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WHERE REAGANOMICS WORKS

by Henry R. Nau

Throughout the Reagan administration's first term, critics have charged that it has no international economic policy save for carrying out its domestic program. The administration, it is argued, has "relegated international economics to a lower priority than any administration in the postwar period" and has formulated its domestic economic policies "in almost total disregard for the outside world."[1]

This charge betrays elements of a mindset that dominated discussion of international economic policy during the 1970s. From a perspective more appropriate to the 1980s, Reagan administration international economic policies reflect a coherent analysis and attack on the major economic ills of the previous decade. Understanding this alternative perspective is essential to balance the policy debate as well as to hold the administration, whose policies do not always conform to this alternative perspective, accountable to its own standards.

The alternative outlook rests on the simple proposition that the world economy is only as good as the national economies that compose it. If national economic policies promote sustained, noninflationary growth, economic relations among states are unlikely to be per-

[1]*See Benjamin J. Cohen, "An Explosion in the Kitchen? Economic Relations with Other Advanced Industrial States," and Richard E. Feinberg, "Reaganomics and the Third World," in* Eagle Defiant: United States Foreign Policy in the 1980s, *ed. Kenneth A. Oye, Robert J. Lieber, and Donald Rothchild (Boston: Little, Brown and Co., 1983); and C. Fred Bergsten, "The Costs of Reaganomics,"* FOREIGN POLICY 44 *(Fall 1981).*

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verse. But deficient national policies, regardless of international arrangements, will probably produce little but international economic malaise and instability.

This self-evident proposition was nevertheless forgotten during the 1970s. Then, global economic problems were traced largely to the malfunctioning of the international economic system itself. Trade and capital flows had become so sensitive and complex, it was argued, that national policies, suffering from divisive special interests at home, could not cope with the new realities. Neither could limited international institutions. Interdependence required more centralized and comprehensive mechanisms and institutions to manage the world economy and to make national policymaking effective once again.[2]

This globalist view has been so dominant that reasserting national authority and tilting toward converging national, rather than global-institutional, solutions under the Reagan administration have been branded disdainfully as economic nationalism or, even worse, economic isolationism. Yet events in the early 1980s and the initial results of Reagan administration policies are making the case for an alternative approach.

The alternative approach reverses the globalist logic and places national policymaking at the foundation of world economy. It emphasizes the need for domestic economic performance among major countries to converge around a few, fundamental indicators—low inflation, flexibility of markets, and open international economic boundaries. If these conditions exist, trade and capital flows flourish and reinforce domestic growth and stability, as well as the effectiveness of national policymaking.

Such a domesticist approach differs from the globalist approach in three important respects. First, it rejects the notion that national policymaking is increasingly ineffective

[2]*See, for example, the two reports of the Brandt Commission,* North-South: A Program for Survival, *and* Common Crisis North-South *(both Cambridge, Mass.: MIT Press, 1983); and especially Albert Bressand, "Mastering the Worldeconomy,"* Foreign Affairs *(Spring 1983).*

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and seeks to revive consensus and the capacity to act at the national level first, before international action. The domesticist views this tack as more realistic because however diverse national economies may be, international diversity is still greater. Second, while domesticists agree that the world economy has become more sensitive and complex, they recall that national policies of price stability and flexible, open markets created this interdependence in the first place. Thus, whether national policies are inflationary or noninflationary, closed or open, is far more important than the existence of international cooperation. If national policies are deficient, as they were in the 1930s, international cooperation can actually worsen matters, as the ill-fated 1933 World Monetary and Economic Conference in London showed. If national policies promote domestic price stability and international comparative advantage, then extensive international cooperation, beyond a basic consensus on these points, may be less necessary.

Therefore, as a third point of difference with globalists, domesticists play down direct, international political bargaining and institutions and advocate instead the use of vigorous national action, working indirectly through the international marketplace, to induce mutual adjustment of national policies toward low inflation, strong market incentives, and open borders. In a world where economic power is more diffuse and competitive, direct international bargaining may be both more difficult and less necessary: more difficult because the larger number of participants impedes agreement at the bargaining table, and less necessary because the move from a hierarchical to a more competitive world market increases the odds that acting on domestic or self-interest grounds also serves the common interest. Thus, national action that commands sufficient economic power in the marketplace and uses it efficiently can improve prospects for international consensus in today's complex world.

The differences between domesticists and globalists are relative, not absolute. Both care intensely about the world and not just about the U.S. economy, and both rely on national

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and international policy. Domesticists prefer to act at the national level but seek international consensus on key aspects of national performance, which ultimately limits national choice. Globalists prefer to act at the international level, in part to secure more, not less, autonomy and effectiveness for national policymaking.

The domesticist view is rooted in an evaluation of the performance of the postwar international economic system. The domesticists contend that, for all its faults, this system has achieved higher sustained rates of growth and development than any previous system over a comparable period in history, and for developing countries as well. From 1950 to 1980 world output tripled and per capita income doubled. Average annual gross national product (GNP) and per capita GNP increased by the same rate in some 60 middle-income developing countries as in the industrial countries. Taking comparative purchasing power into account, real per capita income in the middle-income developing countries actually grew twice as fast as in the industrial countries. In the remaining 90 or so low-income countries, real per capita income rose by less than one-fifth of these increases. Yet from 1950 to 1979, literacy rates in low-income countries increased from 20 to 51 per cent, life expectancy went up from 41 to 57 years, and child mortality declined from 28 to 12 deaths per thousand.

Domesticists play down direct, international political bargaining . . . and advocate instead the use of vigorous national action . . . through the [world] marketplace.

The domesticist attributes these results not simply to historical inevitability or postwar reconstruction, but rather to deliberate policy choices in three basic directions.

First, the postwar system gave pride of place to noninflationary domestic policies as the source of world economic growth and stability. This priority was reflected in the

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commitment by all other countries besides the United States to a fixed exchange rate in relation to the dollar and a commitment by the United States to maintain the value of the dollar in terms of gold. Underlying the gold link was an even more fundamental U.S. commitment to domestic price stability, which became increasingly important during the 1950s and 1960s as the dollar became the principal international reserve currency. Until about 1960, U.S. gold reserves could cover outstanding liabilities against the dollar. During the 1960s, however, these liabilities grew to many times the value of U.S. gold reserves, and the willingness to hold dollars abroad depended more and more on the price competitiveness of U.S. goods and capital assets. Domesticists argue that foreign perceptions of declining U.S. competitiveness, because of the U.S. government's inflationary guns-and-butter policies during the late 1960s, eventually destroyed confidence in the U.S. dollar and the fixed exchange-rate system.

Second, the postwar system sought to liberalize trade, at least in manufactured goods. The decision to allow comparative advantage to work at the margins as governments moved toward lower barriers—totally free trade was never the objective—was decisive for postwar prosperity, particularly when compared with the prewar system. The latter system avoided price inflation, too, but sacrificed prosperity to protectionism. The commitments to freer trade and to price stability, fixed exchange rates, and domestic policy discipline were inseparable. The idea was to prevent countries faced with balance-of-payments deficits or surpluses from altering their exchange rates—except in circumstances of fundamental disequilibrium—or to impose new trade barriers, except for a limited-safeguards clause provided by the General Agreement on Tariffs and Trade (GATT). Consequently, countries either would have to finance deficits or absorb surpluses through reserve losses or accumulations, or eventually would have to discipline the domestic policies that were contributing to their economic troubles.

The commitments to price stability and liberalized trade also implied a third commit-

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ment. That was to preserve a relatively flexible domestic economy, tilting at the margins toward market forces and market pricing to promote efficiency. Since the international means of adjustment permitted by the system were relatively constrained, balance-of-payments adjustments would have to be made largely through domestic changes. Governments were obliged to facilitate this adjustment and to ensure that economies retained enough flexibility to move resources readily from declining to growing sectors. The commitment was not to avoid direct government involvement in the economy but rather to keep economies flexible to fascilitate adjustment. This goal was often best achieved by tilting toward market forces, whether resources were publicly or privately owned.

The Policy Culprit

What went wrong in the 1970s? The most common explanation is offered by the globalists. In this view the unique postwar economic dominance of the United States inevitably disappeared, as postwar allies and erstwhile enemies prospered and increasingly differed with the United States on fundamental economic policy objectives. These differences, which could not be resolved at the bargaining table—despite historic U.S. attempts to stabilize exchange-rate relationships—would have to be accommodated by greater flexibility in the marketplace. Domestic flexibility, which ensured adjustment under the old system, gave way to greater international flexibility. Floating rates absorbed some of the requirements for domestic adjustment and relaxed the need for consensus on economic fundamentals. As a 1977 Trilateral Commission report stated, "An important feature of a renovated [world monetary] system is precisely its scope for accommodation of nations with widely different circumstances and even with somewhat different basic preferences regarding the objectives of economic policy." What is more, floating rates came just in time, as the oil shocks further widened national economic policy differences.

The domesticists agree with this analysis, as far as it goes. But they believe that this

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analysis overlooks and perhaps excuses the central reason for the loss of U.S. competitiveness and the collapse of worldwide commitments to price stability, market forces, and freer trade. The culprit, as they see it, was U.S. domestic policy, specifically, the growing budget deficits and accelerating money growth that began in the late 1960s and that represented such a sharp break with the past. The federal deficit swelled from an annual average of $4.4 billion between 1961 and 1966 to $8.7 billion in 1967 to $25 billion in 1968. After a small surplus in 1969, the budget sank deep into the red during the following decade, with deficits reaching $60 billion in both 1976 and 1980. Similarly, money growth exploded from an average of 3.4 per cent annually from 1961 to 1966 to 6.6 per cent and 7.7 per cent annually in 1967 and 1968. Between 1969 and 1979, money growth averaged 6.3 per cent per year. Largely as a result, U.S. average annual inflation rates increased from 1.8 per cent between 1960 and 1967 to 4.5 per cent between 1967 and 1973 and to 7.9 per cent from 1973 to 1980. During the same period, average annual U.S. unemployment rates rose from 4.4 per cent to 6.1 per cent.

According to the domesticists, this decline in U.S. policy discipline and performance did not result from, but actually contributed to, the decline in U.S. power relative to its competitors, and imposed inflation and instability on them through the international marketplace. Contrary to those who stress declining U.S. hegemony, the domesticists believe that the American role in the world economy was not significantly different in 1970 than it was from the mid- to late 1950s. In 1955, U.S. GNP represented 36.2 per cent of total world output; in 1970, 30.2 per cent. From 1960 to 1970, U.S. exports declined only from 14.9 per cent to 12.8 per cent of the world total. And the dollar's share of total world reserves actually increased from 1955 to 1970. It is difficult, therefore, to attribute the U.S. decline before 1970 primarily to external forces outside U.S. control. More likely, domesticists argue, U.S. domestic policies after the late 1960s squandered U.S. economic power and in the process damaged the world economy.

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Inflation was exported and then compounded by the two oil price shocks. Compared to the 1960s, average annual inflation in the 1970s tripled in both the developed and developing worlds and unemployment in the industrial countries more than doubled.

The breakdown of price stability made it harder to resist protectionism. As it became clear that floating exchange rates did not provide the expected insulation from policy differences, and as daily capital movements exploded in volume, many countries, including the United States, found ready excuses to erect new barriers to trade. Tariff barriers continued to decline under the agreements of the Tokyo Round, but nontariff measures, including quotas and subsidies both for declining and for new high-technology industries, began to spread. New doctrines emerged, declaring free trade an anachronism and calling for various kinds of comprehensive government economic planning and industrial policy. Schemes were also hatched to switch to static principles of managed international trade. Little wonder, domesticists concluded, that at the margins trade patterns no longer contributed to the efficient allocation of world resources.

The collapse of price stability and the erosion of free-trade commitments both facilitated and reflected the loss of commitment to market forces and flexibility. Through the 1970s the role of government grew inexorably, as citizens demanded more and more from their public authorities. For the seven major industrial countries combined—Canada, France, Italy, Japan, the United Kingdom, the United States, and West Germany—that have participated in the Western economic summits, the ratio of total public expenditures to gross domestic product (GDP) rose from 29 per cent in 1967 to around 37 per cent by the early 1980s. In Canada, Italy, Japan, Spain, the United Kingdom, and West Germany, this figure rose even faster. In the middle-income developing countries, central government expenditures alone grew from 18 per cent of GDP in 1970 to 26 per cent in 1980. State-owned enterprises in these countries, often required to pursue nonmarket as well as market objectives, mush-

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roomed—in Brazil from fewer than 150 to almost 500; in Mexico from fewer than 200 to more than 500; in Tanzania from fewer than 100 to 400. Domesticists believe that these developments weakened market forces and market pricing and further reduced national and international economic efficiency.

This administration has been particularly remiss in presenting broad intellectual explanations for many of its policies.

Twice during the 1970s the United States tried unsuccessfully to achieve international consensus on economic issues through diplomatic bargaining. First, at a conference at the Smithsonian Institution, President Richard Nixon sought to restore monetary order after he cut the dollar loose from gold. And at the 1978 Bonn summit President Jimmy Carter tried to convince West Germany and Japan to loosen their fiscal policies and serve as locomotives for worldwide economic growth. But both times America squandered its diplomatic bargaining power by pursuing inflationary domestic economic policies that weakened its power in the marketplace. In the 1980s, domesticists urged a reversal of this approach: an assertive use of U.S. economic power in the marketplace based on noninflationary policies and a relatively passive U.S. economic diplomacy, for example, at the annual economic summits. Domesticists believed that this combination could work because U.S. power in the international marketplace, exploited effectively and enhanced through noninflationary policies, remains much greater than its power at the bargaining table—a fact that frequently irritates U.S. allies. If the U.S. economy, therefore, could be revitalized and steered back to price stability, market incentives, and freer trade, the world economy might be induced to follow. At some point, domesticists argue, changes in the world economy might help the United States apply its reduced political influence at the bargaining table to re-establish consensus and, if necessary, secure

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formal commitments to a revitalized international economic system.

The domesticist approach underlies much of the Reagan international economic program. This is not to say that domesticism's premises are shared consciously or fully by individual administration officials or even by the president himself. This administration has been particularly remiss in presenting broad intellectual explanations for many of its policies.

Yet it is also a mistake to argue that the Reagan administration has had only a domestic economic strategy. This charge reveals the critics' tendency to view domestic reactions to world economy as essentially counterproductive—as nationalistic, neomercantilistic, unilateral, or simply "ideological." Globalist argue that such reactions, by definition, cannot be helpful in dealing with the world economy because the problems lie outside the nation-state. Also, the fragmentation of domestic authority ensures either that there will be no response or that the most reactionary domestic forces will determine international policies. Thus globalists conclude that an emphasis on domestic policies must inevitably reflect a repudiation of international policies, if not of the world economy itself.

In fact, 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. Re-establishing 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. Rather than ignoring the effects of U.S. policy changes on the world economy, domesticism stressed their global importance. Almost immediately, at the Ottawa, Canada, summit in July 1981, the administration made clear that its domestic focus reflected not an "America First" strategy but a reminder that the world economy could only be as good as its members' economies.

Restoring the domestic economic foundation would help stabilize exchange rates and then rejuvenate international trade. From the

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outset, and through the depths of the ensuing recession, the administration championed freer trade. Far from pure rhetoric or cynicism, this view reflected the domesticist conviction that freer trade is the chief economic rationale for having a world economy. Without freer trade, no new growth through comparative advantage is possible. And trade relations pursued for noneconomic purposes do little more than divide up existing wealth and exacerbate political tensions.

The emphasis on domestic policy reform and on "the magic of the marketplace" became the leading themes of administration policies toward international development and finance. These themes were first laid out comprehensively in September and October of 1981 in the president's address to the World Bank, in his pre-Cancún speech in Philadelphia, and in statements at the North-South summit in Cancún, Mexico. Progress toward domestic stability and freer trade, the administration contended, would rejuvenate international financial flows that ultimately depend on real transfers of goods and services to be redeemed. Direct investment and commercial bank lending would increase as countries acquired more predictable access to foreign markets. Financial transfers through the international development institutions could then supplement these commercial flows rather than substitute for them, as was feared in the case of the then-proposed World Bank energy affiliate. Further, concessional development assistance could be reserved for the poorest countries, which was the objective of the administration's controversial policy toward the World Bank's International Development Association.

True to its domesticist precepts, the administration played down international institutional solutions, maneuvering to deflate enthusiasm for global negotiations on North-South issues. Above all, the administration felt that the dialogue and policies of international institutions should not weaken the incentives for domestic policy reform. Initial administration attitudes toward the International Monetary Fund (IMF) were thus understandably skeptical. This institution was perceived as

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drifting away from its primary role as lender of last resort and thereby weakening its leverage for economic adjustment by making more generous, longer-term loans earlier in the adjustment process. Administration officials doubted that economic pressures at this early stage of the adjustment process would be sufficient to produce decisive domestic policy change. In the world of high debt and inflation inherited from the 1970s, the administration valued the IMF more for its policy than for its financing role. The administration concluded that until IMF policies shifted—again, at the margins—caution on new funding made sense.

Exporting Disinflation

From these policy premises, the administration has achieved remarkable success in revitalizing U.S. and, to a lesser extent, world economic recovery and growth. Yet in a number of ways, its policies fall short of its own standards and certainly those of a domesticist.

In its first year the administration concentrated on its domestic economic program of restoring price stability and renewing growth incentives. The expectation prevailed that both lower inflation and renewed growth could be achieved simultaneously, and that the impact both at home and abroad would be beneficial. Under these circumstances, even though the United States was now operating in a much more flexible international environment with floating exchange rates, it seemed reasonable and appropriate to discontinue daily and sustained exchange-market intervention. Such intervention only weakened the impact of U.S. policies in the international marketplace through which, in domesticist fashion, the United States sought lower inflation and improved market incentives around the world.

By 1982 Reaganomics had achieved major tax reductions, less significant spending cuts, gains in deregulation, and, through support of the Federal Reserve, an extremely tight money-supply policy. The outcome, by whatever causal sequence, was large current and projected budget deficits, high nominal and real

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interest rates, a strong dollar, a decline in exports and general economic activity, and lower inflation at the cost of sharply increased unemployment. In this situation, the issue for the administration was whether disinflation—now that it would clearly hurt—should be stretched out or discontinued. If the president was prepared to accept pain and political risk at home, he had little reason to alleviate these costs abroad, where inflation for the most part remained at double-digit levels. Admittedly, the unbuffered export of U.S. disinflation through high interest rates and recession would test the fabric of open international economic relationships, as well as the domestic political processes in some countries. But the administration ultimately concluded that disinflation without growth must be accomplished quickly or not at all.

The lack of early success in revitalizing the U.S. and world economies led to an acceleration of administration diplomacy, albeit of a domesticist rather than a globalist variety. At the Versailles, France, summit in June 1982, the administration elaborated its concept that sound domestic economic policies in the major-currency countries should converge around common indicators of low inflation and greater market flexibility over a medium-term, 2- to 3-year period. It recommended as a coordination vehicle the new multilateral surveillance process that brings together semiannually at the highest political level the five major-currency countries (France, Great Britain, Japan, the United States, and West Germany) and, on an informal basis, the managing director of the IMF. This new mechanism supplements the IMF's bilateral surveillance authority over exchange-rate policies of member countries and focuses on disciplining domestic economic and financial policies among the major-currency countries as the fundamental and lasting route to exchange-rate stability, whether the formal exchange-rate regime is fixed or floating.

The multilateral surveillance concept differed from earlier globalist prescriptions for economic policy coordination in at least three important respects. It focused on domestic policy consequences, not policy instruments

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or direct negotiated policy adjustments; it emphasized a medium- rather than a short-term perspective; and it minimized formal, institutional arrangements.

Administration initiatives at Versailles were not intended to induce immediate policy changes. For that the administration, like the domesticist, looked to the international marketplace. From summer 1982 to summer 1983, international market pressures began to force policy adjustments both in the United States and abroad, reflecting the limits imposed on domestic policy choices if an open international market were maintained.

Beginning in the summer of 1982, the debt crisis in Mexico and other developing countries threatened, along with bad domestic loans, to overwhelm both the American and the world banking systems. U.S. policy adjusted, but in a way that seemed to contradict administration priorities. The Federal Reserve Board sharply accelerated the growth of the money supply. U.S. interest rates declined and the immediate crisis was weathered. But the fundamental fiscal imbalance in the United States remained, threatening the ability to sustain an easier monetary policy without reigniting inflation.

Similarly, international market pressures brought change in French economic policy. After the expansionary policies of President François Mitterrand's Socialist government created repeated pressures on the French franc, and after the United States made clear at Versailles that it would not intervene to halt the franc's slide, Mitterrand turned full circle. In March 1983 he imposed severe austerity measures in an attempt to end the long French love affair with inflation. In addition, during the winter of 1982–1983, more conservative governments came to power in West Germany and Japan and firmed up national commitments to achieve new growth through low inflation and market incentives.

This shift toward common performance objectives of low inflation and market incentives took place during the depths of the worst recession in postwar history. It attests both to the international market power of the American economy, despite all the talk of U.S.

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decline, and to the spreading conviction under the domesticist precepts of the Reagan administration that growth based on nonmarket interventions and increasing prices was not viable in the 1980s. Although international controversies swirled during this period over U.S. interest rates, exchange-market intervention, trade, and the Soviet gas pipeline, the major industrial countries narrowed gaps in their domestic economic performance and set the stage at the 1983 Williamsburg, Virginia, summit for a consensus on economic objectives and, to the surprise of many, specific policies (such as the need to reduce government expenditures).

The current U.S. recovery has not been solely or even primarily a conventional Keynesian phenomenon.

The strong U.S. recovery in 1983–1984 vindicated these policy shifts and, through unprecedented U.S. trade deficits, has sparked initial worldwide economic recovery. For calendar-year 1984, U.S. growth is projected at 6 per cent and, for the industrialized world as a whole, at 4.25 per cent. Meanwhile, inflation in the industrial countries dropped from an average of 13 per cent in mid-1980 to 4.5 per cent in mid-1983, and remained steady thereafter. Disinflation and renewed growth have lagged in the developing world, but the IMF projects average growth of 3.7 per cent in 1984 and 4.3 per cent in 1985.

Moreover, data from the Council of Economic Advisers suggest that the current U.S. recovery has not been solely or even primarily a conventional Keynesian phenomenon. Real GNP has grown at a rate of 7.1 per cent annually during the first six quarters of the current recovery, compared with 5.9 per cent annually for the typical postwar recovery. While personal consumption expenditures have contributed about the same percentage share to the current recovery as to previous recoveries—55 per cent—nonresidential fixed investment, mostly producers' durable equip-

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ment, has contributed twice its usual share to the current recovery—25 per cent compared with 12 per cent.

Meanwhile, the administration's domesticist diplomacy in the international arena has focused attention on the right issues. Indeed, now that sustaining the recovery is the key issue, the multilateral surveillance process is precisely where Reagan's policies should be tested against their premises. Massive U.S. budget deficits cannot continue much longer without deleterious domestic and worldwide results, including devastating consequences for the developing countries. Unless the domesticist is totally wrong about the ills of the 1970s, the Reagan deficits inevitably portend the same domestic and worldwide stagflation as the earlier and much smaller deficits of the 1970s that the president sharply criticized.

One can agree with the administration's view that it matters not only when but also how the deficit is reduced. A return to indiscriminate or automatic tax increases, coupled once again with special-interest-oriented, logrolling spending policies, could bring back the era of stagflation as surely as deficits. But the ultimate test of the Reagan approach is its ability to achieve politically its preferred solutions to the deficit issue. And that means taking the results on November 6 of the president's domesticist-motivated attempt to revive national consensus on the budget issue and making the best deal possible next year in Congress to reduce spending and, failing that, to raise taxes.

The administration should also continue to press other aspects of its domesticist international policy initiatives. Procedurally, the multilateral surveillance process should be strengthened to include more frequent meetings, the participation of the GATT director general, evaluations of convergence not only by the IMF director but also by member countries—which frequently lack a good understanding of how other economies work—and more detailed briefings on these meetings for nonparticipating countries and nonfinance agencies within participating countries. In addition, parallel multilateral surveillance seminars among nongovernmental groups

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from the five largest free-market industrial countries would deepen each society's awareness of international economic relationships and greatly aid the official surveillance process.

Substantively, the summit countries should continue discussions on exchange-market behavior initiated at Versailles. The Versailles-ordered study of exchange-market intervention correctly concluded that intervention could have significant long-term effects on exchange rates only if underlying monetary policy changed as a consequence of intervention. It thereby reinforced the importance of the multilateral surveillance exercise. Nevertheless, differences remain over whether intervention may still be useful in the short run to smooth out exchange-rate fluctuation, given the bandwagon tendency of international currency markets. The Reagan administration, like the domesticist, tends to view these distorting international capital flows more as the consequence of national policies—specifically policies that restrict access to national capital markets—than as the result of unpredictable speculation. Thus the administration advocates removing restrictions on capital markets, as it has done in negotiations with Japan. Liberalizing financial markets, of course, may exaggerate short-term exchange-rate misalignments, as long as markets for investment remain restricted. For the domesticist, therefore, progressively liberalizing markets for all assets—financial as well as goods and services, and investment as well as portfolio assets—is the indispensable condition for lasting exchange-rate stabilization.

Three Trade-Policy Phases

Reagan administration trade policy has gone through two phases and is now entering a crucial third phase. In the first phase, true to its domesticist outlook, the administration gave priority to its domestic economic program. While this program was being put in place, Reagan's trade record was mixed. Restrictions were imposed on Japanese automobile imports but lifted on South Korean and Taiwanese footwear imports. Once the administration's domestic program was adopted in

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July 1981, its preferences for multilateral freer trade became clearer. In February 1982, the United States launched the Caribbean Basin Initiative and prepared an overly ambitious agenda for multilateral free trade for the GATT ministerial meeting held in November 1982. Simultaneously, however, recession weakened the administration, leading to additional individual cases of protectionism at home—the multifiber agreement, steel, and motorcycles, for example—and lack of success at the GATT ministerial abroad.

In 1983 the Reagan policy entered a second phase, pressing for international consensus on a multilateral trade round at the annual economic summits while using U.S. market power to initiate bilateral and regional free-trade discussions—with Canada, Israel, and the Association of Southeast Asian Nations, among others—as a way to catalyze a consensus for multilateral talks. Aided by recovery, this strategy registered some success. The Williamsburg summit placed a new trade round on the agenda of the industrialized countries and the 1984 London summit participants agreed to hold such a round "at an early date."

Now the administration's domesticist trade policy is entering a crucial third phase, where the bilateral and regional free-trade agreements, if they proliferate, as in the case of the recent U.S.-Israel free-trade area, may undercut multilateral, nondiscriminatory negotiations. Much depends on how new worldwide attitudes toward the multilateral trading system, bred in the economic travails of the 1970s, sort themselves out and how U.S. actions influence these attitudes.

These attitudes embrace three schools of thought. The first, entertained by many developing countries, sees the postwar trading system as unjust and inequitable. Not having participated in the system's creation, the developing countries insist on new rules, such as preferences and nonreciprocity rather than most-favored-nation status and reciprocity, and on new institutions—for example, the U.N. Conference on Trade and Development instead of GATT. Having pursued development policies of import substitution,

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they generally doubt the value of unregulated international trade, and tend to treat trade largely as another form of foreign aid.

A second school of thought, advocated by some European governments and industrial policy proponents in the United States, argues that the basic nature of trade and comparative advantage has changed. Competitiveness is no longer a consequence chiefly of comparative factor endowments but of organizational and technological capabilities. These include a country's ability to choose its comparative advantages and to integrate government, industry, and research organizations to create this advantage. The increasing government role makes old rules of nonintervention and quasi-judicial settlement of disputes under GATT obsolete, say adherents of the second school. At the very least, governments have to negotiate more directly to establish a level playing field and at times to be active players in bargaining for market shares.

The third school of thought reflects the growing influence of capital and exchange markets on trade flows. This school argues that prices of internationally traded goods and services are increasingly influenced by massive and often speculative capital flows that overwhelm currency exchange markets and badly distort exchange rates and hence trading patterns based on comparative advantage. Until the exchange-rate system is revamped, liberal trade policies make no sense.

Developing-country attitudes, especially those of the newly industrializing countries (NICs), are crucial to a new trade round. The Reagan administration recognized this by advocating a North-South round at the GATT ministerial meeting in 1982 and by initiating informal trade policy discussions in May and September 1984 between the Quadrilateral Group countries—Canada, the European Community members, Japan, and the United States—and key developing countries, including Brazil, India, Mexico, the Philippines, and South Korea. These discussions reflected some willingness to move away from sterile institutional issues of the 1970s toward more pragmatic policy questions: trade problems left over from the Tokyo Round and characteris-

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tics of a new trade round. The issue now is whether these talks lead to partial negotiations with individual countries or groups of several developing countries, producing discriminatory arrangements and possible confrontation with nonparticipants, or whether they build toward nondiscriminatory, multilateral trade negotiations. The Reagan administration cannot press its bilateral and regional approach too far without forcing countries like Brazil and India back into confrontation. The market power approach to liberalization works only if it yields multilateral consensus; otherwise the world cracks apart into trading blocs.

Industrial policy advocates are unlikely to succeed in pressing their trade views unless the bottom drops out of world economic recovery. Their call for more direct government involvement in deciding comparative advantage and actively managing markets is simply impractical. This approach will politicize all aspects of commercial relations between countries, severely straining good will and political ties. Moreover, the role of government and, more important, the institutional structures and political traditions in individual countries, are different enough to prevent common definitions of acceptable government intervention in trade matters. How does one compare U.S. tax policies that affect credit allocation in U.S. venture capital markets with the administrative procedures of Japanese banks and government agencies that funnel credit to Japanese industry? Similarly, how can huge U.S. space and defense programs, which undoubtedly had significant spin-off effects, be accounted for when U.S. trading partners have had no comparable programs?

Finally, those pushing monetary policy reform in advance of trade liberalization may eventually be won over to new trade talks as convergence of domestic economic performance helps stabilize exchange rates. As some high-level U.S. officials have stated privately, once greater exchange-rate stability through lower inflation and more open and stable capital markets is achieved, the choice of exchange-rate regimes becomes a less weighty issue. Commitment to a specific exchange-rate

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regime—fixed, floating, or gold—is much less important than the more fundamental underlying commitment to price stability.

In the field of finance, domesticists regard capital flows, such as commercial lending and direct investment, as the consequence, not the cause, of predictable prices and flexible, open markets. Without the latter, finance can postpone but not avoid inevitable adjustment.

Reagan administration policies toward international finance betrayed the domesticist preference for adjustment over finance, even if in the short-run adjustment meant less finance. Disinflation and the search for greater market flexibility triggered worldwide adjustment and inevitably interrupted financial flows and international debt accumulation that the Bank for International Settlements stated in 1983 "would have been unsustainable even if world demand ... had continued to grow at a fast pace and interest rates had remained at low levels."

Short-term administration efforts to speed the process of worldwide adjustment relied heavily on the policy role of the IMF, disappointing those who tend to measure support for the Fund primarily in terms of finance. The conclusion of IMF-led adjustment packages attacking inflation and market inflexibilities, particularly due to excessive government intervention, subsequently facilitated both rescheduling of commercial debt and restructuring of government loans. Throughout, the administration sought flexibility on a case-by-case basis. Tailoring negotiations to the individual country's situation permitted granting easier terms—if politically required—without creating precedents that in a more comprehensive approach would have reduced conditionality to the lowest common denominator. The administration consistently resisted appeals for generalized and institutional solutions through global negotiations or an international monetary conference.

The case-by-case approach also seems well-suited for the longer term, as recent Mexican and Venezuelan rescheduling agreements suggest. The IMF is no longer formally involved in these agreements, but banks have access to IMF and government reports and, say Mexi-

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can officials, can suspend the new agreements if they feel the country is heading again for disaster. If this arrangement works informally—and the parties have plenty of incentive to make it work—there seems little need to generalize or institutionalize the process.

The market power approach to liberalization works only if it yields multilateral consensus; otherwise the world cracks apart into trading blocs.

For the longer-term phase, the Reagan administration has stressed the third leg of the domesticist triad—trade-liberalizing negotiations. The fundamental solution to the debt problem, Special Trade Representative William Brock argued in the Summer 1984 issue of *Foreign Affairs*, is more exports, not fewer imports. Significant, new access to foreign markets requires reciprocal trade agreements, since only this traditional technique energizes exporters to oppose protectionist pressures from industries hurt by imports and ultimately makes domestic politics work for trade liberalization. Larger and more predictable access for Third World exports, as opposed to the year-to-year uncertainties created by the current preferences, will then not only help restore these countries' creditworthiness but also attract more foreign investment.

The poorest countries, however, will still lack the infrastructure to trade successfully or to attract private investment. They could be assisted by establishing a link between trade liberalization efforts to help primarily advanced developing countries and long-term concessional finance for the poorest countries. The international financial institutions can facilitate this link. By encouraging multilateral trade liberalization, they can strengthen their case for aid. For under these circumstances, aid transfers not only are less disruptive of market incentives—that is, they no longer support inefficient import-substitution policies—but also are ultimately essential to help poor countries develop the infrastructure

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needed to participate eventually in freer international trade and investment. Aid would then truly supplement private markets, and a new consensus to revitalize aid could be fashioned to include conservative critics of aid.

The World Bank has recognized this potential and focused the last three sessions of the joint World Bank-IMF development committee on trade. If the Reagan administration is true to its domesticist roots, it will support this trade-aid link.

U.S. international economic policies today not only reflect a coherent and cogent analysis of world economic problems in the 1970s but also have worked remarkably well. What is needed now is not a fundamental change of direction but some modifications in line with domesticist standards. The budget issue remains central to U.S. hopes to restore price stability, market incentives, and freer trade. Thus far, it can be argued, the large deficits and high dollar, irrespective of their origins or connection, have on balance been pluses. They have revived both domestic and increasingly worldwide consumption while providing cash balances and net capital inflows in the United States that permitted corporate investment to play a much larger role in this recovery than in previous postwar recoveries. Moreover, as consumption now slows in the United States while investment shifts to plant capacity rather than equipment, interest rates and net capital flows into the United States may decline somewhat, releasing resources to fuel the embryonic investment phase of recovery abroad.

Nevertheless, unless America is in an entirely new era—and thus understands nothing about the economy, budget deficits of $200 billion cannot be less frightening in terms of their long-term worldwide effects than deficits of $60 billion in 1976 and 1980. From a purely economic perspective, cutting spending will do more to sustain the recovery than tax increases, since the level of government expenditure, not the deficit, is the ultimate drain on private resources. But the president will be in his strongest position to cut spending the sooner he addresses this issue. He will then be able to focus on his next domesticist

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objective—new authority for multilateral trade negotiations. For these negotiations to include items of interest to the United States, such as services and high technology, they must also include politically touchy products of interest to developing countries, such as textiles and steel.

The stakes for this administration are high, both for its political place in history and for the credibility of its outlook, which could influence economic policy for decades. If it fails, rather than domestic price stability, market incentives, and freer trade underlying the world economy, the financial crisis will come to dominate all else. 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 together.

No one could welcome this sequence of events. Higher U.S. interest rates will increasingly make debt management impossible and politically antagonize the developing countries, which are already trying to force the governments of industrial countries into more direct involvement in debt reschedulings and new lending. This government-to-government approach could revive the sterile North-South confrontation and highly structured global negotiations that marked the 1970s.

The domesticist perspective offers better prospects for the 1980s. The Reagan administration has rightfully reasserted U.S. power to lead the world back to the domesticist triad of world economic rearmament: low inflation, market incentives, and freer trade. But now it cannot escape the tenets of its own theology. The domesticist perspective offers a useful and long-overdue intellectual template both for appreciating the fundamentally correct international economic policy course charted by the Reagan administration and for appealing to the administration to follow through on its own domesticist priorities.

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