loose fiscal policy and steady reduction of monetary growth. The sharp tax cuts combined with massive defense expenditures will continue to produce large budget deficits, despite the sizable cuts in non-defense expenditures. To fight inflation, which will be promoted by its fiscal stance, the administration is relying solely on monetary policy, thus insuring that interest rates will remain quite high for the indefinite future. This level of interest rates—unprecedented in real terms in modern history and stemming primarily from the faulty policy mix of the administration—has badly distorted and un-

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dermined all major components of the world economy.

Cutbacks in non-defense expenditures and steady and slower monetary growth are highly desirable. But a combination of tighter fiscal policy and less stringent interest rates would combat inflation at least as effectively as the Reagan mix. And only the most doctrinaire supply-sider would claim that large, across-the-board tax cuts will really boost productivity and growth in a non-inflationary manner, given the size of the budget deficit, particularly when compared with the alternative of a tighter fiscal stance and lower interest rates. Moreover, no evidence exists to support the administration's view that fiscal and monetary policies can successfully be targeted on opposite objectives: fiscal policy to stimulate growth, monetary policy to fight inflation.

Indeed, the administration's insistence that its approach is the only path to economic recovery suggests conclusively that its primary motives are not economic in nature, but structural and ideological. For more than any alternative approaches, the administration's program will force a sharp reduction in the size of government as tax revenues fall and efforts to reduce the deficit build pressure for further cuts in expenditures.

In devising this misguided macroeconomic policy, the administration ignored altogether the possible global effects. Of course, domestic considerations should—and always will—be the primary determinant of U.S. economic policy. But the administration's failure even to consider the international impact of its actions will soon have a doubly severe effect on the U.S. economy itself. First, the unprecedented overvaluation of the dollar caused by the policy mix will produce huge U.S. trade deficits and retard U.S. economic growth. Second, the sizable and precipitate fall of the dollar that must inevitably ensue will propel the inflation rate upward.

The administration s explicit declaration that it would not intervene in the exchange markets to help control the value of the dollar has severely compounded these problems. In an earlier era, everyone would have denounced such a position as benign neglect. At the Ottawa summit meeting in July 1981, the administration ignored allied complaints and diverted public attention from the clash through skillful public relations. But the success was short lived. Whatever pose was adopted by officials, West European silence could not be sustained in the face of hostile public opinion throughout the continent.

To be sure, some administration policies have favorably affected international economic arrangements. The early decisions to decontrol oil prices immediately and to accelerate sharply the filling of the Strategic Petroleum Reserve will have a major salutary effect on U.S. energy goals and on the stability of the global energy system. By allowing the so-called voluntary export restraints on Taiwanese and Korean shoe sales to the United States to lapse, the administration bolstered the credibility of its avowed devotion to free trade. This action offset, at least to some extent, negative steps such as the pressure on Japan to limit automobile exports and the drastic slashing of trade adjustment assistance.

The administration took another positive step when it supported the International Monetary Fund's (IMF) program to borrow substantially from Saudi Arabia and a few other countries to finance the IMF's greatly expanded role in the petrodollar recycling and adjustment process, including the related reallocation of voting power within the institution. Moreover, proposed increases in bilateral—largely military—aid offset at least in part the apparent retrenchment in multilateral lending.

The Soaring Dollar

The central issue, however, is the impact of Reaganomics on the overall world economy. According to administration officials, their program will produce a steady decline in inflation and a restoration of private investment and vibrant growth in the U.S. economy. This recovery at home will in turn have a favorable impact on the global economy.

Although the administration may continue to benefit from factors outside its control—such as trends in world oil and food prices that have held back more inflationary pressures—there is no evidence to support its claim that the so-called supply-side tax cuts will greatly benefit the U.S. economy. Indeed, conclusions contrary to the administration's position are reached in the most serious study of the subject attempted so far.[1] Moreover, fiscal and monetary policies cannot successfully move in opposite directions. Although rapid economic growth occurred in the first quarter of this year and inflation receded in the second quarter, each came too early in the administration to be credited to its policies. Likewise, Reagan's economic policy cannot be blamed for the recent decline in gross national product (GNP). In fact, the unprecedented levels reached by interest rates in recent months are the only clear result of Reaganomics to date.

The impact of these rates on the international economic position of the United States is already being felt. When the Reagan administration took office in January 1981, the dollar had climbed by an average of about 9 per cent against the currencies of U.S. trading partners from the lows of October 1978 and by 15-20 per cent against the erstwhile strong currencies—the Deutsche mark (DM), yen, and Swiss franc. Six months into the new administration, the dollar had soared to an average level more than 20 per cent above the lows of late 1978, largely because of the sharp rise in U.S. interest rates. It had moved 30-50 per cent higher against all major foreign currencies and had virtually retraced the two devaluations of the early 1970s, including that negotiated at the Smithsonian in December 1971.

How will this strengthening of the dollar affect the international competitive position of the United States? Since late 1978, when the dollar probably became somewhat undervalued following the corrections made to eliminate the sizable U.S. current account deficits of 1977-1978, U.S. inflation has substantially exceeded that of several key American competitors, notably West Germany and Japan.

Combining the recent currency changes and relative inflation performances, U.S. price competitiveness with respect to these major nations has deteriorated by 50 per cent or more

[1] *Henry J. Aaron and Joseph A. Pechman, eds.,* How Taxes Affect Economic Behavior *(Washington, D.C.: The Brookings Institution, 1981).*

in less than three years, most of it in the last 12 months. The decline against the entire universe of trading nations is much less because countries such as Great Britain and Italy have inflated even faster than the United States. Nevertheless, the average decline in U.S. price competitiveness over the past one to three years is very substantial—somewhere on the order of 25 per cent. The strengthening of the dollar has gone much too far and will be as costly to both the United States and the world economy as was the excessive dollar weakening of three years ago.

Such a huge swing in price competitiveness will have a major adverse impact on U.S. exports and imports, the U.S. current account, and the dollar. The only issues are magnitude and timing. Regarding the former, every percentage point of competitive deterioration is likely to produce a swing of $2-3 billion in the trade accounts. As a result, the U.S. current account, which was in surplus from 1979 through early 1981, will show a deficit that will be a multiple of the $14 billion deficits of 1977 and 1978, which triggered the steep decline in the dollar and the severe international monetary instability of that period.

Economic Costs and Protectionism

This shift has already begun. Deficits will probably begin to emerge in the second half of this year and seem likely to accelerate sharply in early 1982. The full impact of currency changes occurs over a period of about two years. Consequently, the adverse effects of loss of U.S. competitiveness will extend well into 1983 or even beyond, depending on how long the unwarranted strength of the dollar continues. Should the U.S. economy recover rapidly from its doldrums late in 1981 and in 1982, the swing of the U.S. current account into deficit would be further accentuated.

It is not clear just when this major deterioration in the U.S. current account will produce a decline in the exchange rate of the dollar or how far that decline will go. Changes in interest rate differentials and transient political events dominate exchange rates in the short run. But current account positions are more important in the medium and long run. Moreover, the modern history of flexible exchange rates suggests that when exchange rates move they tend to overshoot their equilibrium level severely. Hence, the dollar may well decline sharply and rapidly once the reversal begins.

The U.S. economy will react in several ways. First, net exports will decline and retard GNP growth. A 20 per cent depreciation would mean a deterioration of $40-60 billion if each point of depreciation hurt the trade balance by $2-3 billion. Even in today's $3 trillion economy, growth would fall by 1.5 percentage points, slicing the 1982 growth rate in half or even more. Unemployment would rise by at least 0.5 per cent—approximately 500,000 jobs—or even double that amount. Already in the second quarter of this year, the decline in net exports accounted for two-thirds of the total decline in real GNP. This development represents a major, seemingly unanticipated setback to administration plans.

Second, the induced depreciation of the dollar will adversely affect the inflation rate. The 10 per cent decline in the value of the dollar in 1977-1978 added an estimated 1-1.5 per cent to the level of prices at that time, as prices of imports rose and competitive pressures on domestic producers were reduced. Hence, an inflationary impact of 2-3 percentage points is now quite possible. The rise would substantially retard the hoped-for reduction in inflation in 1982 and beyond. Paradoxically, this will occur simultaneously with the negative impact of the deteriorating current account on growth and jobs because one to two years must pass before the influence of changes in exchange rates shows up in the trade balance.

Third, the inevitable decline of the dollar will reintroduce a high degree of financial instability and tension into the world economy. The Organization of Petroleum Exporting Countries could again cite the weakness of the dollar and the declining value of their dollar assets as a justification for increases in oil prices. Members of the European Economic Community might revive their efforts of the early and middle 1970s to insulate themselves from the unstable dollar by creating a zone of financial stability through the European Monetary System. Steady, sizable, and destabilizing diversification out of the dollar into other currencies might occur.

Particularly if the administration continues to refuse to intervene in the exchange market or otherwise move to help brake the dollar's fall, widespread denunciation of U.S. benign neglect would reappear. The effort to achieve a more assertive U.S. foreign policy would be weakened, even jeopardized.

Current U.S. economic policy probably represents a greater immediate threat to U.S. global interests . . . than do the Soviets or anybody else.

Finally, the policies set in motion seem almost certain to revive strong protectionist efforts. The postwar record reveals that an overvalued dollar is by far the greatest single threat to a liberal trade policy in the United States. The strongest challenge to this policy—culminating in the near-passage of the highly protectionist Mills bill in 1970 and Burke-Hartke proposals in 1971-1972, which would have limited virtually all U.S. imports—occurred at a time when the aggregate unemployment rate was at its lowest level in 20 years. But the final phase of the Bretton Woods system had then produced a dollar overvalued by about 15 per cent. In 1976-1977, the dollar was again overvalued and again protectionist pressures rose. By contrast, in 1974, notwithstanding the highest level of unemployment since the Great Depression, Congress passed the Trade Act, authorizing the extensive trade liberalization that took place in the Tokyo Round of Multilateral Trade Negotiations; the dollar was then in rough equilibrium.

The reasons for this overlooked correlation between exchange rates and protectionism are clear upon examination. When the dollar is in balance, weaker industries faced with foreign competition continue to seek protection but, with rare exceptions, cannot either provide a convincing case that their problems derive from imports or acquire enough allies to achieve a swing in the basically liberal thrust of U.S. trade policy.

When the price competitiveness of all industries deteriorates substantially because of an overvalued dollar, however, trade relationships do pose a problem to the U.S. economy as a whole. Then, coalitions advocating protectionist devices form without difficulty. For example, as a result of exchange rate changes, steel imports are again increasing sharply and export orders are falling in a number of industries. The bilateral U.S. trade deficit with Japan will soar far above today's level, reviving major frictions across the Pacific.

Trade policy implications are thus a major result of the current dollar overvaluation. Those consequences will be more severe the sharper overvaluation becomes and the longer it persists. (It is curious that neither U.S. exporting and import-competing industries nor the workers in those industries ever lobby the government to do something about the exchange rate, although they frequently make enormous efforts on issues such as the Export-Import Bank that have much less effect on their competitive positions.)

The Foreign Repercussions

Although U.S. interest rates are not the root cause of economic difficulties in Western Europe or other parts of the globe, Reaganomics is badly exacerbating the problems of national economies throughout the world. Virtually every industrial and developing country is now devoting major, even priority, attention to fighting inflation. Yet the high interest rates generated by the U.S. policy mix are attracting huge flows of foreign capital to the United States and deterring U.S. investment in other countries. The consequence is steady downward pressure on the exchange rates of these countries. This result adds substantially to their inflationary pressures, in proportion to the extent their economies are open to world trade and financial flows. In general, the smaller the country the greater the effect, but the impact has been sizable even on such large countries as West Germany and Great Britain.

In response, other countries must raise their own interest rates to prevent capital flight. Hence, interest rates throughout the world have risen to record levels. West German

Chancellor Helmut Schmidt may have been correct at the Ottawa summit when he said that interest rates are at the highest levels of the Christian era. They now average between 5 and 7 per cent after allowing for inflation, which is double or triple the historical norm of 2-3 per cent. This situation will result in even slower growth and added disincentives to investment, the opposite of what the Reagan administration intends. The slowing of growth abroad also encourages a further deterioration in the U.S. current account and an added decline in the value of the dollar.

But more than interest rates are involved. U.S. policies are forcing other countries not only to raise their interest rates but also to alter, perhaps drastically, their own fiscal and monetary policies. One response to the recessionary implications of tight money is to increase government expenditures, as France is doing. But such a course increases inflation and runs directly against the underlying goal of the entire Reagan strategy.

Alternatively, if other countries believe in the so-called supply-side component of Reaganomics, they too can employ tax cuts and risk the generation of new inflationary pressures. Since virtually no other country does believe that such tax cuts will call forth sufficient investment to offset the inflationary pressures flowing from them, most will have to tighten their fiscal policies sharply to have even a hope of reducing interest rates. Defense budgets will undoubtedly be cut in such a program, directly undermining the administration's North Atlantic Treaty Organization (NATO) strategy and overall foreign policy.

For example, the West German economy is now stagnant, dragging down growth and promoting unemployment throughout Western Europe. Its inflation rate, although worrisome by West German standards, remains the lowest of any major industrial country. From both the domestic and international perspective, West German economic policy should be mildly expansionary. But because of the rapid growth in government expenditures and budget deficits that this growth has caused, West German expansion would have to come from more relaxed monetary policy. Indeed, structural reasons probably require fiscal tightening whatever the immediate macroeconomic situation. Monetary easing should therefore go even beyond the purely cyclical needs of the moment.

U.S. policy, however, absolutely precludes such an approach in West Germany. Any such easing of West German interest rates would trigger a further plunge of the DM, with unacceptable inflationary results for not only West Germans but also all other countries in the European Monetary System. This is why Bonn in February 1981 raised interest rates even though domestic considerations suggested an opposite move. It is also why Schmidt immediately upon returning from the Ottawa summit worked out a sharp reduction in West German budget expenditures—including a cut in defense expenditures, a far cry from the agreed NATO target of raising such spending by 3 per cent annually in real terms.

Similar results will prevail in the developing countries, with an added twist. A central problem in most developing countries is their massive indebtedness, an issue of immediate concern to the functioning of the global economy. Yet each additional percentage point in the level of U.S., and thus global, interest rates adds about $500 million to the annual current account deficits of Brazil and Mexico and perhaps $4 billion to the deficit of all less developed countries (LDC). As pointed out by Morgan Guaranty Trust Company in its May 1981 *World Financial Markets*, "A one percentage point change in [interest rates] now causes more of a variance in LDC financing requirements than does a one percent change in oil prices." The recycling problem is compounded.

Given the slowdown in world economic growth—caused in large part by U.S. policy—these countries have no alternative but to cut growth rates further. Political and social tensions, already highly flammable, will grow as a result. The U.S. economy and the economies of Western Europe, which depend particularly heavily on exports to the developing countries, will weaken further.

Bad Economics = Bad Politics

Thus, the United States is nakedly and rather bluntly forcing its economic policies and priorities on the rest of the world. This new manifestation of dollar diplomacy alone is enough to cause major problems for U.S. foreign policy.

This time, in addition, the United States is forcing untested and almost certainly misguided economic policies on the rest of the world. Otto Eckstein of Harvard University has testified that "unfortunately, we have only one economy with which to experiment." He might have said the United States has only one world with which to experiment.

The experiment is clearly misfiring. The administration bought a bit of price reduction early in 1981, beyond that resulting from the fall in oil and food prices, because the further appreciation of the dollar lowered the price of imports. But it will reap substantial unemployment from the subsequent trade deterioration and substantial added inflation from the resulting dollar depreciation. Foreigners are already suffering the same twin effects. They will recoup a bit, but probably only a bit, as the U.S. trade balance weakens and their currencies strengthen in response to the decline of the dollar.

Perhaps the greatest misfortune of all is that the administration could have largely, if not entirely, avoided these problems. It could have cut the size of government, reduced nondefense expenditures, supported a steady reduction in the growth of the money supply, and deregulated the economy without causing these international and hence domestic problems. It could have achieved its objectives by modifying the pace, extent, and composition of its tax cuts and defense build-up. In fact, a change in policy mix would have greater promise of achieving the administration's avowed domestic objectives and alleviated the burdens it has placed on the world economy.

Even without these modifications, the administration had a second line of defense. By intervening even modestly in the foreign exchange markets as the dollar soared, it could have achieved three important objectives. First, it could have halted the rise of the dollar and hence limited the current overvaluation. Second, it could have accumulated sufficient holdings of DM and perhaps other foreign currencies to help brake the inevitable decline of the dollar that will ensue. Third, it could have established a tangible form of monetary cooperation with key U.S. allies abroad, which would in turn foster greater understanding and mutual respect.

At this point, a significant decline in U.S. interest rates would contribute more to overall U.S. foreign policy than any other single step now available to America. Indeed, current U.S. economic policy probably represents a greater immediate threat to U.S. global interests—both in Western Europe and the developing world—than do the Soviets or anybody else.

Any administration . . . must consider with utmost care the state of the world economy in defining the nation's economic policies.

Unfortunately, a good deal of the damage of 1981 cannot be undone. Some changes are still possible, however. The administration can stretch out the military build-up to take account of the overriding economic problems and the direct impact of defense expenditures on inflation. It should seek further cuts in nondefense expenditures. Perhaps it could even rescind some of the tax cuts. Whatever the specifics, the goal should be straightforward: to tighten fiscal policy sufficiently to relieve the burden of fighting inflation from monetary policy and to permit a substantial reduction of U.S. interest rates.

On the purely international side, a resumption of exchange-market intervention would also help, especially if the policy mix remains unchanged. Indeed, in the absence of intervention now to accumulate additional foreign currency holdings, it will be very difficult to intervene when the dollar starts to weaken, even if the administration changes its attitude then and permits such action. The only other defense against the dollar decline will be to raise interest rates once more, thus reinforcing all the problems of the current policy mix.

Bad economics traditionally has produced bad politics. This administration ignored the impact of its economic strategy on the outside world. Nor did it think through the international repercussions of that strategy on the United States itself. It did not even study in that light the economic implications of the defense build-up, which presumably it undertook for foreign policy reasons. Now the administration is simply ignoring even the most responsible requests of other countries—such as West Germany and France—to demonstrate sensitivity to the impact of U.S. policy on their economies. Its only economic ally, Great Britain under Margaret Thatcher, has failed miserably with its somewhat similar policies and should be regarded as a dire warning rather than as a source of encouragement.

International economic cooperation is not always easy, but it has been a cardinal element of the foreign policies of both Republicans and Democrats throughout the postwar period. Now it is even more imperative than before.

One of every six U.S. manufacturing jobs depends on markets abroad. One of every three acres of U.S. farmland produces for export. Almost one of every three dollars of U.S. corporate profit derives from the international activities—investment as well as exports—of American firms. The share of trade in U.S. GNP has doubled over the last decade. America depends on imports not just for oil but for more than one-half of most of the key industrial raw materials. Any administration, in its own self-interest, must consider with utmost care the state of the world economy in defining the nation's economic policies.

Virtually every other country in the world attaches a central role to international economic issues. The United States cannot afford to act differently. Continued malign neglect of the impact of U.S. economic policy on other countries would devastate U.S. foreign policy and U.S. domestic prosperity.

One can only hope therefore that the administration will wake up in time to the realities of international economic interdependence. Once it does, there will be at least a chance to alter policies that are already causing severe problems for both the United States and most of its friends abroad.