The Political Economy of International Co-operation

Edited by
Paolo Guerrieri
Pier Carlo Padoan

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PREFACE

International economic relations over the past few years have led to increasing interdependence between monetary, financial, and trade relations. Monetary disequilibria such as exchange rate misalignments have led to mounting protectionist pressures while attempts at warding them off have induced policy authorities to discharge the burden of adjustment on macroeconomic and monetary policies. In turn relative prices and misalignments have led to structural transformations in productive systems and national economies, with feedback effects on prices of factors and goods. The lack of a widely accepted set of 'rules of the game' has increasingly strained the adjustment mechanisms thus adding to the degree of conflict in the international system as well as rendering the search for new forms of international cooperation both more difficult and urgently needed. The traditional view of international economic relations treats trade and monetary relations as separate issues and only recently problems regarding their interaction are being analyzed. In addition traditional theory views both monetary and real phenomena occurring in the real world as deviations from a general equilibrium framework which is itself based on a separation between real and monetary economic aspects.

The real world interaction of real and monetary phenomena has widespread policy implications. National policy strategies take such interaction explicitly into account. Outcomes of international summits have shown that one of the policy issues at stake is that of negotiating on monetary and trade issues separately or jointly.

Issue linkage is also challenging the roles of

international institutions such as the IMF, GATT, or the World Bank - all being established in the context of an international system (Bretton Woods) - whose general rules of the game made it possible to separate money and trade issues while assuring consistent national economic policies.

In the face of mounting interaction between monetary and trade policies new forms of cooperation have been increasingly called for. Notwithstanding partial agreements - such as that achieved at the Plaza Meeting or the bilateral US-Japan agreement on macro-monetary issues - international cooperation doesn't seem to be moving forward. The present state of international relations has once again reflected the 'paradox of cooperation'. While it is generally agreed that a cooperative solution is the optimal one for all actors involved the agents' rational independent behaviour will lead to non-cooperative sub-optimal solution.

The problems of international cooperation have become central in an emerging field of international relations research, 'international political economy'. One of the aims of this approach is to investigate the economic base of political processes and hence attempting to respond on economic as well as political grounds to the problems posed by international cooperation. Although international political economy may not yet be called an established branch of social sciences, the growing number of significant contributions which have appeared in the last few years indicates that progress in this direction is encouraging.

Papers included in this volume are original contributions to this topic and were initially discussed at an international conference held in Rome, in March 1986. Contributors are both economists and political scientists, academic scholars as well as people involved in active policy making. Guerrieri and Padoan provide an overview of the state of research on international cooperation and discuss the role of the macroeconomic regimes. Robert Keohane discusses bargaining mechanisms 'under anarchy', i.e. in a world without a hegemonic power to provide the public good of an international system. F. Saccomanni discusses the role of multilateral surveillance in monetary cooperation. B. Cohen considers the perspective of cooperation with respect to global debt considering different political economy approaches. S. Biasco analyzes the problem of international effective demand management with all the difficulties entailed. J. Pelkmans analyzes the difficulties which arise in international trade regime management in a financially

unstable environment. S. Cohen and J. Zysman consider the role of domestic interest in shaping American industrial policy; C. Bradford reconsiders adjustment policies in developing countries showing how successful adjustment does not necessarily need export led strategies. S. Marris provides a final discussion on the perspectives of macroeconomic cooperation.

The conference, as well as the publication of this book, were made possible thanks to the support of Banco di Napoli, the Ente per gli Studi Monetari Bancari e Finanziari 'Luigi Einaudi' and the German Marshall Fund of the United States. The Centro Studi Americani and the Istituto Affari Internazionali would like to thank them for their help.

Chapter One

INTERNATIONAL COOPERATION AND THE ROLE OF MACROECONOMIC REGIMES

Paolo Guerrieri and Pier Carlo Padoan

INTERNATIONAL COOPERATION: BENEFITS AND DETERMINANTS

In the last decade strengthened interdependent oligopoly in international relations has necessitated even more national economic policy coordination and contemporarily enhanced potential advantages of cooperation. As a matter of fact progress in this direction, as seen, has been minimal. An explanation for this is then worthwhile.

In this respect, the first thing to be clarified should be the meaning of international cooperation, which may and has taken on different and ambiguous definitions, even though not necessarily alternatives. (1)

In the first place cooperation could involve a continuous information exchange regarding national policies, without imposing specific constraints on each country's decisions. Information certainly plays a crucial role in influencing nations' strategies, but it should be viewed more as a precondition for cooperative policies.

In the second place, cooperation could mean a close coordination of national policies via reiterated shared decisions on the definition (even in quantitative terms) of objectives and/or instruments of economic policy. In this case an agreement among national policy makers is required every time on each individual choice to be made. This type of cooperation, though the most frequently advocated by policy makers, is also the most difficult to implement due to the serious constraints it imposes on national autonomies.

Cooperation could take on yet another meaning as a set of norms and rules (regimes) which countries bound

themselves to observe in implementing their economic policy strategies, even though they keep their autonomy in making individual choices. The framework so outlined leads countries to take into account, in their policies, existing interdependence ties, hence modifying their behavior towards a greater system stability. The Bretton Woods era - the long postwar cooperative period - clearly exemplifies this last type of international agreement.

Economic analysis of international cooperation has progressed significantly over the last few years. (2) One major result of research is that cooperative situations are generally Pareto-superior to non-cooperative ones. However the opportunity of implementing cooperative policies may be valued differently according to the economic theory that is adopted.

Extreme neoclassical positions hold that national governments should not interfere with market forces as their free operation would lead to optimal outcomes both in macroeconomic and monetary relations (Vaubel 1979). Even in a neoclassical framework, however, the opportunities for an explicit role of institutions in increasing cooperation may be demonstrated if one realistically assumes that complete markets for all goods do not exist and uncertainty about the future is a relevant characteristic of the system (Illing 1985).

In a non-neoclassical environment the need for cooperation is even clearer. For instance it has been shown (Johansen 1982, Vanderbroucke 1985) that if countries pursue mercantilistic (trade surplus) macroeconomic policies, and hence do not cooperate in the generation of effective demand, the level of world activity will be severely curtailed. This may produce unfavourable consequences on financial, trade and macroeconomic relations.

Recent analyses of macroeconomic perspectives in Europe (3) advocate that economic recovery needs a 'two handed approach': supply policies at the national level should be sustained by coordinated demand management at the international level.

A point that is not taken up in purely economic analysis is why the Pareto superior cooperative solution is so difficult to implement in practice. Several answers may be offered, on the contrary, if one assumes an international political economy perspective. (4)

First to be underlined are the many reasons preventing

a decentralized decision system from providing optimal solutions for the whole of countries. In general terms these reasons originate in two sets of factors.

Firstly, different types of externalities stemming from countries' policies can hinder achievement of an optimal allocation of resources at international level based on free competitive market forces, in the same manner as happens within a single economy. In this regard it suffices to recall the externalities linked to the public good character of solutions in the international game (growth, monetary stability, free trade) that advantage all the countries, apart from their individual contributions in obtaining them. Because of the problems in sharing the supply costs of these goods, their production could never reach optimal levels (Olson 1965). These supply constraints on international public goods could be overcome or at least lessened by means of cooperative agreements, especially if the latter are aimed at penalizing each country's free riding.

The second set of factors reflect countries' relation structure which is a far cry from the idealized picture of perfect competition assumed by orthodox economic theory. Assuming atomistic competitive relations within an economy is a moot point, since medium-large firms prevail in industry and service sectors. But the same assumption gets to be heroic when applied to international relations. (5) Because of the great asymmetries in international power distribution deriving from nations' differing economic, financial and technological capabilities, one is induced to view relations among countries as a system dominated by oligopoly and oligopolistic confrontation. In an oligopolistic framework nations' individual choices (especially leading countries) can determine multiple equilibria solutions, more or less efficient in respect to the whole system but all equally attainable (Friedman 1977). It is well known that non-coordinated interaction among a small number of countries doesn't leave room for specific theoretical outcomes and results, such as a natural equilibrium solution. It follows that independently and autonomously formulated national policies could turn out as - and often are - mutually incompatible. 'Ad hoc' devices in terms of cooperative agreements, promoting such compatibility among national policies, are then required to ensure the public good international stability. Hence, the benefits of cooperation and its superiority in respect to nations' autonomous choices in achieving various countries' economic

policy goals. These benefits have become even clearer since international relations in the last decade reinforced, as previously seen, its interdependent oligopolistic structure.

Highlighting the advantages of cooperation also helps in understanding problems and difficulties of its achievement. In this case one must examine why and how many independent actors (i.e. the countries) are spurred on to make mutual agreements or, as is more frequent, to prefer non-cooperative behaviors. In other words one must single out the determinants of the propensity to cooperate of economies in an oligopolistic system lacking a central authority able to limit the pursuit of national interests or enforce established rules. To accomplish this, international cooperation can be regarded as a game that each country plays on basically two levels (Putnam 1986). On the national level economic policy decisions will reflect interests of those internal pressure groups that greatly influence governments' choices as well as chances for political representatives' re-elections. On the international level, governments will try to expand the effectiveness of national economic policy instruments and at the same time will attempt to minimize negative outside effects. (6) The two levels are closely connected and influence each other so that domestic interests added to external constraints (arising from other countries' choices) will jointly determine the preference function and thus the strategy on what each nation will define its own behaviour. Hence national governments' actions can not only be explained on the basis of external structural factors like international constraints and opportunities. Nor can the governments' choices be explained on the basis of only domestic interests. Both international and domestic forces will generate countries' policies and clear-cut distinctions between national and international policies will not be very fruitful. Equal attention must be paid simultaneously to countries' domestic structures as well as strategic interaction characterizing their policy confrontation in order to explain the determinants of cooperation.

But integrating these two levels of analyses is a hard task, which is still to be realized. Studies on the political economy of cooperation sharply diverge into those analyses linking international relations' structure and cooperation opportunities on the one hand, and those focusing on the domestic bases of foreign economic policies on the other.

The first group includes structural or systemic theories

(7), whose main actors are countries basing their strategies on rational interdependent choices motivated by the net balance at their costs and benefits. The implicit assumption is that each nation's utility function and preference structure mirror those of an easily detectable internal ruling coalition that is stable over time.

Systemic analysis views the problem of cooperation - in terms of both policy coordination and regime definition - especially in relation to its public good character, that set up efficiency criteria against national interest maximization in its supply.

COOPERATION AND HEGEMONIC STABILITY

Probably the most well-known of systemic analyses of cooperation, both among economists and political scientists is the one associated with the hegemonic stability theory. (8) This theory - which has been initially formulated as what should rather be called a hypothesis - holds that cooperation among nations requires the presence of a larger - more powerful - country which will exercise the leadership necessary to enforce cooperation between itself and the other countries. In public choice terms the public good of international cooperation will be supplied (although in a less than optimal amount) if the larger country will bear more than a proportionate share of supply costs (Olson and Zeckhauser 1966, Kindleberger 1981). The hegemon will accept doing so because its net benefits are positive. The smaller countries will have an incentive to participate since they will enjoy partial or total free riding benefits.

Hegemonic stability theory has been put under severe scrutiny over the past few years. Criticism, however, has not only been destructive. The debate has helped, in many cases, to strengthen those parts of the theory which remain valid and discard the others. More importantly the debate has overcome the policy dilemma which is implicit in the hegemonic stability hypothesis according to which no stable cooperative agreement is possible without hegemony; or, to put it differently, collective action is impossible (Snidal 1985). This point is being challenged by the development of the analysis of cooperation 'under anarchy' (oligopoly) which will be recalled below. (9)

We will now take a closer look at the debate on hegemonic stability and discuss the cases in which the

absence of a hegemon is particularly detrimental to international cooperation. Hegemonic stability theory has been challenged on three grounds as a theory of economic behaviour, as empirically relevant, and as a theory of collective action.

As far as the first point is concerned Conybeare (1984) has shown that, in a neoclassical pure trade theory framework it will not be in the interest of the hegemon to promote free trade; rather its benefits would increase by following protectionist policies as these would improve its terms of trade. In this model it is the hegemon which exploits the smaller countries and not vice versa.

Conybeare's analysis is correct. One wonders, however, whether the model he uses is the most appropriate in understanding international relations. Recent developments in trade theory (10) which stress the role of technological innovations and R&D expenditures, suggest that, in a dynamic context, protectionism in one country today may lead to more free trade tomorrow. Protectionism will lead to the accumulation of technological advantages which will allow the country to promote trade liberalization from a more powerful position. This proposition seems much in line with the widely accepted view that, at the end of World War II the United States was in a position to promote a liberal trade regime also because of its technological lead over Europe.

The second point has received much greater attention. Indeed most of the skepticism which has developed over the theory has been associated with empirical analysis. (11) Actually most of the empirical work deals with one issue area, trade liberalization. Scholars have tested the hypothesis that in periods of hegemony the amount of trade liberalization - usually measured by the level of tariffs - has increased.

Results are not always uncontroversial and, at the present state of research, neither of them two extreme hypotheses, i.e. the theory is accepted or rejected, can be verified. However the point we wish to raise is different; if the theory is to be tested empirically work cannot be limited to trade relations. The empirical relevance of the theory has also been discussed with respect to other fields. Keohane (1984) maintains that the theory seems to apply well in the field of energy, less so in monetary relations and hardly at all in trade relations. Susan Strange (1982) has maintained that US financial power - measured by a set of

financial indicators - has not substantially declined over the 1970s, although disorder in the international system can be related to the weakness of the dollar which, in turn, is associated with the decline of US financial power.

Much more work is needed in this direction but, what is more important, the theory cannot be tested in a satisfactory way when applied to each field separately. There are two reasons for this. The first one is related to the concept of power. The theory, correctly stated, should hold that the hegemon is the most powerful country. The problem then arises of giving an empirical content to power. The issue is difficult and controversial, yet it cannot be ignored if power is to remain an operational concept. One suggestion can be advanced. Power cannot be associated with only one dimension (such as size). A larger country need not be a more powerful country. Power is associated with a number of variables which interact among themselves.

This leads to the second reason. Economic analysis of international relations is still largely based on a separation between trade, monetary and macroeconomic aspects. In a neoclassical framework trade is strictly a real phenomenon; monetary relations are neutral and uninfluential, at least in the long run, where macroeconomics is also not relevant.

If one accepts a different perspective these three aspects should be closely integrated. A fully developed integrated theory of (long run) international relations does not yet exist, however a few links among the three issue areas may be offered. One is between trade and finance. Economic history suggests that (12) national currencies have soared to the role of international monies along with the issuing nation's increased share of international trade.

A second link is associated with finance and industry. National financial systems and national industrial systems have developed together and expanded in international markets mutually sustaining each other, although not necessarily having one lead the other (Kindleberger 1983). Success in international trade, in turn, is associated much more with dynamic industrial sectors, technological innovations and hence with the overall behavior of the growth process. The overall productivity of a nation can well be taken as a measure of the country's position in the international economy (Lake 1984), however to associate changes in the country's relative position in the international economy with changes in relative productivity

is only a first step. Non-neoclassical growth theory links productivity changes with changes in the rate of growth which, in turn, is linked to macroeconomic policy. (13)

Without pushing this argument too far one point should be clear. Trade, finance and macroeconomics are parts of a single process as are trade, financial and macroeconomic policies. International (economic) power depends on all of these three dimensions and considering them separately in regime analysis may lead to arbitrary results. The fact that regimes are negotiated, created, and sometimes collapse in one issue area apart from the others should not conceal the strong linkages among them. On the other hand it is well known that issue linkage both between different economic areas and between economic and political areas has always been a characteristic of international relations (Tollison and Willet 1979).

If one accepts the view that power is a multidimensional variable then empirical test of the theory of hegemonic stability (indeed any theory of international regimes) may not appear so clear cut as it appears from existing literature. For instance one of the results of current research is that free trade has not retreated since the collapse of the Bretton Woods system and hence it is not true that a (trade) regime needs hegemonic leadership to operate. It is also true that financial and monetary instability has greatly increased since the collapse of the Bretton Woods agreements (14) and it is also very well known that protectionistic pressures have also increased as a result of increased financial and monetary conflicts (Corden 1984). Leadership may not be so necessary in some issue areas, however cooperation in one area may depend crucially on the exercise of leadership in related areas.

Economic analysis should help to clarify links between areas and identify which of them requires leadership more crucially. One of these areas is macroeconomic relations and the generation of effective demand. As we have argued at more length elsewhere (Guerrieri and Padoan 1986) in an international system characterized by widespread mercantilism and lack of leadership, generation of effective demand is much more difficult and economic conflicts much more frequent. Evidence from both pre-war and post-war periods during which hegemony was lacking does not seem to reject this view. (15) The crucial role of macroeconomic regimes for international cooperation will be discussed again in the concluding paragraph.

We now come to the third point: the relevance of the theory of hegemonic stability in analyzing collective behavior or how cooperative behavior is possible 'under anarchy'.

COLLECTIVE ACTION WITHOUT HEGEMONY

It has been suggested (Snidal 1985) that, taken at face value, the hegemonic stability theory implies that collective action is impossible, since it assumes that a necessary condition for the production of public goods in the international system is a substantial asymmetry in the distribution of power. However, recent research has shown that the supply constraints on public good cooperation could be overcome or at least lessened through a combination of reciprocity strategies at national level and of regimes' definition at the international level (Axelrod and Keohane 1985). Choosing effective strategies and building a vast institution network could satisfy a set of conditions which, as it has been shown, favor cooperation in an interdependent oligopolistic system: mutual interests among countries; lengthy 'shadow of the future'; a proper number of negotiating parties (Oye 1985a).

In game-theoretic terms, as it is well known, cooperation is feasible when countries' pay-off structures are such that mutual cooperative strategies are superior in respect to those of mutual defection and at the same time unilateral defection is more advantageous than unilateral cooperation. But pay-off structures vary according to countries' preference order - in regard to current and future system conditions - and henceforth influence chances for cooperation, since some structures are more favorable than others. (16) Therefore countries are able to affect medium-long run prospects for cooperation by means of strategies aimed at changing pay-off structure.

It has been proven (Axelrod 1984) that strategies of reciprocity, directly linking the country's current behaviour and its expected future benefits, significantly curb advantages of unilateral defection for each country and therefore can improve the outlook for cooperative agreements. Reciprocity deters exploitation strategies that each country, myopically pursuing its own interest and disregarding other countries' decisions, can be tempted to adopt. Obviously, even unilateral strategies - differing from reciprocity - could improve prospects for cooperation,

when, for example, they succeed in reducing costs and above all advantages of being exploited. But these strategies are hard to implement, since they could have side effects that increase a country's vulnerability to exploitation.

Now, 'tit-for-tat' strategies are most effective when actors firstly are able to distinguish between cooperation and defection and, secondly, can effectively punish would-be defectors. In the economic relations, however, game structures make attaining and putting such capabilities into use very difficult. Economic policy objectives and instruments generally lean toward ambiguous meanings and measurements. Furthermore, there are a great many players having wide ranging and heterogenous interests. Due to both factors it is quite hard, on the one hand, to recognize and control others' behaviors and, on the other, there are more chances for autonomous defections. Under such conditions, the effects of reciprocity are liable to spill over on a large number of actors, losing their strength and intensifying rather than discouraging other countries' potential defections. Here, paradoxically, strategies of reciprocity can extend conflicts among countries, via a so-called 'echo effect', as well as generate negative issue-linkages (Keohane 1986). Limits and risks (in respect to achieve cooperation) stemming from reciprocity - when extended to most countries - can be lessened by creating international regimes aimed at defining a set of 'principles, norms, rules and decision-making procedures around which actor expectations converge in a given issue-area' (Krasner 1983). International regimes offer the opportunity of establishing standards for countries' behavior, confining ambiguities concerning cooperation and defection recognition, fostering in other words the countries' ability of mutual check and control and thereby enhancing credibility and effectiveness of strategies of reciprocity. Regimes also directly influence countries' preference structures because their norms of conduct are internalized by countries and information they produce can modify countries' perceptions of their own interests. (17) The strategy used by each country participating in a game is not only based on objective factors but is also dependent on how a country perceives its own interests as well as other countries' strategies. (18) Regimes influence this whole set of information that in game theoretic terms defines each country's strategic space - where preferences are determined and interests perceived - and hence are able to change the actor - countries'

structure of pay-offs as well as prospects for cooperation.

This requires that the role of regimes (as institutions) be considered as a fundamental element in the operation of the international economic system and that understanding the latter cannot be satisfactory without classifying the role of institutions.

THE ROLE OF INSTITUTIONS

As Axelrod and Keohane have stressed (1985), the role of institutions is to enhance communications among players by increasing available information, allowing issue linkages and improving the context of cooperation. Considering the role of institutions helps in clarifying a central issue in current economic debate: the problem of expectations.

As Runge points out (1984), relevant uncertainty in social and economic analysis is uncertainty in Keynes' sense; actors are uncertain about other actors' future behavior. Especially when actors involved are few in number (as in oligopolistic structures) uncertainty will easily lead to prisoner dilemma situations in which the best strategy is defection. If one considers the assurance principle (Sen 1967), then individual behavior will be conditional on the expected behaviour of others. Institutions help reduce such uncertainty and hence favor collective action.

Even the most abstract economic model is based, if only implicitly, on an institutional setting according to the amount and distribution of information which is assumed. As institutions influence the information structure they influence the allocative mechanism of the system. When institutions are organized as regimes they provide the rules of the game for the economic system. However the role of institutions will be different - more or less relevant - according to the economic theory which is adopted. In a neoclassical framework, where the market is assumed to be the most efficient self-regulating mechanism, no exogenously produced rules of the game are needed. On the contrary it is a basic tenet of post-Keynesian economics that the operation of the capitalistic market will produce sub-optimal results and lead to collapse without an adequate institutional framework.

One characteristic of cooperation without hegemony is that collective action should be viewed as a dynamic process in which (limited) agreements and cooperative solutions

result as agents' reactions to the outbreak of crises. Such reactions lead to cooperation insofar as they allow the fulfilment of the three conditions for cooperation under anarchy mentioned above. Cooperation under anarchy becomes feasible if pay-off matrices are changed, if reiterated games are played, if the number of players varies (decreases).

In this respect cooperation under anarchy (oligopoly) can be opposed to cooperation under hegemony which will persist if, and only if, the appropriate power distribution holds. Once the power of the hegemony has been eroded below some 'critical' level, cooperation is simply not possible. Cooperation under oligopoly requiring a 'dynamic' process rather than a 'static' power distribution has - at least - one implication. The institutional structure must also evolve in order to allow new cooperation solutions to be reached. This poses a problem for analysis. A satisfactory theory of institutional change is not yet available, as in the case of regimes, however, it can be argued that shape, distribution and structure of institutions is also dependent on the power distribution on which regimes are based. Power distribution, in turn, varies as a consequence of the evolution of the economic system. This is easily seen if one accepts the view that power is a function of a number of economic variables whose relative and absolute dimensions vary over time.

This process, however, is not a mechanistic one. Power distribution is not the only determinant of the stability of regimes and of institutions. This has to be integrated with a theory of actors' behavior within institutions. Useful suggestions in this respect may be drawn from Hirschman's (1970) well known contribution.

Exit, voice and loyalty are alternative reponses to the decline of goods and institutions which may be extended to international relations. Loyalty and exit are extreme choices which lead to full cooperation or to defection. Loyalty costs are associated with the deterioration of institutions while others defect (free ride). Exit costs are those associated with increasing uncertainty which derives from reactions, and possible retaliations by others in the absence of established rules of the game. Both exit and loyalty may result as unsatisfactory options. Both represent a form of acquiescence to a deteriorating environment and may be considered less than optimal options in a world of uncertainty where institutions are needed for information

production and diffusion. However these two options will be chosen with increasing probability the shorter is the time horizon - the shadow of the future - of the actors involved.

Voice will be the preferred strategy - Hirschman argues - the larger the expected improvement of the quality of the institution and the higher the subjective probability attached to the expected improvement. This - it can be added - depends on the expected behavior of other actors involved (assurance principle).

We are then back at the beginning of the story. Efforts to improve institutions will be more effective the better existing institutions perform. This is not a tautology, rather it suggests that collective behavior and the role of institutions in an uncertain world will interact in such a way as to produce virtuous (improving institutions, better information, increase in cooperation) or vicious circles (vice versa). As we mentioned before one can see cooperation under oligopoly as a dynamic process as opposed to cooperation under hegemony which takes the form of a more static process. Under hegemony the speed at which changes take place is possibly lower than in oligopolistic situations. Success of cooperation without hegemony is linked to the establishment of virtuous interactions among markets, institutions and national policies which make it possible to exploit the three conditions which are necessary for collective action under oligopoly.

As Keohane and Nye (1985) recall, the transformation of institutions is most likely to occur after a crisis - or a threat of a crisis - as the pre-existing allocative mechanisms are no more perceived as satisfactory both by market forces and national governments. Evidence of this may be gathered both from the interwar years (Eichengreen 1985, Oye 1985b) and from the post-Bretton Woods period (Llewellyn 1986). It is hardly questionable that in all major fields of the international political economy the 1970s and the 1980s have displayed much larger instability and less satisfactory performance with respect to the previous decade, yet the international system has - so far - managed itself out of the most dangerous situations. (19)

This suggests two considerations. First cooperation under oligopoly is indeed possible and hence hegemony is not the only possible route to a stable international system. Second, cooperation without leadership is associated with higher instability especially in the formation of expectations. In other words information is a public good

which can be produced both under oligopoly and under hegemony; however past and current events suggest that its production is more efficient when leadership is strong. This leads to the two final points we wish to discuss. The first one is the relation between international cooperation and the role of domestic pressure groups which increases in scope and weight when international regimes are weak (Katzenstein 1978). The second is the generation of macroeconomic regimes after hegemony.

THE DOMESTIC BASE OF FOREIGN ECONOMIC POLICIES

Payoff structures, strategies of reciprocity and international regimes interact in determining each country's incentives for cooperation and therefore in defining chances for cooperation. But cooperation, as already pointed out, is a game that each actor plays on two levels. National governments, in perceiving and determining their interests, are not only hindered by other actors' strategies but also by domestic, political, and social structure as well. Domestic constraints are more than likely able to influence policy makers' pay-offs, making it difficult for a country to follow a cooperative strategy, no matter how optimal it is.

On the other hand it is widely held that domestic factors influence both foreign policy and international relations. (20) There is more disagreement regarding just which factors are more relevant, how their influence is determined and the conditions where it plays a significant part. A well known approach derives from the interest group theory. A country's foreign economic policy can be explained looking at the various internal pressure groups influencing the government's decisions, since this policy generally reflects the ideological attitude and material interests of a ruling coalition which in turn is the expression of a country's domestic structure. The advanced countries' internal structures differ greatly and hence their foreign economic policy strategies also do, inasmuch as their main objective is to reach the highest compatibility among domestic targets and international constraints (Katzenstein 1978).

The interest group-based approach stresses and explains national policy differences rather than the working of an international system. Even so very important suggestions for analyzing countries' propensities to cooperate stem from

this approach.

First to be underlined should be the nature and distribution of domestic interests advocated by pressure groups. In systemic analysis the government's ability to express national interest through its policy decisions is based on the implicit assumption of a relatively stable internal ruling coalition being able to define economic interests of the system as a whole. If, however, there are many domestic influential pressure groups and they have heterogenous interests, the factors behind national policy decisions become more intricate and identifying them more complex. Dispersion and fragmentation of domestic interests could certainly favorably influence a country's propensity to cooperate. But in this case an equally sustainable hypothesis is that specific domestic interest groups can gain from certain policies (be they cooperative or not) while the nation on the whole can lose, and these groups are politically powerful enough to impose these policies upon the government. (21) In this case the criteria by which one assumes a nation's central authority orders its policy preferences and objectives should be reviewed.

Secondly, the country's net balance of costs and benefits arising from government decisions is undoubtedly important but equally so is the internal distribution of such costs-benefits and therefore how they impinge upon domestic interest groups. Such distribution is also dependent on the economic instruments being used. In the macroeconomic area, let's consider fiscal and monetary policy. Domestic groups exert a strong influence over governments' fiscal policy choices since the latter could have and have always had selective and concentrated internal effects. Chances for international coordination among governments - especially in respect to quantitative targets - are not promising in this case but in evaluating them each country's domestic constraints has to be taken into account.

Vice versa, domestic structures count relatively less on monetary policy coordination inasmuch as their effects are widespread and central banks are more institutionally independent from internal politics.

Summing up, what is generally true is that countries can react in a variety of ways to changes and constraints posed by the international economic system. All these answers are economically and politically feasible, and the choice made among them cannot be understood without

explicitly considering the domestic structure and the national preference function coming from it. Therefore domestic forces can strongly influence the conflict-cooperation trade-off. Their analysis can highlight certain aspects of cooperation in terms of strategic variables and additional solutions not explained by systemic theory and most certainly can improve the explanation.

But it could be held that a theory on domestic influences over countries' foreign economic policies is still far off. It still holds true, though, that in games simulating countries' interaction domestic factors should be added to the previously mentioned international ones as determinants of the pay-off structure of each country. One could then attribute to structure of pay-offs the role of an intermediate variable connecting internal and international factors on the one hand, and the latters with international cooperation on the other. (22)

In fact, neither of the two approaches taken separately affords a comprehensive explanation of why cooperation is still so out of reach. It is not enough to look at why and how an international system works or to examine domestic factors influencing countries' decision-making. We need theories integrating international relations and national policies; in other words theories taking into account the overlapping area of domestic and international policies, an issue of mounting importance.

INTERNATIONAL COOPERATION AND THE GENERATION OF EFFECTIVE DEMAND

A necessary condition for the improvement of cooperation in the international economy is the generation of a stable and, possibly, high rate of growth of effective demand. In a neoclassical framework growth is supply determined as Say's law holds (at least in the long run). In a Keynesian perspective the rate of growth of output also depends - if not exclusively - on the rate of growth of effective demand. Demand and supply factors both contribute to the economy's expansion. However, while supply factors depend more closely on domestic structures and policies (such as labor market behavior and the structure of fiscal policies) in a highly interdependent system the expansion of effective demand is more closely dependent on the international environment as domestic macroeconomic policies are

heavily influenced by balance of payments constraints. What is more important to growth is the expectation of effective demand that policy makers convey to market agents. It follows that a stable growth environment depends both on the macroeconomic policies implemented by the larger countries and on the institutional environment which determines the diffusion and stability of expectations.

A high and stable rate of growth improves the benefits of cooperation in all crucial areas of the international economy. It has been shown that (Easton and Grubel 1982) the benefits of free trade increase with the (expected) rate of growth of world trade and, hence, the rate of growth of world demand. It may also be added that while trade regimes influence the allocation of trade flows among countries, macroeconomic regimes determine the overall size of trade. Most of the empirical tests of the benefits of protection have so far failed to produce definitely convincing evidence in favour of free trade because they have concentrated on static benefits.

As far as financial relations are concerned it is well known that, in order for a debt-based system to perform satisfactorily, the rate of growth of indebted economies must be higher than the rate of interest on debt, at least in the long run. This holds true both in neoclassical and Keynesian models. (23) In addition both borrowers' and lenders' propensity to cooperate increases with the (expected) rate of growth (Simonsen 1984).

Macroeconomic adjustment to external imbalances is less costly in a growing world system as deficit countries are less pressed by mercantilistic policies of surplus countries. As less pressure is put on exchange rates for adjustment monetary arrangements are easier to sustain.

In a deflationary environment opposite results are obtained. Protectionistic pressures arise in deficit countries (Corden 1984); debt servicing is more difficult and the propensity to repudiate debt increases (Eaton and Gersovitz 1981); payment imbalances call for large devaluations which impose increasing strains on monetary relations. In general the role of domestic interest groups in shaping foreign economic policies increases as do the conflicts in the international system. (24)

Some conclusions may be drawn, first a high and stable rate of growth (both current and expected) can be considered as a public good as the Keynesian tradition holds (Head 1962, Wallace 1983, Colander and Koford 1985) since

it allows a more satisfactory system performance. This implies that collective action analysis should be applied to investigating the international macroeconomic regime. Second, considering the role played by the rate of growth makes the link among areas such as trade, money and finance clearer, which - as noted above - is often neglected in the analysis of international relations. This implies that a stable and high rate of growth, by improving cooperation in different areas, transforms negative issue linkages into positive ones and sustains supply conditions (in financial and factor markets) which interact positively with demand conditions. Third, the crucial role of growth expectations which emerges from the analysis of trade and finance reinforces some of the results of the political analysis of cooperation; in particular the longer shadow of the future increases the propensity to cooperate as so do efficient expectation formation mechanisms. One major problem is that while institutions (and agencies) which deal with trade and financial issues do exist, there are none for macroeconomic coordination. Perhaps the only - informal - one is the Group of Five. However, as we have seen in the first part, its efficacy in achieving macroeconomic coordination is doubtful to say the least. In particular the G5 seems unable to tackle today's key issue (and indeed of the whole post-hegemonic period) which country should bear the burden of sustaining growth whenever the US economy slows down.

No fully satisfactory solution to this problem may come from strengthening institutions and cooperation in related areas. Monetary agreements such as target zones can impose indirect constraints on macroeconomic policies insofar as these must follow courses which are coherent with exchange rate agreements. However a monetary system may be quite robust and still produce a deflationary bias on member economies. Trade liberalization may promote growth by opening market opportunities and improving supply conditions, however (expected) growth is a precondition for liberalization rather than vice versa. A Keynesian perspective rules out the possibility that market forces alone can produce a satisfactory (high and stable) rate of growth. As for a closed economy, macroeconomic policies are needed to sustain demand and, in a financially complex world, Central Bank intervention is needed to prevent financial instability from developing along with expansion.

An implication for the political economy of cooperation is that different regimes have different impacts on macroeconomic policy coordination. The Bretton Woods system was based on a large, and what is more important, relatively closed core economy. Expansionary US policies had a significant impact on world demand and growth while the American economy received a limited benefit from European (and Japanese) expansion. The erosion of hegemonic power was largely associated with the US economy's increasing dependence on other countries' performance. (25) While under hegemony the macroeconomic regime is clearly controlled by a single country, under oligopoly no single country can pursue unilateral expansionary policies for a long period of time unless adequately sustained by the remaining countries. Under oligopoly cooperation is not only possible, but it is necessary if the system is to avoid collapse.

The establishment of a macroeconomic regime does not necessarily imply that key countries agree each 'period' (each year) on a short term coordination of their macroeconomic policies. Short term negotiations are quite costly and hardly successful as in the short run perceived benefits from cooperation are generally inferior to perceived costs (Lipson 1984). In addition short run coordination does not (by definition) meet the requirement of a long and increasing time horizon for the cooperation process to be successful.

A macroeconomic regime requires that rules of the game for growth be established. This difficult task is related to the problem of asymmetric adjustment between surplus and deficit countries, which, in turn, is rooted in the mercantilistic attitudes of key industrial countries (Guerrieri and Padoan 1986). Under hegemony deflationary mercantilistic policies were, partially at least, mitigated by the US expansionary policies. Under oligopoly, neo-mercantilism induces a deflationary bias on the system which is enhanced by the post-Bretton Woods' era two characteristics of the international system: differences in national preferences with respect to growth and the so-called 'expectation trap' (Boltho 1984).

Key countries like Germany have a strong preference for low growth and tendentially restrictive policies since these will meet domestic interests or, rather, the interests of those pressure groups which are able to influence national policies more effectively. (26)

The expectation trap stems from the distinction between business and financial expectations. Business decisions are based on long-run expectations; when these are unsatisfactory, investment, and growth will be set back. Financial decisions regarding the allocation of funds are largely based on short term expectations and financial operators are quick to react to changes in such expectations. Business expectations are improved by expansionary policies; however, once implemented, these will influence financial expectations as well, which will lead to outflows of funds from the expanding economy. The resulting payment imbalances will call for restrictive policies which will depress business expectations thus frustrating business investment. The expectation trap hypothesis reinforces the view that macroeconomic cooperation requires the establishment of long run rules of the game which will allow for sustainable expansionary policies in a financially complex system.

Recent research has produced new theoretical justifications as well as historical evidence that cooperation is possible under anarchy (oligopoly). However, political scientists' historical and empirical analysis has concentrated on monetary and trade (as well as strategic) aspects neglecting the consideration of macroeconomic regimes. Economists, on the other hand, have produced a large amount of work on macroeconomic cooperation but have failed so far in providing insights into the key problem of achieving macroeconomic cooperation under oligopoly. It has been suggested (Cooper 1985) that one reason for the difficulty in achieving cooperation in macroeconomic policies is that there is disagreement over how the macroeconomy operates in practice. Perhaps this is the case in which more interaction between economists and political scientists, while increasing the numbers of actors involved, would improve the efficiency of the production of the public good of knowledge.

NOTES

1. See Pelkmans (1979) and Cooper (1983).
2. An extensive list of publications on this topic is available in the various papers of the volume edited by Buiter and Marston (1985). Among recent contributions see also Rogoff (1985), Hughes Hallett (1985), McKibbin and

Sachs (1986).

3. See Blanchard et al. (1986) (fn. 3).

4. See, inter alia, Axelrod (1984), Keohane (1984), and for a comparison of different political economy approaches Cohen's paper in this book.

5. The problem with assuming perfect competition is that it simply ignores many aspects of the real world that are extremely important when considering economic policies. In this respect the new views on trade policy deriving from the application of oligopoly and imperfect competition theories to trade relations (Krugman 1986) clearly exemplify the limits of perfect competition assumption.

6. Cooper's (1968) classic formulation integrates the two aforementioned levels, since he sees the central problem of international economic cooperation as 'how to keep the manifold benefits of extensive international economic intercourse free of crippling restrictions while at the same time preserving a maximum degree of freedom for each nation to pursue its legitimate economic objectives'.

7. The list of contributions is too vast to be quoted here. More recent works and an extensive bibliography are available in the collective volume published in the special issue of World Politics, 1985, vol. 38, October on 'Cooperation under Anarchy'.

8. For a comprehensive analysis see Keohane (1984).

9. See, in particular, the essays which appeared in the winter 1985 issue of World Politics.

10. See for example, the essays in Kierzkowsk (1985).

11. See, among others, Lipson (1982), Conybeare (1983), Cowhey and Long (1983), McKeown (1983). For empirical evidence in support see Krasner (1976), Lake (1984).

12. See for instance, Aliber (1982).

13. This point is stressed in the Kaldorian hypothesis of the growth-productivity-competitiveness virtuous circles. However theoretical research in this field requires further clarification.

14. See on this Padoan (1986a).

15. See Eichengreen (1985) and Oye (1985b).

16. Jervis (1978) analyzes how different types of games are related to different prospects for cooperation. See also Oye (1985a).

17. See on this point the various essays collected in the volume edited by Krasner (1983).

18. One of the most important aspect of game-theoretic modelling for the study of oligopolistic interaction comes in describing information conditions and offering dynamic models depending explicitly upon the information conditions, see Shubik (1984).

19. In spite of recurring risks of instability as in the case of the debt crisis.

20. The list of publications is indeed very large. See, inter alia, Katzenstein (1978) and more recently Gourevitch (1986).

21. In this respect the literature on the political economy of trade policy offers many good examples, see Baldwin (1982) and Frey (1984).

22. In the pay-off structure economic theory plays a crucial role. Different economic theories provide alternative frameworks to derive pay-off structures and in doing so lead to different specifications of countries' strategic choices. See infra par. 7.

23. For a discussion of this point see Padoan (1986a), especially ch. 9.

24. See the essays in Katzenstein (1978) and in Lindberg and Maier (1985).

25. For a discussion of this shift in emphasis in international monetary relations before the collapse of the Bretton Woods system see Officer and Willet (1969).

26. This reinforces the idea that weak international regimes are dominated by special interest groups more than by national policies.

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Chapter Two

BARGAINING PERVERSITIES, INSTITUTIONS, AND INTERNATIONAL ECONOMIC RELATIONS

Robert O. Keohane

International economic relations, like all international relations, can be viewed as a struggle for power and wealth in a 'self-help system': that is, a system characterized by the absence of centralized rule-enforcement. (1) One stylized but useful way to think about intergovernmental relations in the international political economy is to view it in game-theoretic terms, envisaging each country as an actor (having different power capabilities, which may vary by issue-area) in a variety of games. (2) Such an approach can of course be extended to deal also with relations among non-governmental actors such as transnational corporations.

Because interests differ and there is no way to prevent their expression, disagreement and contention are essential facts of international life. Governments, transnational corporations, and international organizations will seek to advance their interests (as they perceive them) by foisting the costs of adjustment to change onto others. No matter how much can be gained from joint action whose costs are borne proportionately to benefits received, more can always be obtained by some actors if they can manage to get others to share disproportionate amounts of the costs or to allow them to reap special rewards. And in contemporary international economic relations, changes are always occurring that create new opportunities for negotiation by altering the present distribution of costs and benefits. Thus no political equilibrium exists at which demands for policy adjustment will cease.

During the last forty years, the potential rewards to be gained from cooperation have increased, with the growth of international economic interdependence and the expansion

of governments' involvement in the operation of modern capitalist economies. But the opportunities to bargain contentiously have also expanded. Interdependence multiplies points of potential friction among governments and therefore fosters policy conflict, or discord.

Yet the prevalence of discord in world politics - including the politics of international economic relations - does not mean that international cooperation is impossible. Cooperation implies mutual adjustment of policies to one another rather than complete harmony of interests. Indeed, efforts to cooperate are only necessary when discord exists: if harmony were to prevail, there would be no need to adjust policies to fit the preferences of others. Only the spectre of damaging policy divergence can induce others to change their policies, so that they will bear a greater share of the burdens of adjustment. These efforts entail dispute and conflict; but insofar as they are successful, cooperation ensues.

The decentralized nature of world politics may prevent the consumation of mutually beneficial agreements as a result of what I will refer to as 'bargaining perversities.' These perversities provide incentives to actors to behave in ways that have the effect of hindering mutually beneficial cooperation - in game-theoretic terms, of yielding sub-optimal equilibria despite there being a potential for Pareto-optimal equilibria. As a result of these perversities, all participants are worse-off than they could have been had cooperation been achieved. (3)

This paper will examine the effects of several of these bargaining perversities, and will then discuss two different sets of responses to them. For each bargaining perversity, I will first consider strategic responses - actions taken to discourage opportunistic behaviour in particular situations. Such strategic responses can be valuable in changing incentives that discourage cooperation, but they can create other difficulties that may have equally severe effects on the long-term prospects for cooperation. Strategic analysis therefore leads us toward reflection on institutional innovation as a way of promoting cooperation. Focusing on the role of international institutions in facilitating international cooperation will help us to understand why contemporary international economic relations take place within an elaborate network of institutional arrangements, involving not only formal organizations and rules but informal understandings and patterns of expectations.

Thinking about the role of institutional innovations may also point toward ways of facilitating international economic cooperation during the rest of this century. (4)

I will discuss four sets of bargaining perversities. The most important of these is the problem of 'free riding', or defection, so familiar to students of strategic action in the presence of public goods. An understanding of these issues is essential to a comprehension of why sovereign governments, which normally seek to preserve their own autonomy, often seek to form international institutions, or what have become known as international regimes. In discussing free riding, I distinguish between mere failure to agree to cooperative arrangements (which could be referred to as 'evasion') and reneging on such agreements, or 'cheating'. Because of its special aspects, cheating is dealt with in a separate section, despite the fact that it can be seen essentially as a variant of the free rider problem. Problems of defection and free riding can be dealt with, in part, by employing strategies of reciprocity, although as we will see, these entail more complications in practice than in the laboratory. The institutional context within which reciprocity is employed can be an important factor in the success or failure of such a policy.

Having considered free riding and the specific case of cheating, I then turn to two perversities that reflect the fragmented way in which international relations is organized - which I will refer to as the problems of 'heterogeneous interests' and 'truncated bargaining sets.' In coping with these bargaining perversities it may be useful to restructure negotiating groups, by forming 'clubs', or to link issues together in new ways. Both of these strategies, however, have their own pitfalls, which appropriate institutional innovation can help to alleviate.

DEFECTION, FREE RIDING AND RECIPROCITY

International economic cooperation may create public goods such as stable exchange rates, ample supplies of petroleum that reduce worldwide oil prices, or trade liberalization generalized even to states that do not make concessions. In the presence of public goods, individuals are tempted to act as free riders: to contribute less than their shares for the good but to gain from its provision by others. In game-theoretic terms, the structure of this game is Prisoners'

Dilemma; the best outcome for each player is to defect while the other (the 'sucker') cooperates; but if both defect, the result is inferior to that obtained when both cooperate. (5)

Where the number of players in such a game is very large, and the ties between them are weak, public choice theory predicts that the public good will therefore be underproduced. Cooperation will be suboptimal. Actors will have great incentives somehow to privatize the goods that they produce, by arranging to exclude non-contributors from the benefits. It is not surprising, therefore, that international economic institutions do not produce purely public goods. Governments must join the General Agreement on Tariffs and Trade (GATT) to be guaranteed most-favored-nation treatment by GATT members; they must belong to the International Energy Agency (IEA) to benefit from the emergency sharing system; and they can only draw from the International Monetary Fund (IMF) if they belong to it.

Yet the burdens of membership alone may be small, and the free rider problem may therefore persist within the institution. If the defectors can be identified, the appropriate strategic response may be to adopt policies that discriminate against them - once again, by privatizing what were formerly public goods. Robert Axelrod has demonstrated that in iterated bilateral Prisoners' Dilemma among egoists, strategies of specific reciprocity - TIT FOR TAT - are remarkably effective in promoting cooperation. (6) They lead to greater overall cooperation than do policies of what I call diffuse reciprocity, which do not differentiate among individuals. In a population of egoists, failing to differentiate among cooperators and defectors makes one vulnerable to exploitation. (7)

Axelrod's argument has recently been taken up by several students of international trade. Following the lead of oligopoly theorists as well as political scientists, they have begun to develop 'strategic' economic models in which each actor's choices affect the payoffs received by others. (8) J. David Richardson has argued for an active American trade policy as a means of inducing foreign governments to follow trade and subsidy policies more favorable to the United States. (9) This argument can be reinforced if one assumes imperfect rather than perfect competition, since imperfect competition can create super-normal profits. Under these conditions, government action - such as

subsidies to reduce R&D costs for national firms or guaranteed markets for products - can promote or deter entry and therefore change the distribution of rents. (10) Controversy continues over the practical implications of this theoretical argument for departures from free trade - Paul Krugman, for instance, doubts that the stakes are large and warns against using these findings to support policy activism, (11) while Richardson uses them to bolster the case for active strategic trade policy. From a political scientist's standpoint what is interesting about this debate is not the technical arguments or even the differing judgements of economists about political feasibility but the intellectual ferment in trade theory. The idea of unconditional free trade has long held a sort of ideological hegemony among international economists in the United States, who have sometimes taken support for free trade as a touchstone of being 'a good economist' and who have often seemed to behave more as apologists for mercantilistic competitors (to whom we have sometimes been urged to send 'notes of thanks' for their subsidies to export industries) than as sophisticated observers of strategic interaction.

The Axelrod-Richardson logic creates a potential anomaly, since it suggests that international trade should be characterized by policies of specific reciprocity, in which governments engage in bilateral negotiations and discriminate carefully among their partners to avoid free riding. Strategic behavior should be endemic in international trade. Yet in fact what we find is different: 'reciprocity' in the GATT means that tariff concessions are generalized to all members on a most-favoured-nation (MFN) basis. Admittedly, this does not apply to 'voluntary export restraints' (VERs) and other non-MFN restrictions, which currently account for about one-third of GATT trade as compared with only about ten per cent in 1955, when tariff rates were higher. (12) The pattern is decidedly a mixed one, with bilateral discriminatory arrangements embedded in a multilateral non-discriminatory regime. The question arises of how we can explain the continued strength of unconditional most-favored-nation treatment in view of the attractions of specific reciprocity and the spectre of the free rider problem.

For such an explanation it is necessary to go back into history, particularly the history of American trade policy during the first half of this century. Before 1923, as if anticipating the writings of contemporary advocates of

strategic bargaining, the United States adhered to the conditional rather than the unconditional version of the most-favored-nation (MFN) clause. Unconditional MFN requires a country making concessions to a trading partner automatically to apply them to all other countries with which it has an MFN agreement, without demanding compensation. Conditional MFN treatment, on the contrary, permits the country to demand 'equivalent' compensation and to discriminate against countries that fail to accommodate it. It follows that no country can simultaneously pursue conditional MFN policies toward some countries and unconditional MFN toward others. As Jacob Viner explains:

> The existence of a single unconditional most-favored-nation pledge in a country's treaties makes all the other pledges, whatever their form, unconditional in effect. Suppose that A has most-favored-nation treaties with countries C, D, and E, of which (those with) C and D are conditional and E unconditional, and that A grants to B, for compensation, a reduction in tariff duties. C and D cannot claim from A the benefit of this tariff reduction for their own commodities on the ground that it has been given to B, unless they offer compensation for the reduction equivalent to that given by B. But E can claim the reduction unconditionally, and it must then be extended to C and D also. (13)

For some time only the United States of the major trading powers adopted the conditional form of MFN. This allowed the United States to 'defect', gaining the benefits of others' cooperation without having to contribute itself:

> Dealing mainly with countries who were extending unconditional most-favored-nation treatment to other countries, the United States received, by virtue of her conditional most-favored-nation treatment, everything which she would have received if they had all been unconditional. But she gave nothing in return. (14)

However, the free ride enjoyed in the United States was not quite so enjoyable as it might appear. In the first place, several important countries refused to negotiate commercial treaties at all with the United States, so that they could discriminate against American exports. Secondly,

America's strategic trade policy was encumbered by two defects of specific TIT FOR TAT reciprocity that do not appear in Axelrod's bilateral computer simulation. It was difficult to establish equivalence, since governments tended to exercise biased judgement in their own favor. President Harding's Acting Chairman of the US Tariff Commission complained in 1922 that it was 'almost impossible to arrive at any agreement upon the equivalent concessions to be made by the third party.' (15) And as Franklin D. Roosevelt's Assistant Secretary of State observed, conditional MFN provided incentives for countries to erect trade barriers for bargaining purposes. (16)

An even more serious difficulty with this strategic trade policy resulted from the fact that sequential negotiations were carried out, each of which affected the results of previous bargains. The distribution of benefits resulting from a given agreement could be shifted by subsequent actions by one part or the other. Thus if the United States granted a concession on French lace in return for a French concession on American farm machinery, the value of the American concession to France would depend in part on the discrimination that ensued against Belgian lace, giving the French product an advantage over its competitor. If the United States then made similar concessions to Belgium, in return for compensation, France could demand further concessions from the United States in compensation for the loss it had suffered by the removal of its discriminatory advantage. The result was that what I have called specific reciprocity, as illustrated by TIT FOR TAT and conditional MFN, involved 'unceasing and difficult negotiations which are quite unnecessary and often costly.' (17) As a result of these difficulties, the Harding Administration adopted unconditional MFN in 1923 - eleven years before the enactment of the Reciprocal Trade Act under the Roosevelt Administration.

Thus strategic bargaining, using specific reciprocity, is not as compelling as it may at first seem. Indeed, the postwar attachment of the United States to non-discrimination in international trade is partly a result of its unfavorable experience with its earlier policy of conditional MFN. In international banking regulation as well, the United States and other major industrialized countries do not apply specific reciprocity, since to do so would 'entail a fragmentation of the national regulatory framework to embody the different regulations applied in the home

country of the foreign banks, thereby giving rise to a large range of competitive inequalities within the national banking system.' (18)

Applied unilaterally, specific reciprocity can lead to what Axelrod calls 'echo effects' or feuds. National bias may contribute to the self-righteous application of reciprocity principles to trading partners, inviting harmful mutual retaliation and a poisoning of international relationships. As we have seen, discrimination can also lead to political-administrative nightmares. Yet in response to defection and free riding by others, it remains an essential tool. How, then, can reciprocity be employed in a constructive way?

Clues to answering this question can be found by examining the institutional innovations of international economic policy during the last forty years. The first point to be made is that the gradual institutionalization of the GATT after 1947 and the strengthening of the IMF after the mid-1950s, created expectations that their rules and procedures were likely to endure, and that a series of negotiations would take place within this framework. This helped to extend what Axelrod calls 'the shadow of the future', making governments more inclined to cooperate in the present in order to induce others to continue to cooperate with them in the future.

It is also important to emphasize the mixture of types of reciprocity that characterized the international trade regime. Unconditional MFN is a key feature of the GATT, valued for its contribution to avoiding the feuds, bad feelings, and administrative imbroglios that accompany discrimination among countries. Yet in the absence of a solidary international society, adoption of pure unconditional MFN would open the door to severe free rider problems. GATT has therefore incorporated a qualified version of unconditional MFN. This was done in the 1950s through the 'principal supplier rule', which required compensation for concessions on a given product from all countries supplying at least a certain proportion of the market. In the Kennedy and Tokyo Rounds, item-by-item negotiations were replaced by negotiations on tariff-cutting formulas; the major bargains were struck among the major trading powers, but concessions from others were extracted on a quid-pro-quo basis before final agreements were reached. Although unconditional MFN was retained, the negotiations themselves were highly conditional. 'In the trade negotiations,' said GATT ministers preparing for the

Kennedy Round, 'it shall be open to each country to request additional trade concessions or to modify its own offers ... to obtain a balance of advantages between it and the other participating countries.' (19)

Thus the institutional arrangements prevalent in contemporary international trade involve a compromise between unconditional MFN, on the one hand, and conditional trade negotiations, balanced before final signature of agreements, on the other. The exercise of reciprocity plays a role, but it is constrained by an overall set of norms and institutions that emphasize non-discrimination and liberalization. Strategic responses to the free rider/defection problem are not sufficient in themselves; but in conjunction with appropriate institutions a relatively effective mixture of strategies, able to limit defection without leading to spirals of retaliation, was devised.

I do not claim that this evolving synthesis will remain viable indefinitely. Recently, further innovations have taken place, responding to American and European worries about the intense competition coming from Japan, in steel, electronics, and automobiles, and from the Newly Industrializing Countries of the Third World, particularly in textiles. So-called Voluntary Export Restraint agreements have become common. These agreements are generally bilateral, although the Multi-Fiber Agreement provides a patina of multilateral legitimacy in the textile area. (20) These agreements have been negotiated under pressure from powerful countries on weaker ones, and they in effect involve discrimination because the exports of only some countries are restrained. However, since they provide legitimacy for producers' cartels, and since exporting governments capture the resulting scarcity rents, they are sometimes covertly welcomed by the exporters themselves, at least those whose market share is already established. (21) Institutional innovation is not a panacea: institutions can be used (as the MFA is) for discriminatory and illiberal purposes. Nevertheless, the point remains that strategic responses to free riding and defection may be substantially refined and improved by being placed in an appropriate institutional context.

CHEATING

By 'cheating' I refer to the practice of deliberately failing to live up to one's commitments. As noted above, this form of opportunistic behavior can be seen as a form of defection occurring after agreements have been reached. The cheater appears to cooperate by signing an agreement to do so, but then (usually covertly) fails to carry out his part of it. Cheating involves an additional dimension to evasion since the cheater does not merely seek to be a free rider, but breaks its commitments to do so. This makes cheating morally more blameworthy than evasion; but it gives governments seeking to maintain cooperative arrangements an additional source of leverage. The cheater, but not the mere evader, can be threatened with costs to its reputation as a trustworthy partner with whom agreements can safely be made.

Cheating is a continual possibility in international relations, since there are no centralized enforcement mechanisms to prevent it. Its occurrence is held in check largely by reciprocity, since habitual cheaters can either expect specific retaliation against them or loss of reputation over the long run. Even purely egoistic governments, unconcerned about the effects of their actions on others, worry about their reputations, since the quality of one's reputation will affect the terms on which one can make agreements in the future. Governments suspected of being habitual cheaters will be forced to make less advantageous agreements, as their potential partners demand compensation for the risks they run in dealing with unreliable actors. Reputations are valuable capital assets for governments: as Charles Kindleberger once remarked, 'In economics bygones are bygones, but in politics they are working capital.' (22)

The reputational issues involved in cheating create opportunities for two types of institutional action, having to do with standards and detecting violations.

Egoistic governments only have incentives to maintain reputations for keeping their agreements, if some standards exist by which their performance can be assessed. These standards are most effectively established through institutionalized rules of conduct, agreed-on multilaterally. In post-war macroeconomic policy negotiations, as Stephen N. Marris says, 'both rules and "reputation" were used to try to overcome (the) free-rider problem.' (23)

Even if clear standards exist, cheaters cannot be punished unless they are detected; and in multilateral settings, many governments have few effective means of monitoring others' actions. Anticipating this, governments that regard themselves as relatively poorly informed will be reluctant to make agreements in which they could be victimized, and a form of 'political market failure' is likely to result. As in economic theories of market failure, systematically biased patterns of information, recognized in advance of an agreement by the less informed partner, will inhibit that party from making an agreement. Even mutually beneficial agreements - in which the better-informed partner sincerely plans to carry out his side of the bargain - may not be reached. Just as the market for used cars is imperfect, so is the market for international agreements - in the latter case, not so much because of uncertainty about the present state of affairs but because of uncertainty about others' willingness to comply with agreements and one's own ability to monitor such compliance. (24)

Governments' need for information to monitor agreements creates a demand for international institutions that can provide such services. In view of this it is not surprising that international organizations spend more energy on monitoring agreements than in enforcing them on governments. This is true of GATT, the International Energy Agency, and many other international arrangements, including the Group of Ten - the industrial countries participating in the IMF's General Arrangements to Borrow. A report of Deputies of the Group of Ten, issued in July of 1985, made this point clearly:

> In considering ways to promote the convergence of economic performances toward sustainable non-inflationary growth through the adoption of sound, compatible policies, the Deputies have agreed that surveillance, especially by the IMF, is the basic tool for moving toward these objectives. (25)

Thus insofar as cheating is a potential problem, strategic responses to it must be combined with institutional innovations. Appropriate institutions are necessary not only to inhibit cheating, but to provide governments with the incentives to enter into agreements with some confidence that they will not be duped.

Monitoring states' behavior to detect cheating only

constitutes one of the problems involved in using decentralized retaliation to maintain cooperation. Other 'sanctioning problems' also arise. (26) Players may be unable to focus retaliation on cheaters even if they can identify them; and non-cheaters may lack incentives to punish cheaters.

One way to deal with these sanctioning problems is to build international regimes that not only provide standards against which actions can be evaluated, but that also create structures that facilitate retaliation against those who cheat. Such arrangements were constructed quite effectively by American banks engaged in 'involuntary lending' to Latin American debtors after the crisis of August, 1982. The big money-centre banks set up creditor committees, which assigned responsibility to each bank to supply a certain amount of money for a rescheduling package. Each member of a creditor committee was responsible for dealing with a number of relatively large regional banks, which were expected not only to provide their shares of the loan but to ensure that particular smaller banks in their area did so as well. Charles Lipson describes the problem, it was a matter of overcoming collective action problems by breaking down the large game, 'involving hundreds of banks and considerable opportunities for free-riding, into a series of bilateral games pitting a few small holdouts against money-centre banks.' (27) Creating new institutions (in this case, private institutions at the national level rather than public international organizations) was essential to deal with problems of cheating, or opportunism, that are inherent in large-number, non-hierarchical realms.

HETEROGENEOUS INTERESTS

Governments in the contemporary world have extraordinarily diverse conceptions of their international economic interests. Some of these stem from their widely differing levels of economic development; others from different economic structures, political institutions, group pressures, economic ideologies, or location in the competitive international political system. One consequence of such great heterogeneity is that it is extremely difficult to obtain general agreement on any significant proposition in a universal international organization. Even if the major economic actors concur on a desired course of action, they

may not have sufficient command of political resources - whether votes or other forms of influence - to secure its adoption by the organization. Thus the context within which bargaining is undertaken may lead to a 'perversity': arrangements that would be mutually advantageous for a significant set of actors are not undertaken.

Strategically, the appropriate response to such a situation may be for a small number of like-minded and powerful governments to carry out a joint policy on their own. (28) That is, these governments form a club to carry out their joint policy. The seven powers that meet regularly for economic summits form such a club. (29) So, in the monetary area, do the Group of Ten and the Group of Five.

Such a strategy has its drawbacks, and is not necessarily wise. It is true that the UN General Assembly is too unwieldly, and its voting arrangements too divorced from world power realities, to be an effective representative body. The tortured decade-long existence of the United Nations Law of the Sea Conference, and its mixed results, also reflect adversely on universal conferences in the modern world. Certainly no industrial country's finance minister in his or her right mind would suggest a 'New Bretton Woods Conference' at which 150 countries would be represented with equal voting rights. Nevertheless, universal international organizations are valuable as sounding-boards, reflecting the grievances of the powerless. Furthermore, they have a legitimacy outside of the highly industrialized democracies that no 'rich man's club' can match. Thus forming a club is only worthwhile if it is decided that the need for decision-making coherence outweighs the diplomatic costs arising from others' anger from being excluded, and from the loss of legitimacy that may occur by withdrawing key decisions from wider arenas.

If the club-forming strategy is followed, institutionalization may help it succeed. Internally, clubs will encounter the coordination problems discussed above - in particular, dealing with problems of free riding and cheating. Reciprocity is a crucial device here, but as we have seen, the complications that it raises may be alleviated if it is suitably guided and restrained by institutional rules and norms. Externally, the issues involve the potential abuse of power by the elite, and the related question of legitimacy. The 'free rider problem' turns into what Carlos Diaz-Alejandro once called the 'heavy rider problem,' in which the culprit is not the minor actor evading

responsibility but the great powers, imposing their will on everyone else. (30)

Three different devices have been used to deal with this problem. First, the exclusive club may be attached loosely to an international organization that has wider membership and legitimacy. Thus the Group of Ten is linked to the IMF since its members are the industrial countries participating in the Fund's General Arrangements to Borrow. Secondly, the club may be enlarged to include a number of minor powers, whose interests are similar enough to those of the major countries to ensure that they will not block agreements, while continuing to exclude countries with divergent interests. This is true of the International Energy Agency, which was established in 1974 within the framework of the Organization for Economic Cooperation and Development (OECD), with a similar membership, but which was in effect led by the United States, Germany and Great Britain. (31) Thirdly, clubs may be created not as exclusive entities but in an open-ended fashion, so that any government able and willing to make the requisite commitments may join. The codes agreed upon at the Tokyo Round constitute such an institutional innovation. Membership in those codes is open to all GATT members, but their benefits are not automatically extended on a most-favored-nation basis: countries that do not adhere to the codes are not guaranteed reciprocal benefits. That is, specific reciprocity is reintroduced into the trade area through these codes, yet in a way that does not arbitrarily exclude any governments. Putting the matter another way, the codes suggest the possibility of constructing international regimes with non-discriminatory rules (membership open to all on equal terms) that nevertheless permit discrimination in trade under carefully specified conditions. Clearly, a potential for abuse and hypocrisy arises in giving rich and poor countries equal rights to join in trade arrangements devised principally by the rich; it reminds one somewhat of Anotole France's remark that in the Paris of the Third Republic, beggars and millionaires had a perfectly equal right to sleep under bridges. Nevertheless, such innovations do offer some prospect of permitting multilateral cooperation to continue without the arduous and often frustrating process of reaching agreement in a heterogeneous universal forum.

TRUNCATED BARGAINING SETS

When two parties with partially complementary interests bargain over issues that are highly divisible, it is not necessary to introduce new issues into the negotiation to make agreement possible. Each side simply has to be willing to move into the bargaining range. This is not the case, however, when the issues at stake cannot be divided neatly into increments. Some international economic issues have, at least in part, this quality. Governments can launch a new trade round or not; they can declare Poland in default or avoid doing so; they can establish fixed exchange rates or allow them to float. One frequently-used strategy in such situations is to try to change a dichotomous issue into an incremental one. Instead of arguing about fixed versus flexible exchange rates, governments can discuss multilateral surveillance procedures; and they can compromise on which issues should be included in a proposed trade round. But due to the inherent characteristics of certain issues, this strategy may have its limits. Insofar as it does, the consequence may be that discord persists due to the fact that to reach agreement one party must accept net losses.

In such a situation, drawing linkages among issues may render new bargains possible: that is, issue linkages may 'facilitate the completion of a greater number of mutually beneficial agreements among nations.' (32) The United States may agree to greater exchange rate intervention if France consents to a new trade round; Third World governments may agree to allow scientific research off their costs in exchange for an Extended Economic Zone; Egypt may acquiesce in an American peace initiative in the expectation of increased economic aid.

The implication of this line of argument is that what I have called 'truncated bargaining sets' may be a hindrance to international cooperation. If issues are compartmentalized rigidly, it may become impossible to make the side-payments and trade-offs necessary to reach agreement, even if (in a wider context) the common interests exist on which such an agreement must rest.

If the strategic advantages of linkage are clear, however, so are the liabilities. Linking new issues to one another can extend the range of contention. Incommensurable questions may be joined together, without a clear metric to permit trade-offs. Or emotional issues of

sovereignty and self-reliance may generate intergovernmental animosities or domestic protests. Radical Egyptian nationalists viewed Sadat not as a hero but as a traitor to the Arab cause, willing to exchange priceless national honor for subsidies from the United States; many Latin American critics of the IMF fear that their governments are selling their sovereignty for loans; Germans are highly sensitive to implicit American threats to reduce US military protection over West Germany unless the Bonn Government accommodates American economic demands. In the Law of the Sea negotiations, linkages became so complex that they seemed likely, at certain points, to render the negotiations incapable of settlement. Thus the advantages of linkage are not unalloyed; separating issues also has its attractions. For many years, trade and finance were kept quite rigorously separate; and European-American relations of the 1950s and early 1960s thrived under a 'two-track system', which discouraged military-economic linkages. (33)

The question then is one of under what conditions linkages should be encouraged, and under what conditions discouraged. It may be that no general answer to this question is possible, but a clue may be found in Kenneth Oye's distinction between 'backscratching' and 'blackmailing.' (34) The backscratcher merely offers to follow a policy that would, in itself, be suboptimal, in return for compensation on another issue. 'Backscratching' is welfare-enhancing for the same reasons that trade, in a Ricardian model, is welfare-enhancing. The blackmailer, in contrast, threatens to do something that would hurt himself or herself, in addition to hurting the victim, unless bribed not to do so. Blackmailing does not necessarily enhance welfare; and if the threat is carried out, everyone's welfare is reduced. As Schelling has pointed out, one difference between the backscratcher's promise and the blackmailer's threat is 'that a promise is costly when it suceeds, and a threat is costly when it fails.' (35) The fulfilment of the backscratcher's promise contributes to overall welfare, while the fulfilment of the blackmailer's threat detracts from it.

In domestic law, backscratching is allowed and blackmailing prohibited. Similarly, optimal international institutional arrangements would facilitate backscratching and discourage blackmailing. Unfortunately, the distinction is difficult to make clearly in practice - threats can be couched as promises, as in the gangster's 'promise' not to

hurt a businessman who pays protection money. Yet in thinking about how international institutions could overcome the problems posed by truncated bargaining without leading to escalating cycles of retaliation, this distinction may be helpful.

CONCLUSION

Because international relations are non-hierarchical, cooperation is often hindered by bargaining perversities, which make it difficult for independent actors, particularly governments, to make mutually beneficial agreements. Many of these perversities result from temptations to defect from cooperative agreements, either by refusing to assume obligations that others undertake (evasion) or by cheating on agreements. Some perversities result from the way in which international relations are organized; groups may have excessively heterogeneous interests, or issues may not be linked together in ways that facilitate mutually beneficial trade-offs.

Dealing with these bargaining perversities often requires adjustments in strategy. Reciprocity can be an effective way of deterring and punishing defection and cheating. Forming smaller groups of like-minded states, and linking issues together, may both facilitate cooperation under conditions. Yet strategic responses generate their own pathologies. Reciprocity may lead to feuds or to extensive political and administrative complications. Smaller groups, especially of powerful states, may be perceived as exploitative or domineering by other governments. Issue-linkages can lead to blackmail as well as to mutually beneficial political exchange.

A sophisticated strategic approach to international economic negotiations therefore requires an institutional dimension. Institutional innovations can create a complex but workable mix of specific and diffuse reciprocity, as in the international trade regime that evolved during the thirty or so years between the formation of GATT and the conclusion of the Tokyo Round. Cheating can be restrained, and compliance with agreements encouraged, by the institution of clear rules and procedures, often embodied in international organizations and monitored by the secretariats of those organizations. Clubs can be legitimized, or created in an open-ended way, if they are

formed.

NOTES

1. Kenneth N. Waltz (1979).

2. For an interesting attempt to clarify thinking along these lines for political scientists, see Duncan Snidal (1985).

3. This focus means that our attention will be directed at the impact of the decentralized international political system on international economic cooperation. It should be emphasized that no claim is made about the superiority of this explanation to those that emphasize lack of knowledge, low estimates of the value of cooperation, or the impingement of domestic politics. My claim is simply that this international political approach makes a significant contribution of its own.

4. In his article on economic interdependence, Cooper (1985a) points out that there is, 'perhaps paradoxically, a somewhat better record at creation and maintenance of rule-based regimes' than of coordination of specific economic policy actions (p.1228). Oudiz and Sachs (1984) conclude their article by posing questions about the role, if any, that international organizations should play in 'fostering and overseeing cooperative arrangements' (p.58).

5. Russell Hardin has shown that Prisoners' Dilemma is similar in its essential logic to the 'logic of collective action', or dilemma of public goods, as discussed by Olson. See Russell Hardin (1982), Chapter 2. The classic references on dilemmas of collective action are Mancur Olson, Jr. (1965), and, for the problem of alliances, Mancur Olson, Jr. and Richard Zeckhauser (1966), vol. 48.

6. Robert Axelrod (1984).

7. I define reciprocity as exchanges of roughly equivalent values in which the actions of each party are contingent on the prior actions of the others in such a way that good is returned for good, and bad for bad. Specific reciprocity refers to exchanges of items of equivalent value between specified partners; diffuse reciprocity to situations in which equivalence is less strictly defined and one's actions are directed toward a group in accordance with norms of social obligation. Diffuse reciprocity is regarded by many sociologists and anthropologists as a crucial norm holding societies together. For a fuller account, on which

the above paragraphs draw, see Robert O. Keohane (1986).

8. For a rich early statement of oligopoly theory, on which Waltz relies heavily, see William Fellner (1949).

9. J. David Richardson, January 10-11 (1986), p.13.

10. Avinash K. Dixit and Albert S. Kyle (1985), Richardson (1986). The seminal work cited in both articles is by James A. Brander and Barbara J. Spencer. See Brander and Spencer (1984).

11. Paul Krugman (1986).

12. Jock A. Finlayson and Mark Zacher (1981).

13. Jacob Viner (1951), p.103.

14. Ibid., p.105.

15. William S. Culbertson (1937), p.246.

16. Francis Bowes Sayre (1939), p.109.

17. Sayre (1939), p.109.

18. R.M. Peccioli (1983), p.78.

19. John W. Evans (1971), footnote 36, p.185.

20. Vinod K. Aggarwal (1985), p.191.

21. On the economic effects of voluntary export restraints, see C. Fred Bergsten (1975), pp.239-71. It is worth noting that in 1981, after the United States ceased to press for a VER in footwear, Korea and Taiwan maintained the restraints on their producers.

22. For a fuller discussion, see Keohane (1984), pp.105-6.

23. Comment by Marris on the Oudiz-Sachs (1984), p.68.

24. On market failure, see especially George A. Akerlof, 'The Market for Lemons' (1970). For an extended argument using the analogy of market failure as a way to account for the characteristics of international regimes, see Keohane (1984), pp.82-98.

25. IMF Survey, Supplement on the Group of 10 Deputies Report, July 1985, p.13.

26. Robert Axelrod and Robert O. Keohane (1985), esp. pp.234-8.

27. Charles Lipson (1985), p.220.

28. See a series of papers by Ronald McKinnon recommending coordinated action by Germany, Japan and the United States: McKinnon (1974), (1980), (1982). For similar suggestions, see Richard N. Cooper (1984), especially pp.182-4 and Robert O. Keohane and Joseph S. Nye (1985), pp.157-9.

29. For a shrewd analysis of the summit process, see Robert D. Putnam and Nicholas Bayne (1984).

30. Carlos F. Diaz-Alejandro (1978).

31. For an analysis of influence patterns in the IEA in the 1970s, see Robert O. Keohane (1978). The IEA had weighted voting but since it made all its decisions by consensus, this was not a major factor in determining the distribution of actual influence in the organization.

32. Robert D. Tollison and Thomas D. Willett (1979).

33. Richard N. Cooper (1972).

34. Kenneth A. Oye (1979).

35. Thomas C. Schelling (1960), p.177.

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PERSPECTIVE

Bruno S. Frey

Robert Keohane's paper makes fascinating reading and provides a great number of useful insights into the working of the international political economy. Important issues are treated well and presented clearly.

Keohane starts by identifying the crucial aspect of international economic interaction: the various actors (nations) act independently of each other, and there is no centralized rule enforcement. This starting point is the only useful one because assuming the contrary (that an international super-authority exists which is able to enforce rules) defines the central problem away. Keohane then proceeds by dealing with the major problem areas with which international cooperation is faced: free riding in the form of evasion and cheating; heterogeneous interests, and truncated bargaining sets. Finally, he presents policy proposals.

For an economist, Keohane's paper is of special interest. It skilfully employs many ingredients from economics and thereby shows that economic thinking can be usefully applied to new (unconventional areas). But economists should also take seriously Keohane's critique of the rather naive stance of economists, namely that the 'support of free trade (is considered) a touchstone of being "a good economist".' This criticism is well put, and is generally supported by empirical studies of the views of professional economists which my co-workers and I have recently undertaken. (1) We asked them to respond to the following statement: 'Tariffs and import quotas reduce general economic welfare'. The answers given by economists in several European countries and in the United States are

Table 2.1: Answers of professional economists to the proposition: 'Tariffs and import quotas reduce general economic welfare'

	agree	disagree
Austria	85%	13%
France	70%	27%
Germany	94%	6%
Switzerland	87%	10%
United States	95%	3%
Total (N = 936)	88%	10%

(The complement to 100% consists of 'no answer')

given in Table 2.1.

As can be seen from this table nearly 90% of the economists surveyed are indeed in support of free trade. This holds also for each country, with free trade finding the highest degree of support in the United States and Germany (95% and 94%, respectively). As may be seen, however, professional economists in France support the proposition to a lower degree, namely 70%. An analysis with the help of probit analysis was moreover able to show that full professors of economics (cet. par.) support the proposition to a significantly higher degree than other economists do, which speaks in favour of Keohane's point. It is noteworthy that economists employed in the government sector (cet. par.) are significantly less convinced that tariffs and quotas reduce economic welfare.

Following academic custom, I did not, however, come to Rome to praise Keohane but rather to criticize him. I advance in the following six critical propositions closely based on his paper, discuss them and make suggestions on how to overcome the shortcomings identified.

> **Proposition One:** Keohane's strong reliance on game theory with countries as actors may be inappropriate in the study of international political economy.

Governments, public administrations, interest groups and international organizations are extremely important actors in the international field. Often, the interests of a nation as

a whole may significantly diverge from the interests of government politicians. This may be illustrated by two examples from international economic interaction:

(a) Theoretical and empirical research on the effects of boycotts or embargoes have come to the practically unanimous conclusion that they are not able to induce the boycotted nation to behave as desired. Thus, the boycotts of the League of Nations against fascist Italy strengthened Mussolini's position, because it brought Italians to rally round their government. As boycotts also impose costs on the boycotting nation, it should not be undertaken from the point of view of the nation as a whole. Nevertheless, governments often impose boycotts because it allows them to demonstrate a strong resolution without having to resort to outright war. It is thus an advantageous type of activity from the point of view of government politicians.

(b) The second example relates to the participation in international organizations. Here again there may be considerable differences between the benefit-cost relationships of governments and the nation as a whole, as represented by the voters. For example, with very few exceptions, politicians, public administrators and diplomats argued strongly in favour of Switzerland joining the United Nations. The reason is that these actors benefit privately from Switzerland being a member, by giving them enhanced status and a new field of activity. In the popular referendum taking place on March 9, 1986 the Swiss citizens voted overwhelmingly against membership. This clearly shows that with respect to international interaction and cooperation there can be a marked difference of interest between politicians and the nation as a whole. My suggestion is that it is useful to carefully analyze who the effective actors in the international system are, and that one should not automatically or necessarily follow the game theoretic usage of treating nations as actors. (It should be noted that Keohane essentially does this in later parts of his paper, thus contradicting his own statement at the beginning of the paper.)

Proposition Two: Keohane's study reveals the crucial role of institutions. They should therefore be introduced into the analysis from the very beginning.

Keohane starts from an 'institution-free world', then (correctly) shows how important institutions are in real life and then brings them in at the end without analyzing their behaviour.

Consider as evidence the 'reciprocity anomaly' discussed in the paper:

- according to Axelrod's experiments, the 'tit for tat' strategy is optimal. 'Tit for tat' corresponds to specific reciprocity in international economic relations which should be observed in reality due to its optimality.
- In fact, specific reciprocity does not occur in international trade relations. In GATT, for example, rules such as the 'most favoured nation clause' are followed. We thus observe the exactly opposite type of behaviour from the one expected.

Keohane concludes rightly that the explanation must lie in the institutional conditions of international trade relations.

My suggestion is to start with a theory including institutions determining the existing rules and organizations. This requires a theory of behaviour which leads to the next proposition.

Proposition Three: Keohane's approach lacks a theory of behaviour of actors and therewith of organizations.

Nowhere in the discussion of issues of international political economy does Keohane provide any analytical theory of how actors behave. In particular

(a) it is not shown how governments act, i.e. what their goals (utilities) are and by what their possibility space is restrained. Yet it is obvious, as well as empirically well established, that governments are strongly constrained by the need for re-election, and by various financial and administrative constraints.

(b) Nor is it shown how international organizations behave. Their actions are strongly shaped by the inability and unwillingness of member states to effectively monitor these organizations.

My suggestion is that international political economy should use the models of behaviour developed in modern political economy, or Public Choice. (2)

Proposition Four: The facts brought forward by Keohane can be explained more suitably by differentiating clearly between (a) the level of the current politico-economic process; (b) the level of the social consensus.

Keohane is rather helpless to explain the anomaly referred to above, namely that specific retaliation is optimal but that existing institutions (such as GATT) emphasize, and are based on, trust, fairness, confidence, reliability and stability. At the same time there is hard bilateral bargaining on the negotiations level.

I suggest that one should first consider the level of the social consensus. On this level the basic rules are arrived at which, under the veil of uncertainty, are in the interest of all participants. The basic framework of trust, confidence and reliability is thus arrived at by unanimous consent.

In the current politico-economic process actors behave within the basic rules established. This allows for hard bargaining in specific negotiations without affecting the basic consensus.

The policy task is to bring about ways of forming a consensus, by exploiting the (partial) uncertainty of the actors involved.

Proposition Five: Keohane uses an (implicit) theory of advice which presumes a benevolent dictator acting in the interest of mankind (maximizing a social welfare function).

Keohane speaks of a 'demand for international organizations' with the task of providing standards against cheating and monitoring services, as well as of creating structures to

facilitate retaliation. The essential question - which is barely dealt with by Keohane - is who has got an incentive to fulfil these tasks?

Later in the paper, Keohane explicitly talks of 'optimal international institutional arrangements'. Here the question is: 'Optimal' for whom? 'Optimal' from what point of view? It looks as if Keohane thinks of mankind as a whole. By doing this, reality is left out, because no actor exists having an incentive, and the capability, to pursue the interests of mankind.

My suggestion is to look at the incentives of existing actors which presumes a well worked out theory of behaviour, and to think about the rules which are capable of establishing the necessary incentives.

Proposition Six: Keohane notes that 'the gains from policy coordination may be ... relatively small'. In fact, there exist even substantial benefits from independent, non-coordinated action.

In the paper the study by Oudiz and Sachs is mentioned which claims that the gains from the coordination of business cycle policy is 0.2% of GNP for the US, and 1% for Japan. However, no reasons are spelled out why this should be so.

I suggest that one can go further by considering the 'economic theory of federalism'. This theory shows that there are considerable benefits from independent action. There are three major benefits when nations act independently in the international political economy.

(i) competition may be established showing which type of macro-economic policy (e.g. Keynesian or Monetarist) works best under specific circumstances;
(ii) flexibility and innovation are furthered when actors are not bound to international treaties;
(iii) there is no need to follow ineffective and inefficient policies determined by coordinated action. The common agricultural policy of the European Community is a case in point. A country which is not a member of the EC has at least the chance of being able to undertake a wiser policy.

NOTES

1. Bruno S. Frey, Werner W. Pommerehne, Friedrich Schneider and Guy Gilbert, Consensus and Dissension Among Economists: An Empirical Inquiry. American Economic Review 74 (Dec. 1984), 986-94; Werner W. Pommerehne, Friedrich Schneider, Guy Gilbert and Bruno S. Frey, Concordia Discors, Or: What Do Economists Think? Theory and Decision, 16 (1984), 251-308.

2. An attempt at such an application has been made in Bruno S. Frey, International Political Economics. Blackwell, Oxford 1985. An Italian translation under the title Economia Politica Internazionale will be published by Franco Angeli, Milano in 1986.

Chapter Three

ON MULTILATERAL SURVEILLANCE

Fabrizio Saccomanni*

> There is a tide in the affairs of men,
> Which, taken at the flood, leads on to fortune;
> Omitted, all the voyage of their life
> Is bound in shallows and in miseries.
> On such a full sea are we now afloat;
> And we must take the current when it serves,
> Or lose our ventures
>
> William Shakespeare
> Julius Caesar, Act IV, Scene 3

INTRODUCTION

The demise of the Bretton Woods system marked the end of a monetary system based on rules embodied in an internationally-agreed charter, ratified by national legislatures of the member countries of the International Monetary Fund (IMF) and having force of law in each of them.

The Articles of Agreement of the IMF, as amended in 1976, no longer contain any specific rules of behavior. The failure to agree on a new set of rules led to a charter which

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* This paper reflects the personal opinions of the author who is Head of the Foreign Department of the Banca d'Italia; therefore the views expressed here are not necessarily those of the Banca d'Italia. The final version of this paper benefited from comments by Mauro Michelangeli; however the responsibility for any remaining errors rest with the author.

did not go beyond imposing on members some 'general obligations'. In order to balance the weakening of discipline engendered by the removal of rules, the IMF was given surveillance powers in two crucial areas: exchange rate policies (Art. IV) and the management of international liquidity (Art. VIII).

There is broad consensus that the exercise of surveillance powers by the IMF has been ineffective in preventing the widespread exchange rate volatility and misalignments, as well as the excessive swings in liquidity supply that have characterized the 1973-85 period, and that in those respects the floating rate system has worked no better than that of Bretton Woods. This is the conclusion reached, inter alia, by two independently-produced reports on the functioning of the international monetary system: the Report by the Group of Ten (G-10) and the Report by the Group of Twenty-Four (G-24). (1)

The starting assumption of the present paper is that the state of affairs described above is to a large extent the result of the continuing deterioration in the organization and procedures of international economic cooperation, a trend initiated well before the move to generalized floating of exchange rates in 1973. There is a long-established school of thought which maintains that international economic cooperation is possible only if there is one hegemonic power which acts as a recognized leader in imposing rules and monitoring compliance; in fact, cooperation was at its peak in the 19th century and after World War II when Great Britain and the United States provided the hegemonic leadership that was to be the backbone of the Gold Standard and of the Bretton Woods monetary systems respectively. According to this school, the crisis of economic cooperation of the early 1970s would be the result of the declining weight of the United States in the world economy following the spectacular growth performance recorded by Western Europe and Japan in the 1950s and the 1960s. This writer, on the other hand, regards himself a follower of another school of thought, best represented by the work of Robert O. Keohane (1984), which maintains that non-hegemonic cooperation, although difficult, is not impossible. This is so because countries have complementary interests and because they have inherited from past hegemonic periods 'international regimes and institutions' which make cooperation beneficial even for countries attaching high priority only to the pursuit of their own national self-

interest. Keohane recognizes that 'shared interests and existing institutions make it possible to cooperate, but the erosion of American hegemony makes it necessary to do so in new ways'. This paper is a contribution to the search for such new ways.

In discussing the evolution of international cooperation, reference will be made to the considerable analytical work that has been conducted on this topic in the Banca d'Italia, both in individual contributions and in the team efforts that were eventually transfused in the G-10 Deputies debates. Padoa-Schioppa (1983) noted that the transition from a fixed exchange rate system to a regime of floating reflected the inclination of the international community towards giving greater weight than in the past to the exercise of discretionality in the management of the international economy. Such a move, although economically justified, was however accompanied by a decline in institutional cooperation (as embodied for example in the IMF) in favor of what Padoa-Schioppa defines as 'ad hoc cooperation'. Having examined the reasons why ad hoc cooperation is bound to fail, Padoa-Schioppa concludes that the present state of the international economy requires a strengthening of institutionalized cooperation because it alone can ensure that discretionality is exercised in the interest of the system and not of individual countries. Dini (1984) went a step further suggesting that, in order to compensate for the abandonment of rules of behavior in the international monetary system, the institutional character of international economic cooperation 'must be ensured by the adoption of agreed rules of procedure involving an element of constraint' (emphasis added). It is in this spirit that the Italian Deputies in the G-10 advanced a formal proposal to establish within the IMF and alongside its traditional Art. IV surveillance a new broad concept of multilateral surveillance. Elements of that proposal were retained in the final G-10 Report, but the main innovative aspects of multilateral surveillance found little support among the Deputies, particularly those of the major countries.

The purpose of the present paper is to expand on the original Italian proposal and to suggest concrete - although admittedly rather bold - steps to implement a comprehensive set of procedures within the framework of the IMF to enable it to carry out surveillance activities in the interest of the system and with the objective of bringing about greater stability in exchange rates and in

international liquidity flows.

The paper is organized as follows: Section 2 will be devoted to an examination of the factors - both political and economic - which have undermined institutionalized cooperation in the international monetary field, with particular reference to the progressive watering down of the IMF role as the central monitoring agency of the system. Section 3 will review briefly the outcome of recent attempts to revive international monetary cooperation of an ad hoc character to confront the widespread exchange rate instability and the debt crisis of the 1980s. Section 4 will outline the details of a proposal for the introduction of multilateral surveillance procedures in the IMF.

THE DECLINE OF INSTITUTIONALIZED COOPERATION

The economic causes that led to the collapse of the Bretton Woods system have been examined countless times and they will be considered as known for the purposes of this paper. It is however important to recall here some basic points which are relevant for their implications on the role and functions of the IMF.

The exchange rate system

A main consideration behind the Nixon denouncement of the Bretton Woods Agreement on August 15, 1971 was the conviction that the fixed exchange rate system was 'unfair' to American interests: as the United States spent billions of dollars in the costly defense machinery of Europe and Japan, these same countries were accumulating trade surpluses, thanks to their undervalued exchange rates which they strongly resisted to change. The image - used by President Nixon - of the United States as the good giant tired of competing with one hand tied behind the back (presumably by a gold chain) found widespread support in the public opinion and in the US Congress in a period when - as Henry Kissinger notes in his narration of these events - 'the frustrations of the Vietnam war were encouraging xenophobia'. (2) In the Congress influential politicians strongly supported the action of the US Government and Robert Solomon (1977) recalls that Congressman Reuss 'favored a dollar devaluation ... on the condition, among

others, that at no time in the future will free convertibility between the dollar and gold be re-established. The Treasury's gold window will remain closed'. (3) Under these circumstances it is not surprising that in the negotiations to reform the exchange rate regime held in the Committee of Twenty (C-20) no agreement was reached, since several industrial countries (particularly France) and all the developing countries were strongly supporting a return to some form of par-value system.

The failure of the C-20 negotiations forced the IMF to take a position on floating exchange rates to offer guidance to members. In June 1974 the IMF Executive Directors adopted a decision on 'Guidelines for the management of floating exchange rates'. (4) Again the guidelines reflected the inability of the major countries to agree on substantive principles: the guidelines did not go beyond recognizing that exchange market intervention should be undertaken to prevent day-to-day or week-to-week fluctuations in exchange rates (Guideline 1), but a decision to intervene to counter movements of a longer duration was left to the discretionality of the member (Guideline 2) (in any case with the consent of the country issuing the intervention currency, as requested by Guideline 6). Guideline 3 enabled countries to establish target zones for their exchange rates if they wished to do so, while Guideline 4 instructed the Fund to encourage members with no target zone to take (unspecified) actions to keep the exchange rate close to a 'range of reasonable estimates of the medium term norm for that rate'. Guideline 5 prevents the use of exchange restrictions. It is clear from the foregoing that the only point of agreement among the major countries was on the need to intervene to counter disorderly market conditions; all the rest was in fact quite vague and it is indeed surprising to see that such a technically complex issue as the establishment of target zones for exchange rates was addressed with such levity by the IMF Executive Directors, particularly as the guidelines did not contain specific procedures for the exercise of surveillance.

As the stalemate between the United States and France on the future of exchange rate system went on, no immediate decision was taken to implement the guidelines on floating exchange rates. By mid-1975 however, an agreement appeared possible on a compromise solution for amending the IMF Articles of Agreement that would allow a formal ratification of the 'right to float' (as requested by

the United States) while accepting the presumption of a return to a par-value system as the ultimate objective for each country. The US Congress again took position and the Subcommittee on International Economics of the Joint Economic Committee issued a Report in August entitled 'Exchange Rate Policy and International Monetary Reform' (1975) which contains the following recommendations:

> Recommendation 1: Authorization to float
> Floating should require no IMF authorization. Any amendment of the IMF Articles of Agreement should treat the adoption of a fixed parity or the decision to let the foreign exchange value of a nation's currency be determined by private supply and demand in exchange markets as equally acceptable policy options. Each option should be accompanied by a set of agreed guidelines designed to prevent Fund members from manipulating exchange rates to export domestic economic problems.
>
> Recommendation 2: Intervention
> The United States monetary authorities should intervene in exchange markets only to combat or to prevent the emergence of disorderly conditions. Intervention should not attempt to influence the trend of exchange rate movements. Swap borrowings and loans entered into between the Federal Reserve and foreign monetary authorities should normally be liquidated, i.e., the position fully reversed, within six months of the initial transaction. Only as a result of the most extraordinary circumstances should swaps remain outstanding for more than a year. United States monetary authorities should not accumulate additional reserves in the form of foreign exchange.

The recommendations of the Congress require little comment. Suffice it to note the reference in Recommendation 1 to the concept of exchange rate manipulation, which obviously stems from the conviction that Japan and the European countries were manipulating their exchange rates to obtain an unfair competitive advantage over the United States and 'to export domestic economic problems' (presumably unemployment). Recommendation 2 is also largely inspired by similar concerns: intervention should not stop the dollar from

depreciating and the Federal Reserve should not borrow abroad or accumulate reserves to spend to stabilize the dollar. Aside from these national concerns, the congressional report pays little or no attention to systemic problems.

Following the rapprochement in November 1975 between the position of the United States and France at the Rambouillet Summit of the Heads of State and Government of six major industrial countries (later to become the 'Seven'), an agreement was reached at the Jamaica meeting of the Ministers of the IMF Interim Committee in January 1976 on an amendment to the Articles of Agreement to the Fund. As it is well known, the new Art. IV of the Articles of Agreement gives full satisfaction to the United States concerns about the legality of 'floating' and the illegality of 'manipulating' exchange rates. Countries favoring a stronger commitment to the stability of the exchange rate system obtained, aside from the reference to a future par-value system, the solemn declaration that the IMF would 'exercise firm surveillance over the exchange rate policies of members, and adopt specific principles for the guidance of all members with respect to those policies' (Art. IV, Section 3(b)).

The agreement was recognized at the time as an achievement of Realpolitik: the world was still under the impact of the first oil shock and it seemed reasonable to avoid any commitment that would be difficult to keep in an environment of widespread financial instability. Moreover, everybody agreed that the major drawback of the Bretton Woods system was its rigidity and that any new system was bound to be more flexible to have a chance of being a lasting one. In sum, the new Art. IV was regarded as a victory of pragmatism over the illusion that the evolution of complex international relations could be predetermined in a detailed code of conduct.

A first test of the new pragmatic approach was to be found in the drafting of the 'specific principles' called for in Art. IV. The IMF Executive Board on April 29, 1977 took a decision on 'Surveillance over exchange rate policies' which sets out the 'Principles for the guidance of members' exchange rate policies'. (5) The Principles are only three but not very specific: Principle A enjoins members to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over

other members; Principle B requires that members should intervene in the exchange markets if necessary to counter disorderly conditions, but Principle C specifies that in such interventions members should in any case take into account 'the interest of other members, including those of the countries in whose currencies they intervene'.

Before analysing the other sections of the 1977 Decision a brief comment is in order on the approach underlying the principles. It is obvious that the main concern is again 'exchange rate manipulation' as an instrument of unfair trade practices. Intervention is restricted to cases of market disorders and subject to the approval of the issuer of the intervention currency. This means that a country could not buy dollars in the market to prevent the appreciation of its currency without the consent of the United States.

These impressions are confirmed by the section of the Decision which describes the 'Principles of Fund surveillance over exchange rate policies'. Basically the IMF is required to conduct a strict surveillance on the policies of each member, but the objective is not to ensure that they are compatible with each other and likely to produce a stable set of exchange rate relationships: the objective is to ensure that the member is not tampering with the market forces to keep an unrealistic exchange rate. Thus the Fund is required to look whether the member is (i) intervening too much; (ii) making excessive recourse to official borrowing or lending abroad; (iii) introducing restrictions or incentives to current payments and/or to capital flows. In line with these objectives, the 'procedures for surveillance' place a strong emphasis on the traditional bilateral consultation procedures between the IMF and the authorities of individual member countries which existed already under the Bretton Woods system (Art. VIII and Art. XIV consultations) and which were chiefly designed to assist members in keeping their exchange and trade regimes free from restrictions. A new role in the surveillance procedures is assigned personally to the Managing Director who is empowered to initiate informal consultations with members when he considers that their 'exchange rate policy may not be in accord with the exchange rate principles'.

The broader systemic implications of exchange rate policies however are not subject to specific surveillance procedures, with the understanding that they 'will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within

the framework of the World Economic Outlook'. (6) Artus and Crockett (1978) of the IMF supported such case-by-case approach to surveillance arguing that given 'the many uncertainties inherent in the appraisal of exchange rate policies ... such surveillance cannot be based on a single objective indicator or even on a precise set of rules'.

Systemic considerations received some attention by the Executive Directors only with the 1979 Decision instituting the so-called 'Supplemental surveillance procedure'. According to such procedure the Managing Director was empowered to initiate consultations with a member in connection with exchange rate developments which 'may be important or may have important effects on other members'; (7) such language implies that consultations can be held even if there is no violation of the exchange rate principles of the 1977 Decision. The new procedure however has been virtually unutilized.

From the foregoing it appears clearly that the IMF Articles of Agreement and its surveillance decisions basically reflect the position of the United States Administration and Congress; however this could not have happened, politically and technically, without the consent of the other major industrial countries. In Europe, Germany too shared the belief that fixed exchange rates were not in its interest. The experience of 1969, when massive capital inflows of dollars forced the monetary authorities to suspend temporarily the par-value obligations and let the Deutschemark float, was crucial in determining the German position in international monetary matters. The D-mark was allowed to float because the Bundesbank was losing control over domestic monetary aggregates. It then became clear (and it was confirmed by subsequent events) to the German authorities that a fixed D-mark/dollar rate would quickly turn the D-mark into an international reserve asset, subjecting the conduct of domestic monetary policy to the vagaries of international short-term capital flows. (8) Thus, while Germany has adopted a pragmatic approach as regards exchange market intervention and has joined the exchange rate mechanism of the EMS, it has refused to enter into any exchange rate obligation linking the D-mark with the other main reserve currencies.

The attitude of the Japanese authorities towards floating exchange rates had been initially guarded, but over time they have become strong supporters of the floating system since it allowed Japan sufficient leeway to keep the

yen relatively undervalued and the trade balance in surplus. More recently Japan has openly indicated its reluctance to accept an exchange rate target, even in mild forms. Like Germany, however, Japan has always considered exchange market intervention as a legitimate and effective instrument of economic policy, particularly if undertaken in a coordinated manner among the major countries.

The attitude of the major countries in favor of a more flexible and discretional approach to international monetary relationships implied, per se, a reduced reliance on the IMF and on institutionalized cooperation in general. Such trend was however reinforced by two additional factors. The first factor was of an intellectual nature, namely the strong support with which academic economists - with only a few exceptions - welcomed the transition to a regime of floating exchange rates. Floating rates, they explained, would ensure the equilibrium of the balance of payments and therefore would eliminate the need for official intervention, hence for official reserves and even for central banks. (9) Such monetarist predictions obviously became strong arguments for reconsidering the usefulness of international monetary institutions. Capturing with the usual perceptiveness the Zeitgeist, the 'Economist' asked itself in 1976: 'Do we need an IMF?' (10) suggesting that under the new regime of floating the IMF had nothing to do but to lend money to a few least-developed countries, something the World Bank was better equipped to do.

The second factor contributing to the decline of institutionalized cooperation was of a political nature, namely the climate of confrontation that characterized North-South relationships in the 1970s. The first oil shock gave birth to a new political alliance between oil-producing and less developed countries (LDCs) whose chief objective was to increase the weight of the South in international monetary matters. The strategy of the OPEC-LDC alliance took two forms: the first one was to make sure that the IMF would not use its surveillance powers only with respect to the LDC. One accomplishment of such strategy was to include in the IMF Articles of Agreement the qualification that the exchange rate principles to be (later) adopted by the Fund 'shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members' (Art. IV. Section 3(b)). The second strategic initiative of the OPEC-LDC alliance was to take out of the Bretton Woods

institutions the debate on international economic reforms. This move, supported also by the ambiguous attitude taken by some European countries, led to various initiatives such as the Global Negotiations in the context of the United Nations, the North-South Conference, the Euro-Arab Dialogue. A common theme of these negotiations was the proposition that the central problem of the post oil-shock era was the 'money versus energy' trade-off. Such question could not be discussed within the IMF-World Bank context, because the voting power in those institutions was weighted too much in favor of the industrial countries, but also because energy was outside their sphere of competence. The 'new international economic order' could only be negotiated in a political forum such as the United Nations. Although some of the moderate oil-producing countries continued to support, also financially, the IMF and the World Bank, they were politically committed to the new course of the LDC monetary diplomacy.

Such state of affairs in turn fuelled the suspicion in the major industrial countries that the IMF would eventually become a UN-type institution where economic problems would be treated exclusively as political issues. A major consequence of this suspicious mood was the decision of the main industrial countries to hold periodically restricted 'summit' meetings among themselves.

All the developments described so far took place in less than ten years. By the end of the 1970s the international community had replaced clear and binding commitments with vague and non-binding understandings, while the traditional institutional fora for monitoring the operation of the world monetary and financial system had been replaced by a multitude of non-institutional meetings where the only procedural constraint was the adoption of a final press communiqué.

Kenneth W. Dam (1982) recalls that in defending the Jamaica Agreement before the IMF Annual Meeting in September 1976, US Treasury Secretary William Simon had said: 'The Fund should, in its surveillance of members' exchange rate policies, proceed by a careful and evolutionary approach ... We need to construct, through a case-by-case approach, a common law based on case history'. Dam, a lawyer and a US Deputy Secretary of State, expresses doubts as to whether a 'common law' approach had indeed been followed in adapting the surveillance procedures: 'The specific principles in the surveillance

decision were not much more specific than those in the Articles of Agreement themselves, and yet, since the results of consultations are not made public, it is impossible to know whether those principles have been given any more definite content. Certainly unless consultations have produced new principles that then bind members in later consultations, nothing that a lawyer would recognize as "a common law" approach can be identified. The lack of illuminating comment by Fund officials and Governments, however, suggests that little or nothing of the "common law" approach is to be found in the consultation process and that the consultations do not represent, from a legal point of view, any substantial development from those already held by the Fund with members under Articles VIII and XIV.' (11)

In other words, under the new Articles of Agreement the IMF was left with just one instrument (bilateral surveillance) to pursue the twin objectives on ensuring stability of the exchange rate of individual countries and stability of the exchange rate system as a whole. This has meant in practice that the IMF has exercised its surveillance only on countries experiencing recurrent balance of payments problems (mainly LDCs in need of financial assistance) rather than on countries whose policies have a systemic impact.

The management of international liquidity

In the Bretton Woods system, the management of international liquidity had to rely on the quota-drawings mechanism and, after the 1969 amendment, also on the Special Drawing Rights (SDR) scheme. Implicit in this structure was the belief that liquidity could be scarce, but never excessive. Thus the system was endowed with mechanisms to supplement liquidity rather than to control its creation and distribution. Such mechanisms could at best reabsorb the liquidity they had created (through a repurchase of earlier drawings or through SDR cancellation). There was no provision for checking the growth of liquidity created through other channels.

The Bretton Woods system collapsed inter alia because of the tensions generated by an excessive creation of liquidity denominated in dollars; and in the reform negotiations of the C-20 much time and effort was spent to

devise new rules for containing the growth of liquidity created by the US balance of payments deficits: the focus of those debates was on convertibility of the dollar into other assets and on 'asset settlement' of the US payments deficits. By a strange coincidence of history, however, when the reform discussions were nearing their unhappy completion, the world found itself in a situation of dollar shortage, as a result of the quadrupling of oil prices in 1974 and the need to finance huge oil-deficits. In the end the collective wisdom of the reformers decided to leave the provisions of the Articles on international liquidity largely unchanged. The resulting feeling of uneasiness with this conclusion was quenched by the introduction of a new section in Art. VIII which contains the following masterpiece of linguistic intricacy: 'Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve assets in the international monetary system.'

Unlike Art. IV, the provisions of the Art. VIII have not been the subject of further elaboration by the Fund and there are therefore no principles of guidelines for members to follow in the field of international liquidity management. A de facto guideline transpired nevertheless from the debates that followed the oil shock. The recycling of the oil-related surpluses would be conducted largely by financial markets, with official recycling mechanism playing a relatively minor role; oil-importing countries would therefore seek to obtain from the market the funds needed to finance their payments deficits, it being understood that the IMF in the last resort would be the lender for countries with little or no access to financial markets. Within this limitation, the IMF continued to play an active role in the management of official international liquidity. In the brief span of just six years (1974-9) the IMF increased its quotas twice, established a number of new facilities, disposed of one-third of its gold holdings and resumed allocations of SDRs. (12)

Despite the IMF activism, the share of Fund-related reserve assets in the total of the world's non-gold reserves declined from 12.9 per cent at the end of 1973 to 8.8 per cent at the end of 1980. However, throughout the decade the IMF retained a crucial role as a forum for debating

problems of international liquidity management. It also acted as a catalyst for private financial flows, by contributing to the implementation of balance of payments adjustment programs.

THE SPREADING OF AD HOC COOPERATION

While the 1970s were characterized by the decline of institutionalized cooperation, the first half of the 1980s seems to have marked the beginning of an area of ad hoc cooperation. This is an important phenomenon which requires more analysis than can be provided in this paper. A few main aspects are however immediately discernible.

A first point is that the spreading of ad hoc cooperation has been the result of an increase in the demand for international consultation and policy coordination which was met by an expansion of the role and functions of the fora for non-institutional cooperation. The increase in demand came from events like the debt crisis and the dollar overshooting, the management of which was outside the capability of individual countries. A second point is that ad hoc cooperation, although still conducted outside institutions, has acquired over time an operational character which it did not have in the 1970s, particularly in the field of exchange rates matters. A third point is that in the 1980s the desire to avoid - for political reasons - 'global solutions' to global financial problems - such as the management of the debt crisis - has led the international community to resort also in this area to devices of ad hoc cooperation, mainly at the expense of the Bretton Woods institutions.

The turning point in the evolution of institutional cooperation in exchange rate matters can be located between 1979 and 1980 in connection with the negotiations on the establishment of a Substitution Account (SA) in the IMF. The SA proposal grew out of the debates that surrounded the long slide of the dollar in 1977-78. The Carter Administration had strongly intervened in November 1978 to stabilize the dollar by mobilizing the equivalent of $30 billion in various forms (swap lines with other central banks, sales of foreign currency denominated bonds) including a drawing on IMF credit lines and the sale of SDRs against D-mark and yen. This was the first instance in which the United States signalled its willingness to finance its payments deficit without increasing its dollar liabilities,

selling instead non-dollar assets (thus reviving the hopes that the 'asset settlement' principle would be generally applied). At the same time key officials of the US Administration encouraged the IMF to study the possibility of setting up a scheme whereby the 'dollar overhang' could be converted into SDRs. The SA was expected to stabilize the dollar exchange rate and to shield the other major industrial countries from the inflow of dollar funds. The IMF Interim Committee failed to agree on the SA scheme for a variety of reasons, (13) but it is worth recalling the attempt in this context because the establishment of the SA would have had major institutional repercussions on the structure of the IMF, the fact of introducing into its legal framework an internationally-managed 'exchange stabilization fund'. Moreover the SA proposal was an implicit recognition that the existing IMF machinery was inadequate to cope with the impact that a massive flight from the dollar was likely to have on both the exchange rate system and the pattern of world financial flows. In the event, the change in the stance of monetary policy in the United States in October 1979 and the return of confidence in the economy that accompanied the election of President Reagan took care of the falling-dollar problem and contributed to the shelving of reform proposals.

The issue of exchange rate stabilization became relevant again as the dollar began its irresistible rise in 1981. The IMF's passive attitude in the connection is a significant indication of the precarious state of institutional cooperation. This is a further evidence of the inadequacy of bilateral surveillance which becomes de facto inapplicable in situations involving the major industrial countries, despite its elaborate procedural arrangements. (14) This is so because bilateral surveillance forces the IMF to single out individual countries as responsible for problems having multilateral connotations and systemic implications.

The dollar problem was raised and discussed in the context of the Summit meetings of the Seven (G-7), which thus began to acquire a more concrete and operational character, while remaining basically a 'debating society'. At the Versailles Summit in 1982 the Seven approved a 'Statement of international monetary undertakings' which contains, inter alia, the following point: 'We are ready to strengthen our cooperation with the IMF in its work of surveillance; and to develop this on a multilateral basis taking into account particularly the currencies constituting

the SDR'. Since only the currencies of the major five member countries of the IMF are included in the SDR basket, this text is considered as the birth certificate of the Group of Five (G-5), although it more appropriately marks the debut of a nine-year-old group until then kept informal and low key. But aside from that, the Statement is important because it represents what may be regarded as a turning point in the evolution of surveillance. In fact what the Statement says is that the G-5 countries will no longer regard themselves as subject to the IMF surveillance: they will cooperate with the IMF 'on a multilateral basis'. In other words the G-5 countries will be henceforth subject to their own surveillance. This 'new deal' in surveillance will reach full maturity only gradually and was openly spelt out on the occasion of the so-called Plaza Hotel Agreement of September 22, 1985. The G-5 met - the Plaza Announcement reads - 'in the context of their agreement to conduct mutual surveillance'. Thus G-5 surveillance, mistakenly believed to be 'multilateral', is more accurately redefined as 'mutual'. The significance of this point is underlined by the fact that the IMF Managing Director, who had attended certain sessions of the G-5 in a personal capacity, was not invited to the Plaza Meeting.

A second important consequence of the Versailles Statement is that it marks the beginning of a long process of rehabilitation of exchange market intervention as an instrument of economic policy. Although the Statement itself reiterated the Art. IV prescription (interventions only to counter disorderly market conditions), the G-7 agreed to conduct a study of the impact of exchange market intervention. The study prepared by experts of the G-7 countries (Working Group of Exchange Market Intervention (1983)) did not reach unanimous conclusions. However, it conducted an impressive number of econometric tests which failed to confirm the extreme position whereby interventions would in any case be (i) ineffective and (ii) counter-productive, as frequently and publicly maintained by influential US policymakers. This enabled the Ministers of Finance and Central Bank Governors of the G-7 to review the study and to reach significant conclusions. They recognized that 'exchange rate stability must lie in the direction of compatible mixes of policies'; that the behavior of exchange rates should be regarded 'as one possible indication of need for policy adjustment'; that 'intervention can be useful to counter disorderly market conditions and to

reduce short-term volatility' and 'may also on occasion express an attitude toward exchange markets'. And finally they concluded that they would be 'willing to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful'. (15) It would take two more years for these vaguely-worded principles to be translated into action, first by the European Central Banks in February 1985 and, following the Plaza Agreement, also by all the G-5 countries.

Although the US change of attitude with regard to exchange market intervention was an important development in international cooperation, considerations of systemic stability played a limited role in the decision. Like in 1971, it was the pressure mounting from Congress in the form of an avalanche of protectionist bills that convinced the Administration to act to correct the large overvaluation of the dollar and to redress the US competitive position in world markets. It is worth noting, however, that while in 1971 Congress had acted to free the United States from institutional constraints, the draft bills recently submitted to Congress place the problem of the US trade deficit in a systemic context and call for 'rules of behavior' that would force the US Government to adjust the imbalance. Among these, aside from the suggestion to return to the gold standard (at an appropriately devalued parity), it is worth mentioning the proposals whereby the Federal Reserve would be obliged to build up a strategic foreign exchange reserve, selling dollars against foreign currencies, or to carry out foreign exchange market interventions in relation to the outcome of the trade balance in the preceding quarter. Congressional interest in the monetary reform issue has been further highlighted in the much-publicized 'Congressional summit on exchange rates and the dollar', a bi-partisan initiative sponsored by Senator Bradley and Congressman Kemp.

Against this background, the US Administration has been obliged to show greater disposition than in the past for a re-examination of the merits and demerits of the floating rate system. At the same time, great care has been used in avoiding any commitment to new monetary arrangements that would imply a greater degree of official management of the system, such as a target zone approach.

On the basis of these considerations, it seems premature to regard the G-5 initiative as setting the world monetary system de facto on a target zone regime, as

indicated in some press reports, because the machinery for policy coordination and monitoring that would require it is simply not there. Thus, while the Plaza Agreement achieved the result of accelerating the dollar's decline, it has not created the conditions for restoring the stability of the exchange rate system.

TOWARD EFFECTIVE MULTILATERAL SURVEILLANCE

The events described in preceding sections have been the background of the review of the functioning of the international monetary system conducted by the Deputies of the Group of Ten in 1984-5. Although the G-10 Report has not led to any major reform proposal, it contains important elements of analysis which are worth recalling in the context of this paper.

Surveillance proposals in the G-10 Report

A first major conclusion of the G-10 Report is that the system of floating exchange rates does not manage itself, to paraphrase Bagehot, and that some degree of official management is required to avoid excessive short-term volatility or medium-term misalignments. Official management should make sure that countries adopt policy mixes that are internationally-compatible and likely to produce stability in exchange markets.

A second major conclusion is that the concept of international liquidity, as traditionally defined, no longer applies in a world in which the bulk of reserves is originated by the intermediation of international financial markets. This conclusion has far-reaching implications for the control on international liquidity: it means that liquidity creation can be influenced only by controlling the conditions which affect the lending policies of international commercial banks, namely credit and interest policies in the major countries. This means, inter alia, that international liquidity control is a function which impinges on the activity of both Central Banks and Agencies of prudential banking supervision, which could therefore be performed only in a context where both instances are appropriately represented.

The third major conclusion is that a stable monetary system requires a strengthening of the surveillance of the

IMF on both the exchange rate system and the process of international liquidity creation. And there is the important recognition that, in the circumstances of the system described above, 'surveillance of exchange rate policies and surveillance of international liquidity cover a great deal of common ground' and that there is a 'need for their implementation to be closely integrated' (G-10 Report, para. 67).

As regards the strengthening of surveillance two schools of thought have emerged in the G-10. One school, representing the majority of the G-10 countries, saw no need for new surveillance arrangements having an institutional character: it was felt that the Articles of Agreement and the relevant decisions of the Executive Directors gave the IMF sufficient scope to conduct an effective surveillance activity, if only all countries were willing to cooperate in the endeavor. The strengthening would basically result from the fact that the IMF would pay greater attention in its bilateral consultations to a large number of policies and factors affecting directly or indirectly the behaviour of exchange rates. In addition a form of 'enhanced surveillance' would be conducted with respect to highly indebted countries 'with the aim of facilitating non-IMF financing in connection with multiyear debt reschedulings' (G-10 Report, para. 47).

The second school, representing a minority view, advocated new arrangements for the conduct of Multilateral Surveillance (MS). (16) The novelty of the arrangements, compared with existing procedures, was that MS 'should concentrate on countries which have a large impact on the world economy' (G-10 Report, para. 49). Moreover, the Report states that 'the specific context of multilateral surveillance should be the examination of the external repercussions of national policies and their interaction in the determination of the global environment' (para. 50).

Despite these clear indications, the G-10 Report did not elaborate further on the actual implementation of MS, particularly its integration in the traditional IMF surveillance procedures and techniques. Indeed the Report is not even entirely clear as to which institution should perform MS: para. 51 and para. 52 of the Report mention a role for the IMF and for the G-10 itself; para. 53 recalls the role played by the Working Party No. 3 of the OECD in reviewing 'major countries' fiscal and monetary policies and the way these interact internationally, with particular

reference to the evolution of external positions and exchange rates'; para. 54 finally expresses the belief that 'the GATT should have broad powers to exercise surveillance over all forms of trade restriction' and that 'close cooperation between the IMF and the GATT should be maintained'. There is no detailed indication for the implementation of surveillance over international liquidity.

The Report is also vague as regards the instruments of MS: the only specific suggestion is the request that a separate chapter of the IMF World Economic Outlook paper be drafted to analyse the policies of the major countries, their interaction and international repercussions. It is suggested that the special chapter be discussed by the G-10 Ministers and Governors. In the paragraph of the Report devoted to exchange rate target zones (para. 31) is also expressed the view that target zones 'would promote greater international policy consistency by reinforcing multilateral surveillance'.

A new proposal for multilateral surveillance

The critical examination of the evolution of international economic cooperation conducted in the preceding paragraphs provides important indications that should form the basis of any further attempt to strengthen multilateral surveillance.

The main lesson drawn from the experience of the post-Bretton Woods era is that ad hoc cooperation, although it may have allowed the discretionality needed to overcome specific crisis situations, it has not restored stability in the international monetary system. Ad hoc cooperation - almost by definition - attacks the symptoms of the disequilibria rather than their deep-rooted causes. There is a growing consensus among Government officials and academic economists that international monetary instability is the result of uncoordinated economic policies by the major countries. Effective policy coordination cannot be achieved in a non-institutional context, since countries are not willing to relinquish, even in part, their economic sovereignty unless they know exactly which are the commitments undertaken by the other countries participating in the coordination exercise. Moreover, experience has shown that non-institutional cooperation provides for an effective decision-making process only when there is unanimity among

the participating countries. Any MS approach should therefore entail a mechanism for policy coordination placed in an institutional context.

The institution that is best equipped to carry out MS remains the IMF. The IMF has a universal character and has traditionally been identified with the international monetary system itself. The IMF charter is an international treaty ratified by the Parliaments of member countries. And, most importantly, the IMF already possesses the legal and procedural instruments to carry out MS, a point which will be examined in detail below. The introduction of MS procedures would endow the IMF with the instrument it has lacked until now to pursue the objective of systemic stability envisaged by the Articles of Agreement.

Any new MS procedure must take into account the revealed preferences of the major industrial countries as regards exchange rate matters. The IMF has already recognized that the major countries do not like binding exchange rate commitments. It should also recognize that these countries have established a practice of discussing their respective exchange rate policies among themselves, in restricted fora where it is possible to analyse the systemic implications of those policies and where 'peers' pressure' can be exercised. These features can and should be reproduced in the IMF context, taking into account the fact that the behavior of the exchange rate system is indeed determined by the policies of a few major countries.

A final point concerns the outcome of MS. As a mechanism of policy coordination, MS should ideally result in an agreement on a set of policy commitments recorded in an official document which will form the basis for subsequent monitoring and policy adjustment.

The introduction of the principles outlined above into the IMF legal framework will probably require an amendment of the Articles of Agreement, although it is not to be excluded that alternative solutions might be found. This question is however not particularly relevant in the context of the present paper and its treatment would require a legal expertise that this writer does not command. In what follows it will be assumed that the innovations suggested below, in as much as they are consistent with the main principles of the IMF, could be accommodated within the legal framework of the Fund in some technical form.

Main features of a new multilateral surveillance procedure

Multilateral surveillance obligations

The IMF would introduce a new category of obligations for its members alongside those already set forth in the Articles of Agreement. The obligation would be to cooperate with the Fund in the framework of MS with the objective of attaining stability in exchange rates and in international liquidity flows. Such obligation would apply only with regard to countries whose policies have a direct impact on the behaviour of the exchange rate system and the process of liquidity creation: basically the United States, Japan and the countries participating in the European Monetary System (EMS). In practice, it may be useful to extend the obligation to all the countries of the G-10, having in mind the fact that the G-10 has established effective relationships with a non-IMF member like Switzerland and with a non-industrial country like Saudi Arabia.

The suggested innovation could appear as violating the long-standing IMF principle of the 'uniform treatment of members'. Aside from the leeway offered by the concept of 'uniform treatment' itself (which could not be interpreted to mean 'equal treatment'), it is worth noting that the Articles of Agreement already envisage different obligations for members who are in difficult situations. Typical is the case of the special obligations imposed by Art. XIV on members who maintain exchange restrictions, which differ from the general obligations of Art. VIII that apply to countries having no exchange restrictions. Similarly, Art. XXII specifies the obligations for countries participating in the SDR Department, which are not applicable to non-participant members. Moreover, from a political point of view an obligation for the major countries to accept MS could be seen as a way of correcting a much-lamented asymmetry in IMF practices, according to which surveillance would be de facto exercised only on small countries, particularly those using the Fund's resources.

Multilateral Surveillance Council

MS would be carried out in the form of joint deliberations of a new body, the Multilateral Surveillance Council, whose members would be the countries subject to MS obligations. The Council will be chaired by the Managing Director of the IMF and will meet at least twice a year to review the

policies of the members. The review will be conducted on the basis of a paper prepared by the staff of the IMF setting out the main quantitative aspects and providing an analytical framework for the policy discussions. The Council would meet before major countries formulate their domestic policy programs (in particular the budget and monetary targets) and should review the main reasons behind the policy stance of each country. The Council would also review the actual outcome of past policy implementation in relation to targets and to the subsequent economic performance. The Council could be convened at any other time as deemed necessary by the Managing Director (who could be given powers to initiate consultations in the Council, along the lines envisaged by the 'Supplemental surveillance procedure' of 1979), or by an appropriate number of members of the Council. The Council would of course be free to develop, with the help of the IMF Staff, its own procedural arrangements and analytical tools, particularly in the field of indicators of the need for policy changes. In this context a role could be envisaged for exchange rate indicators, such as target zones or similar norms.

Members will be represented in the Council by two high-level officials, having policy-making responsibilities in the Finance Ministry and the Central Bank, a practice already established for the meetings of the G-10 Deputies or for the Working Party No. 3. The Council could also meet at a higher level (Finance Ministers and Central Bank Governors) as deemed necessary. Occasionally the Council could hold enlarged sessions involving other members of the IMF, representatives of other official institutions and groups (17) and representatives of the banking community. Typically such enlarged sessions should be devoted to a review of the international liquidity or the external debt situation.

The Council would not supplant the role of the IMF Executive Directors who will retain responsibility for the administration of the Fund, the execution of its policies, in particular those on the use of financial resources and on the conduct of the traditional Art. IV surveillance.

The introduction of the Council could be seen as a continuation of the decision to establish the Interim Committee as a ministerial advisory body, having de facto policy-making functions; it could be seen as a move in the direction originally advocated at Bretton Woods by J.M.

Keynes himself, who saw the need for a high-ranking Executive Board meeting periodically to discuss policy issues, rather than a body of permanent representatives.

The idea that the major countries should get together to formulate jointly their policy decisions is not a new one. Charles Kindleberger (1967) believed that under a regime of fixed exchange rates 'the monetary policy of the major countries, say, the Group of Ten, should be determined internationally ... Instead of the Federal Open Market Committee, which makes monetary policy for the USA, we need an Atlantic Open Market Committee'. The argument applies a fortiori under a managed floating system.

Multilateral Letter of Intent

The main outcome of MS would be the drafting of an official document which would be called the Multilateral Letter of Intent (MLI). The document would be in all respects similar to the letter of intent which members have to submit to the IMF to obtain financial assistance involving use of the so-called credit tranches. Similarly, a MLI would set forth the objectives of the members as regards the variables of international relevance such as trade and capital flows, interest and exchange rates. The letter would also contain a review of the policies adopted by members and of their interaction and international repercussions; the letter would then express a judgement on the adequacy of the policies with respect to the objectives. Although the MLI should be signed by all the members of the Council, it is not necessary that there be unanimity on all points; minority views could be recorded in the letter, including the motivations for the dissenting opinions.

The MLI, like the traditional letter of intent, should be a formal document involving a political commitment rather than a contractual obligation. The commitments and the targets of the MLI could be reviewed and changed in light of developments, but always in the context of the procedures established by the Council. Non-compliance with the performance criteria will not involve specific sanctions other than the procedural burden of having to justify before the Council the reason for the non-compliance and to specify new targets and new policy commitments.

The Council might decide whether or not the MLI should be published. If not, it would be treated as a confidential document of the IMF. In any case the Managing

Director will illustrate the content of the MLI to the Executive Directors in a restricted session where he would obtain the views of the members of the IMF not represented in the Council.

CAN IT WORK?

The writer is aware that the implementation of the MS scheme outlined above might face insurmountable political obstacles. However, the scheme does not impose any particular policy constraint on any country; it just imposes the procedural constraints of explaining the rationale of one's own policies, of listening to the explanations of other countries, of evaluating jointly the interactions and the repercussions. Obviously the process may result in a political embarrassment if a country's policies are found inadequate by the Council, or if a country is seen as non-complying with international commitments. Here two considerations may be made. A first one is that many member countries of the IMF have been subject in the past to such political pressures in connection with requests for IMF assistance; many LDCs and several industrial countries (United Kingdom, France, Italy) have signed letters of intent to the IMF. They might have preferred not being obliged to do so, but they have survived the experience and gained from it. A second consideration is that political pressure in the form of criticism will be brought to bear in any case, sometimes publicly and in unpleasant terms: it would then trigger stiff reactions that would not facilitate international understanding. The MS procedures aim at channelling criticism into an appropriate context, where it can be allowed to play a constructive role.

More importantly, this writer is convinced that the management of interdependence is an historic inevitability. And to manage interdependence is a full-time job, that cannot be replaced by automatic devices (gold standard, target zones) or by occasional raids in the market (à la Plaza Hotel). Policy coordination is in many ways still an uncharted sea, although the topic is now receiving increasing attention by professional economists. (18) There is a need to develop a new analytical framework and to test the performance of traditional instruments in the context of policy coordination. This is a process that can only be completed gradually and pragmatically: MS aims only at

ensuring that the process does not lose momentum and sense of direction.

NOTES

1. See Deputies of the Group of Ten (1985) and Deputies of the Group of Twenty-Four (1985).
2. See Henry Kissinger (1979), p.950.
3. Indeed Capitol Hill normally plays a major role in shaping the position of the US Treasury in negotiations on international monetary issues. The power of the US Congress on such matters stems from the fact that the IMF Articles of Agreement are an international treaty that can be amended only if ratified by the legislative powers of the signatory countries. In addition, IMF quota subscriptions, although technically an exchange of assets (dollars against a reserve position on the IMF) rather than government expenditure, are treated in the US Congress as budgetary appropriations and are therefore subject to the much more complicated congressional procedures reserved for the approval of expenditures.
4. The text of the Guidelines is reproduced in the 1974 Annual Report of the IMF, pp.112-16.
5. The text of the 1977 Decision is published in the 1977 Annual Report of the IMF, pp.107-110.
6. The 'World Economic Outlook' is a forecasting exercise conducted twice a year by the IMF on the basis of a paper prepared by the IMF Staff and discussed by the Executive Directors. The WEO papers have been made public by the IMF since 1980 in its 'Occasional Papers' series.
7. The text of the 1979 Decision is published in the 1979 Annual Report of the IMF, p.136.
8. See Otmar Emminger (1977), p. 42. He believes that floating rates have provided Germany with an effective protection from imported inflation, which he regards as 'a permanent task'.
9. Such extreme position was, only half-jokingly, taken by Prof. Fritz Machlup in 1969 when he told me, at that time a student of his at Princeton University on secondment from the Banca d'Italia, that he was not surprised of my bias in favor of fixed exchange rates. 'You central bankers' - he said - 'would be all unemployed under a regime of floating rates'. Similar views, in various forms,

were expressed by most followers of the monetarist school.

10. See 'The Economist', January 17, 1976.

11. See Kenneth W. Dam (1982), pp.260-1.

12. For details, see IMF Annual Reports.

13. See Stefano Micossi and Fabrizio Saccomanni (1981), pp.183-4.

14. The IMF has made rare recourse to the 'Supplemental surveillance procedure' of 1979, the last occasion being a devaluation of the Swedish krona in 1982. The 'Information notice system', a procedure designed to bring to the attention of the IMF Executive Directors large changes in real exchange rates, has been activated only three times in the case of major currencies, twice for sterling and once for the US dollar. It is the irony of history that the notice regarding the dollar was not issued during the long period when the dollar was rising, but on March 1985, soon after it began to decline as a result of the coordinated interventions of European Central Banks.

15. The quotations are from the Communiqu* issued by the Ministers and Governors of the G-7 in Washington on April 29, 1983.

16. The entire section of the G-10 Report devoted to MS stems from the Deputies discussion of a 'policy paper' prepared by the Italian delegation; the Italian paper was the only contribution on the subject submitted to the Deputies. See Rainer S. Masera and Mario Sarcinelli (1984).

17. Attendance should be limited to institutions who can give an effective contribution to the performance of MS: the World Bank, the BIS, the OECD and the Committee on Banking Regulations and Supervisory Practices (the so-called 'Cooke Committee').

18. See Stephen Marris (1984) and the literature surveyed in his paper.

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PERSPECTIVE

Loukas Tsoukalis

In this paper, Saccomanni examines the role and nature of international cooperation in the post-1971 monetary system. He observes the decline in institutionalised cooperation during the 1970s, analyses the factors which led to this decline and also the effects on exchange rates and international liquidity. He notices in more recent years a renewed interest in cooperation which remains, however, ad hoc, and hence inadequate as a means of restoring stability in the international monetary system. The paper ends with a concrete proposal for the establishment of an effective system of multilateral surveillance in the context of the IMF, which is based on a policy paper submitted by the Italian delegation to the G-10.

There is little I can find to disagree with the diagnosis of the problem in Saccomanni's paper. I do, however, have serious reservations as to the feasibility and effectiveness of the course of therapy offered.

The radical transformation of the Bretton-Woods system, with the de jure end of the dollar-gold convertibility in 1971, the advent of generalised floating in 1973 and the partial privatization of the creation of international liquidity following the first oil shock, marked a clear shift to the market. This in turn represented a major departure from the underlying principle of the post-war international economic order, namely that trade liberalization would be supported in a collective management of international money.

In the new 'system', multilateral surveillance of exchange rates proved to be a tabula rasa. As for international liquidity, it became increasingly an endogenous

factor, with private banks riding on the crest of newly-found enthusiasm about the efficiency of the market.

I agree with Saccomanni about the leading role of the United States in shaping the new 'system', although he is also careful in reminding us of the presence of members of the supporting cast such as the Federal Republic of Germany and Japan. To the various factors he identifies behind the decline of institutionalised cooperation, I would add another one, namely the divergence of economic policies among the major Western industrialised countries and the growth of economic nationalism which characterised the period after the first oil shock.

The recent rediscovery of the virtues of international cooperation can be explained mainly in terms of the growing concern about the effects of the long-term misalignment of exchange rates and the implications of the debt crisis. Saccomanni finds the kind of ad hoc cooperation which has developed in recent years, and exemplified by the Plaza Hotel agreement of the G-5 in September 1985, as patently inadequate. He argues that 'ad hoc cooperation - almost by definition - attacks the symptoms of the disequilibria rather than their deep-rooted causes'. So far so good. He then goes on to propose the institutionalization of cooperation through the creation of a Multilateral Surveillance Council and the issuing of regular Multilateral Letters of Intent as a means of tackling those 'deep-rooted causes'.

Does the main problem as regards the management of the international monetary system stem from the lack of appropriate institutions? Is there strong reason to believe that the holding of regular meetings among high level policy-makers from different countries, or even the publication of Multilateral Letters of Intent would have an appreciable effect on national policies? This would assume that certain essential pre-conditions are fulfilled, such as the perception of the existence of compatible interests among the major actors, a generally accepted paradigm explaining the nature and direction of the main macroeconomic relations and, last but not least, the ability of political leaders to deliver the goods promised by them in international fora. The latter implies the lack of serious restraints imposed by domestic political structures. Otherwise, there would be a serious risk of ending up with a procedure arising from the creation of new international institutions as a substitute for effective policy.

I shall try to illustrate my well-intended skepticism

with two examples. The significant realignment of the exchange rates of the major currencies, which brought about a large depreciation of the US dollar and a corresponding appreciation of the yen and most Western European currencies, between September 1985 and the early months of 1986 was the result of a concerted effort based on exchange market intervention and official statements aimed at influencing market opinion. This meant the abandonment of previous policies of benign neglect on behalf of the United States and also the rejection of mercantilist pressures on both Europe and Japan. Behind this remarkable example of international economic cooperation, we can find an almost unique combination of events and interests. Fears about growing protectionism in the United States were combined with the anti-inflation priority of most Western European governments and the deep concern among central bankers about an eventual crash-landing of the dollar. But yet, even in this particular situation, Western governments do not appear ready to tackle some of the underlying causes of the large financial disequilibria in the world economy. Is the US political system capable of dealing swiftly with the large fiscal deficit and are the Germans and the Japanese ready to adopt more expansionary policies in order to sustain world growth rates and also in order to take some of the pressure off the exchange rates? I honestly doubt as to whether the holding of more international meetings under the auspices of the IMF or any other organization would make a considerable difference.

The other example comes from the EC experience. The European Monetary System has often been presented as a model of successful cooperation among sovereign countries intended to ensure a certain degree of exchange rate stability. Its success in this respect is undeniable. Moreover, exchange rate changes have become a matter of collective decision which is in itself a revolutionary development in international cooperation. However, in terms of convergence of inflation rates the progress has been rather slow. Interest rates have been used as the main instrument to keep currencies within the permitted margins.

Certainly, the EC countries have travelled by international standards a long way in the field of monetary cooperation. But we should after all remember that the countries of the Community share a high degree of economic interdependence and common institutions. They also have similar political and economic structures. For

example, no EC country has an internal division of powers similar to that of the United States, which in itself constitutes a major obstacle in the ability of the world's dominant and still relatively insular economy to accept any external constraints on the conduct of its economic policies. On the other hand, EC monetary cooperation has operated under the leadership of the Federal Republic of Germany which has combined economic strength with stable financial policies. This is clearly not true of the leading power in the international system during the last twenty years. All the above factors make me extremely skeptical about the possibility of reproducing some aspects of the EC experience in the monetary field on the international level.

Saccomanni believes that the management of interdependence is an historic inevitability. I certainly have no reason to disagree as regards the desirability of such a development. I do, however, fear that the contradiction between the internationalization of economic forces on the one hand and the political reality of nation-states on the other will persist for long, thus continuing to cause serious strains in the system. If the effective management of interdependence proves to be a painfully slow process, we might not want to reject outright the idea of throwing some measure of sand on the wheels of international finance. This could help to avert an eventual backlash of economic nationalism. In the meantime we should try to improve gradually the mechanisms of international cooperation. But without building up great expectations.

Chapter Four

GLOBAL DEBT: WHY IS COOPERATION SO DIFFICULT?

Benjamin J. Cohen

Of the many issues affecting international economic relations over the past few years, few have seemed more urgent than the problem of global debt. When Mexico's Finance Minister, Jesus Silva Herzog, made his celebrated phone calls to Washington on August 12, 1982, informing US and IMF officials that his country could no longer meet its debt-service obligations, the entire financial system - indeed, the whole world economy - suddenly appeared to be at stake. If Mexico, with a debt then estimated at $82 billion, were to be forced into default, could Brazil or others be far behind? And if defaults were indeed to spread to other Third World borrowers, could bank balance sheets in capital-market countries survive the blow? Was the world faced with a repetition of the financial collapse of the 1930s? Was another Great Depression in the offing? The United States and other creditor governments, together with the International Monetary Fund and commercial banks, had no choice but to come to Mexico's rescue, as well as to the aid of other major debtors, and to keep a close watch on the situation ever since. Far more was involved, clearly, than just a few billion dollars' worth of interest.

Yet the debt problem, regrettably, is still with us. As this paper is written, some three-and-a-half years after Mexico's rescue, that nation's difficulties seem if anything even more threatening than before. And much the same can be said of other major debtors as well, from Peru and Venezuela to Nigeria and the Philippines. The financial system was stabilized after 1982; the immediate crisis was managed. But it would hardly be inaccurate to say that, to date, disappointingly little progress has been made toward

the goal of a genuine resolution of the overall problem.

The gist of the debt problem may be easily stated. It is a matter of who should bear the burden of adjustment. At its essence, the issue of cooperation boils down to this: Can the actors involved achieve some form of agreement on how the burden of adjustment should be distributed? Given the variety and number of actors involved - including transnational actors such as the Fund and commercial banks as well as state actors in both debtor and capital-market countries - cooperation on the global scale is obviously needed. The question is: Why has cooperation proved so difficult?

The objective of cooperation is clear. It is to durably ease the cash-flow strain on debtor countries in a context of both renewed economic development and continuing stability in financial markets. The challenge is implementation: How do we get from Here to There?

Roadmaps abound, of course. Indeed, proposals to deal with the debt problem have become a veritable growth industry since 1982, with ideas covering the full range of possibilities, from the most restrained to the most radical. (1) At one pole are comparatively modest suggestions for innovations or extensions of existing financial measures, e.g. reduced interest-rate spreads, multi-year rescheduling, or insurance or co-financing schemes. At the other pole are potentially revolutionary plans for interest or debt forgiveness or some form of consolidation of obligations via a new or existing international organization. In between are a plethora of possible schemes for payments smoothing or for linking the flow of debt service formally to some measure of a debtor's estimated capacity to pay. The difficulty of finding a more satisfactory solution can hardly be ascribed to a lack of human imagination. Quite the contrary, in fact. What has been missing is not a plausible range of alternative options for the actors involved but rather an ability to agree, explicitly or implicitly, on some choice or choices among them. Our objective is to explain that inability.

One conceivable explanation is, simply, that there may be no more satisfactory solution than the present. That is, the situation may already be 'Pareto-optimal', in the sense that no one (e.g. debtors) can be made better off without someone else (e.g. banks) being made worse off. Agreement

may be elusive because at least some key actors stand to lose absolutely from a genuine resolution of the problem. In fact, however, such a possibility may be easily dismissed. The contrary is far more likely; that is, a truly durable cooperative solution would almost certainly be in everyone's overall interest. The United States and other capital-market countries would gain, on balance, insofar as the very real risk of world financial disruption could be significantly reduced. Banks and other private lenders would gain insofar as the capacity of debtors to satisfactorily service their obligations could be effectively enhanced. And the debtors themselves would gain insofar as their development process could be speedily resumed and new external financing encouraged. Net benefits would surely be had by all.

On the other hand, absolute gains are hardly likely to be equal for all; and in addition, the costs of adjustment would most certainly be distributed differently depending on whose roadmap is followed. The common interest that everyone has in a durable cooperative solution is tempered by the knowledge that relative burdens, on balance, would surely vary significantly under alternative proposals. Formally, in the language of game theory, the situation is akin to a mixed-motive, variable-sum game threatened by Prisoners' Dilemma. The actors involved have interests that are neither completely irreconcilable nor entirely harmonious. Incentives for both competition and cooperation exist. The Prisoners' Dilemma is that while players could conceivably, or even probably, benefit from cooperation, each separately may hope to gain more by acting on its own; but if in fact each does try to act independently, the outcome will most likely be inferior for all. Competition over relative shares can become so severe that it reduces the size of the pie in total. The potential for joint gain may be destroyed.

The only viable solution to the Prisoners' Dilemma is cooperation, explicit or implicit, to raise the welfare of all the players concerned. And so we are driven back to our central question: Why is cooperation so difficult? What obstacles prevent a cooperative solution, despite the perception of common interest?

Three tentative hypotheses suggest themselves, not necessarily mutually exclusive, each reflecting a major branch of the scholarly literature on International Political Economy today:

(1) Out of the so-called 'public choice' approach to IPE, which stressed the use of tools of conventional

economic analysis to examine non-market decision processes, (2) comes the possibility that some or all of the actors are, simply, irrational. The assumption of rationality, in the sense of responses to incentives that are systematic and hence predictable, is central to public-choice theory. But what if some of the players in the debt 'game' are not in fact rational in this sense? That alone could account for the difficulty of achieving some form of durable cooperation.

(2) Alternatively, out of so-called system-level or 'international' approaches to IPE, which focus on constraints and incentives for behavior derived from the global economic system, (3) comes the possibility that the problem traces back to a lack of leadership on the debt issue. What may be missing is a dominant power, or 'hegemon', to take responsibility for organizing a durable cooperative solution.

(3) Finally, out of so-called unit-level or 'domestic' approaches to IPE, which focus on internal characteristics of group actors to explain behavior on external economic issues, (4) comes the possibility that particularism is the key to explanation of our problem. Players in the debt game, including transnational actors as well as states, may be impeded in the formulation and implementation of coherent objectives by persistent dissonances within their own policy networks and governing elites.

Each of these three tentative hypotheses will be critically evaluated in turn.

Is irrationality the explanation? Rationality, in the context of public-choice theory, is classically defined as being synonymous with preferences that are both ordered and consistent: actors are assumed to be able to calculate the costs and benefits of alternative courses of action in order to maximize their utility in view of those preferences. Is it possible that some or all of the players in the debt game are simply not behaving in accordance with their own best interests?

Irrationality as such is easily rejected. As a hypothesis, it is equivalent to asserting that actors knowingly fail to exploit opportunities to increase their own net benefits. That flies in the face of most evidence as well as common sense. As in modern theories of exchange-rate determination, it is unnecessary to resort to such unlikely characterizations of behavior in order to account for suboptimal real-world outcomes. Prolonged 'overshooting' of currency values, for instance, can be shown to be wholly consistent with 'rational' expectations and 'efficient'

foreign-exchange markets. (5) No assumption of 'irrational' speculation is needed. Likewise, with respect to our own subject, persistent failure to achieve a durable cooperative solution of the debt problem can be shown to be wholly consistent with pure maximizing rationality on the part of all the actors involved.

Return to the image of the Prisoners' Dilemma. The risk of joint loss follows directly from the assumption that each player behaves separately in a perfectly rational manner. Payoffs are evaluated, alternatives compared, and strategies devised that will (hopefully) achieve the best possible outcome available, given the player's own preferences and the anticipated strategies of others. Depending on how payoffs are structured, a cooperative (positive-sum) solution may simply be unattainable. The 'dominant' strategy for some or all players may turn out to be 'defection' (i.e. non-cooperation) instead. Alternatively, there may be no dominant strategy at all; that is, the outcome may be indeterminate.

The point is illustrated in Table 4.1, employing the standard 'payoff matrix' of game theory. Six hypothetical games are described, each specifying the net gains for each of two players (A and B) to be derived from alternative choices of strategy. Although admittedly very simple, begging a host of complex practical questions, (6) this sample may nonetheless be regarded as broadly indicative of the range of possible outcomes of the debt problem. Only in Game 1 is mutual cooperation the dominant strategy for both parties. In the remaining five games, non-cooperative solutions can be confidently predicted. In Game 2, for instance, sometimes labelled 'Bully', defection is the dominant strategy for Player B, in effect exploiting A's fear of the consequences of defection to achieve a more favorable outcome for B. Likewise, in Game 3, labelled 'Chicken' (after the dangerous teenage game where victory consists of forcing opponents to 'chicken out'), defection is the dominant strategy for whichever player is able to out-bluff the other. In both Games 4 (the classic Prisoners' Dilemma) and 5 (labelled 'Deadlock') defection is the dominant strategy for both players. And in Game 6 no strategy at all is dominant: any outcome is possible. Yet in none of these games is it necessary to assume that behavior is in any way irrational. All players at all times continue to act in what they regard as their own best interests.

Table 4.1: Six Hypothetical Games

Game 1: Dominant Strategy = Cooperation

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	4,4	3,2
	Defect	2,3	1,1

Game 2: Dominant Strategy = Defection by B

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	4,3	3,4
	Defect	2,1	1,2

Game 3: Dominant Strategy = Defection by Either A or B

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	3,3	2,4
	Defect	4,2	1,1

Game 4: Dominant Strategy = Defection by Both

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	3,3	1,4
	Defect	4,1	2,2

Game 5: Dominant Strategy = Defection by Both

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	2,2	1,4
	Defect	4,1	3,3

Game 6: No Dominant Strategy

		B's Choice	
		Cooperate	Defect
A's Choice	Cooperate	3,4	2,1
	Defect	4,2	1,3

However, to reject irrationality as such is not the same as to accept the opposite - that everyone involved in the debt problem must therefore be acting with classical rationality. That is what logicians would call the fallacy of the excluded middle. In fact, as Herbert Simon in particular has emphasized, the assumption of pure maximizing rationality is no more representative of reality than the

reverse assertion of irrationality. (7) Between these polar alternatives is the far more realistic possibility that actors are constrained in some way in their abilities to make calculations and compare alternatives: their rationality is bounded by limits on their information-processing capacities. The key implications of the concept of bounded rationality is that actors thus tend to 'satisfice' rather than maximize; that is, they cope with their limitations by finding courses of action that manage merely to settle at or above some satisfactory level of achievement - their 'aspiration level.' Any strategy is regarded as acceptable (i.e. 'viable') so long as it equals or exceeds this critical threshold. In a multilateral setting, in turn, this pattern of behavior almost certainly tends to ensure that outcomes will be less than truly optimal. Here, it would appear, is the basis for a more plausible explanation of the difficulty of achieving durable cooperation on debt.

Certainly there are reasons to believe that rationality is in fact bounded when it comes to the debt problem. Of particular importance is the high degree of uncertainty surrounding every aspect of the issue, which makes it virtually impossible for actors to structure any sort of useful payoff matrix for comparing possible alternative strategies. On debt, calculations about potential costs and benefits are necessarily subjective - matters of judgement on which sincere individuals may sincerely disagree. But if consenus is lacking on costs and benefits, then how can actors possibly be expected to achieve cooperation, which necessarily demands some implicit or explicit accord on trade-offs among the various parties involved? Agreement over the distribution of the burden of adjustment is precluded if we do not even know what the burden is.

Consider, for example, the question of patience in debtor countries, which is central to evaluating whether any new actions beyond 1985's Baker Plan are in fact needed. Is there really a risk that the pot might reach the boiling point in the Third World, resulting in social or political disorder that could conceivably drive governments into debt moratoria or even formal default? The answer makes all the difference in the world. If the answer is no, then there seems little reason for banks or capital-market countries to offer any additional concessions to debtors. The situation is more like Game 2 in Table 1: creditors can effectively 'bully' debtors into acceptance of the status quo, which remains the creditor's most advantageous option. But if, on

the other hand, the answer is yes, then there seems every reason for banks or capital-market countries to offer concessions as a way of cutting potential losses. The situation may be more like Game 3 ('Chicken'), where until now creditors have held the upper hand through threats of sanctions against defaulting debtors. Do creditors really want their bluff called?

Obviously, chances for a durable cooperative solution to the overall debt problem would be enhanced by a convergence of views on how seriously we should in fact view the risk of overheating in the Third World. Not surprisingly, however, given the practical uncertainties involved, the situation is instead one of sharp divergence of opinion - debtors and their sympathizers arguing that the risk is real; banks and capital-market countries, by and large, dismissing the threat as close to negligible, stressing instead the rational self-interest of sovereign debtors always and under all circumstances to honor their outstanding obligations in order to preserve their external creditworthiness. No wonder a genuine resolution of the problem remains so elusive. Lacking a clear picture of the structure of payoffs, each side is reduced to making do as best it can with conditions as they presently exist. Viability rather than optimality becomes the dominant objective of behavior.

Is there any way to clarify the picture at all? I would argue that much could be gained by a closer reading of financial history. (8) In fact, the past record of international lending, from the princely loans of the Bardi and Peruzzi of fourteenth-century Florence right down to the foreign bond sales of nineteenth-century London and New York in the 1920s, gives scant grounds for confidence in the rational self-interest of sovereign debtors always and under all circumstances to honor their outstanding obligations. On the contrary, debt payments have frequently been suspended or even formally repudiated, often despite that best of intentions, for reasons that could not have been easily anticipated in advance - e.g. war or revolution, world depression, severe terms-of-trade shocks, or failed investment schemes. Life is like that. To discount the seriousness of such risks in present conditions would seem myopic at best and downright dangerous at worst: 'Chicken' in high finance. To decline to play such a suicidal game would seem not alarmism but simple prudence.

History also suggests that once debt-service difficulties

do arise (as they surely have since 1982), a little give and take on all sides helps to maximize chances for a successful resolution of outstanding problems. The experience of the nineteenth century is especially instructive in this respect. In the decades before World War I, sovereign borrowers anxious to preserve their creditworthiness - like their counterparts today - often agreed to a measure of foreign participation in the management of their domestic affairs. Public finances would be reorganized, debts restructured, and economic policy conditions imposed by consortia of foreign creditors playing a role not dissimilar to that of the IMF in our own era. However, in return, some kind of debt relief was typically conceded, in forms ranging from consolidation and reduction of the face value of existing debt or refinancing it at substantially lower rates of interest, to cancellation or capitalization of arrears on more liberal terms. Investors, in effect, accepted partial losses rather than insisting on contractual demands that no longer seemed consonant with a borrower's altered capacity to pay. The burden of adjustment was shared all around rather than concentrated largely on debtors alone. And as a result, both the growth of borrowing nations and the flow of international credit tended to be quickly and efficiently restored. The outcome, clearly, was mutually advantageous. More attention to the lessons of history might make it easier to surmount the bounded rationality of today's actors to achieve similar results now as well.

What about lack of leadership as a possible contributory factor to the persistence of the debt problem? Many so-called system-level or 'international' approaches to IPE stress the presumed need for a dominant power, or 'hegemon', to take responsibility for organizing cooperative solutions to multilateral problems. Is it possible that this is what is missing?

I have said that the debt situation is akin to a mixed-motive variable-sum game threatened by Prisoners' Dilemma. An alternative way of saying the same thing is to describe the situation as an example of 'market failure' caused by the unwillingness of any one actor, or group of actors, to take responsibility for the needed 'collective good' of a durable solution. The dilemma is a familiar one to students of collective action. Collective goods (or public goods) are by definition characterized by 'non-excludability';

that is, no one can be excluded from their enjoyment once they are provided. Hence for most actors individually, there is little or no incentive to contribute to their production. No one wants to pay costs that could conceivably be avoided: everyone wants to be a 'free rider' if he/she can. And so there is a tendency for collective goods to be underproduced or perhaps even not produced at all - equivalent, in game-theory terms, to saying that the potential for joint gain may well be destroyed by competition over relative shares.

The parallel between game theory and the logic of collective action in this respect has been perceptively noted by Robert Keohane:

> The logic of collective action ... is similar in its essentials to this logic of Prisoners' Dilemma. In situations calling for collective action, cooperation is necessary to obtain a good that (insofar as it is produced at all) will be enjoyed by all members of a set of actors, whether they have contributed to its provision or not. When each member's contribution to the cost of the good is small as a proportion of its total cost, self-interested individuals are likely to calculate that they are better off by not contributing, since their contribution is costly to them but has an imperceptible effect on whether the good is produced. Thus, as in Prisoners' Dilemma, the dominant strategy for an egoistic individualist is to defect, by not contributing to the production of the good. Generalizing this calculation yields the conclusion that the collective good will not be produced, or will be underproduced, despite the fact that its value to the group is greater than its cost. (9)

Out of this logic comes the so-called 'theory of hegemonic stability' - the popular argument that order in international relations requires the presence of a single, strongly dominant actor (a hegemon) prepared to provide the collective good of stability. (10) Everyone may wish to be a free rider, but not everyone can afford to be. Dominant powers, in particular, are constrained by the potential systemic consequences of their own actions, as well as by potential 'feedbacks' from the wider system to themselves that may result from those actions. Since they presumably have the biggest stake in the system, they have little choice but to be concerned about possibly adverse 'ripple effects'

that could flow from their individual behavior. From this follows an interest in taking some responsibility for systemic stability and maintenance, even should that mean bearing a disproportionate share of the cost. And from that interest follow what have been identified as the two central propositions of the theory of hegemonic stability: (1) order in international relations is typically created by a single dominant power; and (2) maintenance of order requires the continued presence of hegemony. The core of the argument was most succinctly expressed by Charles Kindleberger in 1973: 'For the world economy to be stabilized, there has to be a stabilizer, one stabilizer'. (11)

Since Kindleberger wrote, of course, all kinds of caveats have been introduced to qualify the bluntness of his assertion, leading to a general consensus among scholars today that, more realistically, neither of the theory's central propositions can be taken entirely at face value. As summarized by Robert Keohane: 'There is little reason to believe that hegemony is either a necessary or a sufficient condition for the emergence of cooperative relationships. Furthermore ... cooperation does not necessarily require the existence of a hegemonic leader ... Post-hegemonic cooperation is also possible.' (12) As summarized by Duncan Snidal: 'The theory of hegemonic stability is a special case ... There can be no single neat answer.' (13) Yet this does not mean that leadership is therefore unimportant, particularly insofar as the first proposition is concerned. Quite the contrary, in fact, as both Keohane and Snidal are quick to admit. Concedes Keohane: 'There is some validity in a modest version of the first proposition of the theory of hegemonic stability - that hegemony can facilitate a certain type of cooperation ... Hegemonic leadership can help to create a pattern of order.' (14) Concedes Snidal: 'While dominance by a single actor may not be necessary, models of collective action indicate that some asymmetry may be useful in reducing the number of (actors) whose participation is necessary for cooperation to succeed.' (15) Leadership may not be the sine qua non for generating the collective good of stability; but durable cooperative solutions will almost surely be a good deal more difficult to organize without it.

The importance of leadership in this respect, as a facilitator of cooperation, is certainly evident in the debt problem, where the number of actors involved is extraordinarily large - including literally hundreds of

commercial banks around the globe as well as the IMF and several dozen governments in capital-market countries and the Third World. In such a complex setting, cooperation is hardly likely to emerge spontaneously: a durable solution must be organized. And that calls for initiative by those most capable of bringing everyone to agreement; that is, those with the greatest capacity to threaten or cajol others into accord. This does not mean that the leader (or leaders) must necessarily end up bearing a disproportionate share of the burden of adjustment; the issue of the distribution of costs and benefits at the outcome is quite separate from the issue of what rewards and punishments are needed to get the process initially started. Nor does it mean that the maintenance of agreement necessarily requires the continued presence of a dominant power; in that respect, scholars like Keohane and Snidal seem quite correct in arguing that international cooperation can be preserved even 'after hegemony'. It only means that someone must take responsibility for getting the ball rolling in the first place. Someone must lead.

And who could that someone be today, other than the United States? America's global hegemony, since World War II, may have declined significantly over a broad range of economic issues. Still, insofar as the debt problem is concerned at the present time, there is simply no other obvious candidate. America is unique in its capacity to exercise effective influence over creditors and debtors alike, by means of bribes or side-payments or by threats to withhold assistance. Moreover, America is the universally acknowledged leader. As Susan Strange has written, in presenting an avowedly 'European' view of the issue: 'Nothing happens unless the United States leads.' (16) If the necessary initiative is to come from anywhere, it would appear, it must come from Washington. In the words of US investment banker Felix Rohatyn:

> The real question we are facing is whether our government will take the lead in proposing to negotiate some ... plan with Latin America, Europe, and Japan in view of all the political benefits we could derive from such an initiative. Or will we wait for a desperate Mexico or another country to unilaterally default on its payments, denounce its debts, and set off a crisis? (17)

In fact, a certain amount of initiative already has come

from Washington as we saw earlier. Both the initial multilateral strategy developed after Mexico's 1982 crisis and the 'new' strategy proposed three years later by Secretary Baker were put together directly and quite explicitly under American leadership. However, as we also saw, neither of these initiatives could be seriously regarded as a really durable solution of the debt issue, each being rather more in the nature of a piecemeal response to a fundamental problem. Leadership per se has not been missing; but it has been a disappointingly limited kind of leadership, effectively focused on short-term crisis management rather than true crisis prevention. Washington has seemed unwilling or unable to go the extra step, to organize the needed cooperation among all of the actors involved. Can we understand why?

Two plausible reasons, not mutually exclusive, suggest themselves. On reason, harking back to the previous section of this paper, would appear to be genuine disagreement with the view that any extra step is actually needed. Many officials in Washington, up to and including the highest level of policy-making, seem to believe quite sincerely that the status quo (or as little change as possible from the status quo) is their most advantageous option, given their own calculus of the costs and benefits involved. The high degree of uncertainty surrounding every aspect of the issue appears to make them satisfied with viability, rather than optimality, as the dominant objective of policy. To the extent that this is so, of course, the argument for a closer reading of financial history, to help clarify the structure of potential payoffs, is manifestly reinforced. If America is to lead, US officials above all others must have a clear comprehension of the lessons of the past.

But bounded rationality is not the only reason for Washington's disappointing performance to date. Many officials, after all, do study history; and it is known that not everyone in the present government dissents from the view that some extra step is still needed. This suggests a second reason for the limitations of Washington's initiatives, anticipating the next section of this paper. Part of the problem also appears to stem from divergences of opinion within the US policy establishment. America's exercise of leadership is compromised by dissonances within its own decision-making processes.

Internal dissonances are usually ignored by system-level models like the theory of hegemonic stability, which posits a

direct relationship between power and outcomes. Following James March, (18) that theory may be termed a 'basic force model': if America is still the acknowledged leader, with all the capabilities of such, then America should be expected to lead. But this obviously overlooks crucial differences in the internal characteristics of the United States and other relevant group actors - e.g. differences in intensity of motivation, political culture, institutions, interest-group pressures, or other factors that significantly affect decision-making processes. Comprehensive analysis must go to the unit level as well, to take account of these factors too. March calls these 'force activation models' - explanations that focus on the decision processes needed to 'activate' the posited relationship between power and outcomes. In the present context, this level of analysis would appear to be of particular pertinence.

America has long been known as an international actor whose domestic structures make foreign economic policy-making especially cumbersome and complex. In terms of the 'weak-state, strong-state' distinction developed by Peter Katzenstein, Stephen Krasner and others, (19) the United States can be viewed as a 'weak state'; that is, one where agreement within existing policy networks and governing elites is particularly difficult to achieve or maintain. Even when central decision-makers are themselves able to agree on a coherent set of objectives, they frequently are frustrated in trying to implement their policy preferences because of internal dissonances and discord; and this dilemma tends to become most intense when the issue involved takes on high public visibility, as is true of the debt problem today. Discussion of the crisis since 1982 has generated much attention in the United States, but little consensus. Accordingly, Washington's initiatives on the issue could hardly have been expected to be anything but disappointingly limited. Washington had been unable to take the extra step, even had it actively wanted to, because it has not had an effective coalition of domestic support behind it.

This brings us to the last of the three alternative hypotheses with which we began - the possibility that the key to our problem is particularism, not only in the United States but in and among other group players in the debt game as well. The difficulties of achieving internal consensus are a dominant theme of so-called unit-level or 'domestic' approaches to IPE; by extension, these approaches

can be applied to the analysis of decision processes not just within individual states or transnational actors but also within limited aggregations of such actors with broadly shared interests in an issue area. How important are such difficulties in the present context?

The evidence is that they are in fact of considerable importance, both at the level of individual actors (governments, banks) and at the level of the relevant aggregations of actors - namely, the capital-market countries, debtors, and the commercial banking community. For our purposes here I shall concentrate on the latter level, focusing on these three aggregations that are the principal players in today's high-stakes tug-of-war over the distribution of the burden of adjustment. Cooperation to resolve the debt problem would be difficult enough, in principle, even in the presence of strong cohesion and convergence of views within each of the three groups. But cooperation in practice is made even more difficult because instead, within each group, consensus tends most often to be not firm but feeble or even absent altogether. There is little question that persistent dissonances at this level contribute significantly to explaining why agreement has remained so elusive on a broader global scale. To use the venacular: none of the three relevant aggregations has really been able to 'get its act together.'

Within the group of capital-market countries, dissonances have been mostly implicit rather than explicit - but nonetheless serious for all that. Publicly, creditor governments have maintained a more or less common front since 1982, a relatively easy task so long as the main onus of adjustment continued to fall elsewhere. Privately, however, tensions have been evident, especially over the question of what substantive concessions might eventually be asked of them in order to achieve a truly durable cooperative solution. European governments, in particular, take the view that since most of the major troubled debtors are located in Latin America, a region universally regarded as of greater interest to the United States, it is up to Washington to carry the larger share of the burden; and some have evinced considerable impatience with America's failure to exercise more effective leadership on the issue. France, as usual, has been most willing to vocalize its criticisms of Washington, questioning for instance the practicality of Secretary Baker's 'Program for Sustained Growth' when it was unveiled in October 1985. Asked French Finance Minister Pierre

Beregovoy, pointedly, during the meeting in Seoul: 'Will commercial banks make commitments if the risks seem to them unreasonable? Nothing could be worse than to build up hopes that reside on a misunderstanding.' (20) In fact, beyond a preference for the status quo, which costs them little, little consensus at all exists among the capital-market countries on what to do next.

Among debtors, dissonances have been more open, despite their evident shared interests in realizing a less asymmetric distribution of the burden of adjustment. Efforts to achieve some measure of solidarity have not been lacking, of course, especially in Latin America. Starting with the Quito Declaration of January 1984, and continuing with the series of meetings of eleven Latin governments in what has come to be known as the Cartegena Group, accord has been sought on a common list of proposals to be put to the capital-market countries and their banks. Rarely, however, have debtors shown much inclination to translate their consensus at the level of rhetoric into concerted action at the level of practice. The dreaded 'debtors' cartel' has not come into being, mainly because of particularist concerns about what that might mean for national creditworthiness in international financial markets. Few debtor governments have seemed prepared to associate themselves too closely with a potentially confrontational collective stance if this might jeopardize their own individual relations with foreign creditors. Most have preferred instead to negotiate separately with creditors in hopes of getting the best deal possible on debt rescheduling or new finance. And this in turn has put debtors as a group at a distinct disadvantage, enabling the banking community and creditor governments in effect to continue 'bullying' them into acceptance of the status quo. That was evident as early as the spring of 1984, when an explicit 'divide and rule' strategy began to surface among the bigger banks in reaction to the new rhetoric then coming from Latin America: 'carrots' (e.g. multi-year reschedulings, liberalized terms) would be dangled as rewards for good behavior, while a 'stick' of hard bargaining would be reserved for recalcitrant debtors no longer disposed to 'play by the rules'. (21) It was also evident in the fall of 1985, when faute de mieux the Baker Plan became the focal point of discussion despite widespread skepticism among debtors. As one observer commented: 'Although the Baker Plan is not seen as providing a long-term solution to the regional debt crisis,

the absence of a monolithic Latin American bargaining position has enabled the United States to seize the initiative in the debate. (22)

Most striking have been the dissonances among banks, both within the capital-market countries and between them. In the United States, for instance, it is well known that significant divergences exist on the debt issues between the large money-center banks, on the one hand, and smaller regional and local banks on the other. Most smaller banks, which first became involved simply as minor participants in broad loan syndications, would like nothing better now than to get rid of their Third World exposure as quickly as possible, and have often baulked at deals for debt reschedulings or new credits negotiated over their heads by syndicate leaders. The money-center banks, by contrast, with their far more concentrated exposure, feel they have little choice but to protect their investment as best they can, and have not been reluctant to resort to a good deal of arm-twisting to persuade restive regional and local institutions to stay in the game. In what is politely called 'peer pressure', smaller banks have been threatened with reduced interbank credit lines, a cut-off of correspondent services, or even worse. Needless to say, this has not been conducive to fraternal feelings within the US banking community.

Likewise, between the United States and Europe, it is known that serious frictions have developed because of differing perceptions of interest. European banks, with their relatively lower exposure in the key Latin American region, and with their traditionally much higher loan-loss reserves (often hidden), can afford to be rather more generous about possible debt relief than can the large American institutions, whose reserves are still comparatively low (albeit growing). Large-scale provisioning by the Europeans, encouraged in part by generous tax codes, has enabled them in effect to already write off a large fraction of their exposure. Hence they see less reason for substantial new lending now, as called for in the Baker Plan (in this, they are joined by the smaller US banks), and would be more inclined instead, in nineteenth-century fashion, simply to formalize the write-offs and then try as quickly as possible to get back to business as usual. American money-center banks react with horror to such suggestions.

Dissonances like these are not an absolute barrier to broader agreement, of course. As Robert Putnam and

Nicholas Bayne have shown in their study of the annual economic summits of the seven major industrial nations, divisions within governments may actually facilitate rather than hamper cooperation between states, insofar as opportunities are created for the formation of effective transnational coalitions of like-minded officials. (23) The same point applies, in principle, to the even more complex game of international debt. However, as Putnam and Bayne go on to stress, whether transnational coalitions will in fact coalesce depends greatly on the willingness of decision-makers in any of the relevant groups actually to go out and find potential allies. In the debt game to date, such a willingness has been conspicuously absent, most probably because of the continuing high degree of uncertainty surrounding every aspect of the issue. In practice, therefore, agreement on a broader scale has been conspicuously absent too.

Summarizing, it is clear that in fact there are several crucial factors contributing to the persistence of the global debt problem. First is the bounded rationality of all the actors involved, which hampers their ability to structure any sort of useful payoff matrix for comparing possible alternative solutions. Second is the lack of sufficiently effective leadership by the United States, owing not only to the bounded rationality of American policy-makers but also to well-known structural weaknesses in America's domestic decision processes. And third is the particularism that is evident in each of the three main aggregations of actors - the capital-market countries, debtors, and commercial banking community - which further impedes durable agreement on some distribution of the burden of adjustment, again seemingly owing at least in part to the bounded rationality of the players involved. All three factors help to explain why cooperation is so difficult.

Is there any way out of the impasse? One practical implication is that a vigorous educational effort would be useful, paying particular attention to lessons derived from the past record of international lending, to reduce the high degree of uncertainty surrounding the debt issue and thus aid in achieving greater consensus in calculations of the costs and benefits associated with various policy options. Another implication is that some alternative catalytic agent is needed, as a substitute for a United States constrained by

its own internal limitations, to take responsibilty for getting the ball rolling in the first place. And a third is that opportunities for potentially instrumental transnational coalitions should be exploited to the extent possible, in order to overcome the stalemate caused at present by dissonances within all the relevant group actors. Are any new actions along these lines possible?

Perhaps the most promising approach, not underestimating the difficulties implied, would be to rely more on the two multilateral institutions most directly involved in the problem - the IMF and World Bank. Either one, or preferably both together, is in a unique position to follow through on each of these three implications. Though neither can boast America's capacity to threaten or cajol others into accord, each does still enjoy some reputation for institutional impartiality and disinterested commitment to the collective good of a durable solution. Neither is parti pris to the struggle over the burden of adjustment. Hence either would be well placed to play the needed catalytic role, both by initiating an appropriate educational effort to improve information-processing capacities, and by searching more actively for potential coalitions to move toward agreement on a durable solution. Cooperation on debt is not impossible. The challenge is still implementation.

NOTES

1. For a useful comparative evaluation of many of these ideas, see C. Fred Bergsten, William R. Cline, and John Williamson (1985).
2. For an example, see Bruno S. Frey (1984).
3. For an example, see Robert O. Keohane (1984).
4. For an example, see Peter J. Katzenstein (1978).
5. See e.g. Jeffrey A. Frankel (1985).
6. For example: Who are the players? What are they playing for? What is a 'play'? Are 'plays' simultaneous or sequential? Is the game repeated? How often? and so on. As useful as game theory is as an aid to understanding strategic issues, its practical limitations when applied to real-world problems must also be kept in mind. For more discussion, see e.g. Glenn H. Snyder and Paul Diesing (1977), ch. 2.
7. See e.g. Herbert A. Simon (1982).
8. See Benjamin J. Cohen (1986).
9. Keohane (1984), pp.68-9.

10. For examples, see Charles P. Kindleberger (1973); Robert Gilpin (1981).
11. Kindleberger (1973), p.305.
12. Keohane (1984), pp.31-2.
13. Duncan Snidal (1985), pp.612-14.
14. Keohane (1984), pp.31-49.
15. Snidal (1985), p.613. Emphasis in the original.
16. Susan Strange (1983), p.179.
17. Felix Rohatyn, 'The New Chance for the Economy', The New York Review of Books, April 24, 1986, p.21.
18. James G. March, 'The Power of Power' (1966).
19. See e.g. Katzenstein (1978), and Stephen D. Krasner (1977), pp.160-81. But cf. Peter Gourevitch (1978), pp.900-7.
20. As quoted in The New York Times, October 7, 1985, p.A10.
21. See e.g., The New York Times, June 17, 1984, Section 4, p.2.
22. Alan Riding, 'Baker's Debt Plan Gets Latin Scrutiny,' The New York Times, December 16, 1985, p.D12.
23. Robert D. Putnam and Nicholas Bayne (1984), pp.208-11.

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PERSPECTIVE

Pier Carlo Padoan

Professor Cohen's paper offers an analysis of cooperation in international debt which contains aspects of general interest. He discusses different approaches in international political economy, public choice, regime theory and domestic interests, and considers the answer that each of them offers to the question of why cooperation in debt is so difficult. Public choice analysis, which is based on neoclassical economic theory, maintains that the difficulty of achieving cooperation stems from limited rationality which makes the full perception of the benefits of cooperation hardly obtainable. Regime theory links the lack of cooperation to the absence of a hegemonic power which provides the necessary leadership for the implementation and operation of a cooperative agreement. Regime theory may be considered also in terms of public choice. A regime is a public good and it is well known that its provision requires that a larger country bears a more then proportionate amount of supply costs. Finally cooperation may be difficult because domestic interest groups influence the foreign economic policy of key nations in a direction contrary to cooperation. Each of the three approaches offers interesting insights and one is tempted to investigate the possibility of producing an integrated framework. I will not attempt such a demanding task. The point I wish to stress is that progress in this direction requires something else: an economic theory of debt generation and financial distress.

There are not many such theories at hand. Modern economics has traditionally been based on the concept of self-regulating markets embedded in general equilibrium

analysis. In such a framework situations of financial distress and crisis are the consequences of incorrect market behaviour or policy errors.

One notable exception is the 'financial instability hypothesis' developed by H. Minsky over a number of years. Although Minksy has developed his theory for a closed economy its application to the problem of international debt is illuminating. (1) The fundamental idea is that financially sophisticated systems have a propensity to produce endogenous financial instability and crises. Two conditions are necessary to avoid the emergence of financial distress: (a) a high and stable amount (rate of growth) of effective demand to allow indebted units to make profits and debt to be serviced, (b) lender of last resort facilities to minimize risks of diffusion of crisis to the financial system should bankruptcies occur.

The financial instability hypothesis supports and reinforces the analysis of cooperation in international debt offered by the three political economy approaches. To say it differently these approaches may be reconsidered within the framework of the theory of financial instability. I will offer a few examples of how such an integration is possible.

The financial instability hypothesis is based on the Keynesian view that financially sophisticated systems are characterized by widespread uncertainty. Hence a problem of expectation formation arises. Uncertainty may be a source of bounded rationality which leads to non-cooperative outcomes. (2) The negative effects of uncertainty are enhanced when (the rate of growth of) effective demand is low and unstable for (at least) two reasons: single nations (or actors) perceive the distribution of costs and benefits of cooperative agreements - which is generally asymmetric - less favourably and hence their propensity to cooperate decreases (Simonsen 1984); secondly a stable rate of growth enhances the shadow of the future which also increases the propensity to cooperate (Oye 1985). In this respect a high and stable rate of growth is a public good as it improves the expectation environment.

This leads us to the second point considered in Prof. Cohen's paper: the lack of leadership as a cause of insufficient cooperation. Hegemonic stability theory has been under severe scrutiny and criticism in recent years I will not discuss this literature here. Let me only observe that critics have largely neglected the role of leadership in macroeconomic cooperation in general and in effective

demand generation in particular. This is probably due to the theoretical framework which is usually considered in political economy research: neoclassical economics. However, in a post-Keynesian framework the problem of effective demand generation is crucial, as there is no assurance that the ex-ante level of world demand will be enough to produce stable growth.

When leadership is lacking cooperation 'under anarchy' in the generation of effective demand is probably more difficult than in other issue areas. This is particularly important if we assume that industrial countries pursue neomercantilist policies as recent developments in the world economy show and as has been true in the past (Guerrieri and Padoan 1986).

Growth is only one of the two fundamental conditions for the stability of a complex debt system. The other being a reasonably stable financial environment. The debt crisis lays its roots in the lending rush of the 1970s when a largely unregulated private banking system considered sovereign lending as the best possible option (Llewellyn 1982) for their strategies. Over the past decade symptoms of financial distress, not only related to Third World debt, made it clear that cooperation was needed in a field closely related to that of sovereign lending: regulation of private banks operating in international markets. This offers a good example of the role of domestic interest groups in shaping national foreign economic policies and cooperative processes. National banking industries have pressed for increased financial liberalization to enhance their competitive position while being ready to ask for lenders of last resort intervention whenever the risk of collapse arose. Monetary authorities on their part were ready to provide such facilities when needed (Herring and Guttentag 1983). At the same time they have tried to increase cooperation with monetary authorities of other countries. In some occasions however cooperation between national monetary authorities has suffered drawbacks also as a response to the pressure of national banking industries whenever increased cooperation in regulation was perceived as a threat to their competitive position (Hawley 1984).

The interaction between monetary authorities and private banks, both at the national and at the international level, may be analyzed as a problem of collective action in the provision of the public good of creditworthiness (Hirsch 1977), which is a basic input for the operation of financial

systems. Pressures from domestic interest groups may lead to the under-provision of such a public good. In addition collective action may be quite problematic (Lipson 1985, 1985). Since cooperation among banks is a necessary condition for the achievement of cooperation between lenders and borrowers, domestic interest groups may exert a negative influence on macroeconomic and financial cooperation at the international level. One conclusion of our brief analysis is that the three approaches considered by Prof. Cohen can provide elements for a unified view. National behaviour, as influenced by domestic interest groups, determines the amount of the provision of public goods which are necessary inputs to the operation of the world political economy. Different regimes produce different mechanisms of collective action, however it need not be true that hegemony be the only regime which allows a cooperative solution. The task of suggesting a unified framework for the study of international cooperation goes well beyond our scope. A second conclusion is that progress in the understanding of international politico-economic relations requires a synthesis between international and domestic determinants of foreign economic policy. In the third place progress in our knowledge of international relations will be improved if economists and political scientists increase mutual cooperation and exchange. The insight of many economic models would be enhanced if integrated with more realistic models of political behaviour. Political analysis would, in many cases, be strengthened through the integration with the appropriate economic theories.

NOTES

1. For an extension of Minsky's theory to the international system see Padoan (1986).
2. Even in a neoclassical framework if incomplete markets are assumed. Illing (1985).

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PERSPECTIVE

Hyman P. Minsky

Adam Smith's 'Invisible Hand' and David Hume's and David Ricardo's 'Price Specific Flow Mechanism' are two well nigh ancient conjectures that dominate the intellectual world in which economists live. The Price Specie Flow Mechanism rests upon the validity of the Invisible Hand proposition, for it assumes full employment and a quick and easy transition to new relative and absolute prices whenever a change in the fundamental real variables or in the 'superficial' monetary variables takes place.

Both conjectures depend upon positing the neutrality of money. It is now well known that the Invisible Hand conjecture cannot be shown to be true under the abstract conditions posited by economic theorists (1) and that systems with debts denominated in money (i.e. with a fundamental non-neutrality of money) are likely to be endogenously unstable. (2)

In a capitalist economy with a continuum of assets, stretching from special purpose real capital to the liabilities of banks that function as money, the default-free asset - money - is never neutral. This is so because money is almost always (i.e. except when the state is running an overwhelming deficit) created in an exchange for private debts which are entered upon to finance investment activity and positions in capital assets. The process of money supply creation and destruction therefore affects the investment-consumption division as well as the ratio of employed to potentially employable resources.

The Price Specie Flow Mechanism tied the determination of exchange rates and price levels to the money supply. Trade imbalances were the initial and sole

disequilibrating factor in the exchange market, and the adjustments of price levels resulting from the flow of specie operated to eliminate the trade imbalances. This 'scenario' of how international trade and the international flow of financial assets were related dominated discussion at least through the time of Jacob Viner's Studies in the Theory of International Trade. (3)

As Keynes's income flow ideas were integrated into the analysis of the international trade adjustment mechanism, the idea emerged that a country could improve its domestic income and employment (as well as the profits of its domestic businesses) by a positive trade balance. This ability for a country to improve its domestic prosperity by 'beggar-my-neighbour' policies depends upon the existence of other countries that are economically and financially secure enough to allow their own prosperity to be sapped. These other countries possessed 'fiscal independence', which rested upon their ownership of offshore assets. The employment and profits they lost through the trade account came back in the form of interest and dividends; albeit the workers and domestic profit earners lost even as rentiers gained.

The analysis of R.S. Sayers in Bank of England Operations, 1890-1914 (4) provides a key to understanding the actual rather than the theoretical workings of the international gold standard, of the era just prior to World War I, which centered around the London money and capital markets. It also provides a framework that enables us to understand contemporary problems and it provides insights into what is needed to provide a viable international system in today's world. Sayers' framework integrates trade, capital asset incomes, long term foreign investments and flows of short term monetary investments into a balance of payments statement. This framework specifies an initial condition given by the inherited net international investments of any country and then allows for three markets that adjust so that the ex-post balance of payments 'balances'. This framework implies that if there are 'independent' developments that change the desired currency composition of monetary assets there will need to be adjustments in exchange rates, trade balances and long term capital movements.

The framework derived from Sayers breaks the balance of payments into four components, or tiers. The first tier is the current balance on trade and services; merchandise, tourism, banking services, etc. The second tier, as an ex-

post value, is the payments made on account of both principal and interest or dividends because of outstanding international financial contracts. As the existing stock of financial assets commit payments over time, there is also an ex-ante reading for this second tier. For example the debtor nations of Latin America see these tier two payment commitments as a 'burden' stretching forward in time. Each period, so to say, begins with payment commitments due to financial commitments that were entered upon in the past, that are legacies of the past.

The third tier consists of long-term capital movements, which Sayers viewed as new placements using the facilities of London's investment banking community. These new placements can reflect capital development projects and therefore are a demand for funds from the center that is largely independent of the current performance of the borrowing and lending countries.

To Sayers the fourth tier, consisting of movements of money market assets and ultimately specie, was a balancing item that filled the gap that the first three tiers created. However, with modern money markets that use technologies that make movements through 'space' both instantaneous and cheap and which, since the break down of the Bretton Woods system are characterized by fluctuating exchange rates the tier four movements are likely to be initiating or sustaining elements in the determination of the structure of the balance of payments.

Sayers critique of the Price Specie Flow Mechanism emphasized the significance of tier three in the balance of payments. Long term capital movements, mainly in the form of debt and equity issues placed on the London market, would vary depending on the interest rates. The world of the years just prior to World War I was characterized by a large payment flow towards Britain on account of the international indebtedness structure. This was viable because Britain normally ran a deficit on trade account. However, the cash flow due to earnings on asset account exceeded the deficit in the trade account. The new foreign investments out of London furnished the rest of the world with the sterling to offset the deficit on tiers 1 and 2. The rest of the world being in debt in sterling welcomed the short term money market assets they acquired; in effect the short term capital movements financed part of the long term capital movements.

If the accumulation of short-term holdings in London

became too large for the portfolio needs of the various offshore banks and central banks they would opt for holding gold. This put pressure on the gold holdings of the Bank of England, and the reaction of the Bank would be to raise the 'bank rate'. This would slow down the new issues in the London capital market, the sum of the first three tiers would now tend to lower the holdings of sterling balances. Quite quickly the flow of gold out of the Bank of England would stop and be reversed. The equilibrating mechanism for the balance of payments did not rest upon changes in price levels, money wage rates, or employment levels. The equilibrating process normally revolved around the capital and money markets.

Sayers analysed a fixed exchange rate system in which the maximum gain that could be made by being right about the course of the exchange rates was small and in which a movement was sure to halt and be reversed once the gold points were reached. Furthermore in the ancient days prior to World War I communication was slow and transactions were costly. We now live in a world of flexible exchange rates where a movement of the exchanges in one direction are not guaranteed to set off processes that stop and reverse the differences. There is no point of reference by which a norm for exchange rates is set.

The combination of flexible exchange rates, instantaneous and cheap communication, and portfolios of money market assets that are being managed in an effort to achieve a maximum total return means that a movement of the exchange that starts in one direction can build up momentum. This is so because the total return measured in a home currency will include the appreciation that results from being in another, appreciating currency. Thus if a currency is viewed as appreciating or depreciating, the short term capital movements will both initiate and give momentum to exchange rate movements.

After Volcker returned from Belgrade and turned the Federal Reserve to the defence of the dollar, a huge international indebtedness denominated in dollars became a feature of the world. This indebtedness was exacerbated by the escalation of oil prices and the consequent accumulation of assets by the OPEC powers. Furthermore there was a sizeable movement of long term funds from the United States. In these circumstances political and business cycle developments can lead to a large movement of short term funds to the center; the result will be a large appreciation

of the currency of the center and the emergence of a large balance of trade deficit by the center. Quite suddenly the industries of the center will be uncompetitive in world and in its own domestic markets.

By the standards determined by the Price Specie Flow Mechanism the exchange rate movements will be perverse. The deficit in trade will be associated with an appreciating currency. However, the world we live in does not conform to the specifications of the Hume-Ricardo model. The financial and speculative features of the world we live in can have profound employment and profit of industry effects. The policy reactions to the real problems brought about by the exchange rate cycles need to emphasize the importance of limiting the gains that can be anticipated from swings in exchange rates. The need is to develop an exchange rate regime in which the appreciations and depreciations of currencies are limited. Swings of the dollar-lira exchange rate such as have occurred in the years since the break down of the Bretton Woods system are not conducive to rational investment programs in either country.

Given that the modern transaction technology and the complex financial linkage among countries are here to stay, the fluctuating exchange rate system has to be abandoned. The main policy issue is to develop an exchange rate regime in which the anticipated returns from holding assets denominated in one currency or the other is not dominated by anticipated movements of exchange rates. The European Monetary System might be a guide. The dollar, the mark and the yen need to be joined in a Super Snake.

In this Super Snake the clearing instrument would be a currency unit that the Central Bank need acquire even as it feeds an equivalent amount of reserves into its banking system. The deficit countries need extract reserves equivalent to its clearing losses from the reserve base of its banking system. The worthless clearing unit will enforce the symmetry of adjustment. There will be at best limited gains possible from speculation. The total return available from portfolios will not be dominated by what can be earned by aptly playing the exchanges. The longer term changes in industrial structure will reflect changes in enterprise, they will not be the result of the distorting cycles in exchange rates. International efficiency is not well served when the activities of a casino dominate in determining investment patterns.

NOTES

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Chapter Five

IS PROTECTION DUE TO FINANCIAL INSTABILITY? A SCEPTICAL VIEW

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The central question addressed in this paper is how trade policies have changed in response to various aspects of financial instability in the past decade. Since financial instability may mean different things to different countries or different ministers of trade, the topic can be extended enormously. I shall consider three different phenomena as manifestations of financial instability: (1) exchange rate volatility; (2) prolonged exchange rate misalignments; (3) debt crisis; thereby excluding possible other candidates such as terms of trade swings caused by oil or commodity price oscillation. A fourth candidate to be classified under this heading could arguably be the failure of macroeconomic stabilisation policy, given the macro-instruments usually considered to be relevant: fiscal, monetary and exchange rate policies. The failure of stabilisation policies will be defined as high unemployment with or without high inflation, and some observations on the impact on protection will be made.

In a strict sense it is virtually impossible to attribute a trade policy response to 'financial instability'. The presentation is therefore merely suggestive. The paper begins with a political economy perspective of how trade policies are shaped. The central question of whether and how instabilities prompt protection is then addressed for each one of the four possible manifestations of 'financial instability'. This discussion is extended by looking at trade policy trends and asking the question whether perhaps these trends could be attributed to the instabilities identified. An overall assessment and a few recommendations are presented at the end.

A POLITICAL ECONOMY OF TRADE POLICIES

The outcomes of trade policy-making are established after a complex process in which political, economic, legal and diplomatic factors play a role. It is useful to conceptualize the policy-making as interaction of supply and demand factors, given the incentives and the roles of the various actors, and the degree of discretion they have, both domestically and internationally. Nevertheless, it is clear that such an approach should not be mechanically employed since for instance domestic constraints may differ widely, dependent on the prevailing economic order of the country concerned, the nature and intensity of government intervention and control, the economic and social infrastructure, the level of development, the system of representative democracy (if at all present) and bureaucratic traditions.

Creating GATT

The interaction of demand and supply of protection, possibly induced by financial instability, is subject to self-imposed international regulation. It is therefore essential first to have regard for the constraints imposed by GATT. The international trading order has public goods characteristics and this prompts a number of questions. The nub of the problem is how to achieve cooperation among the major players, even if this is perceived as beneficial to all, without there being sufficient confidence in the avoidance of free riding. There is as yet no satisfactory solution for this problem. Among the four recognized principles of international economic organisation (1), automacity and supranationality assume away the problem of realizing the public good, i.e. it is in fact supposed that either no free riding incentives exist (which in turn must imply a peculiar look on the domestic political and social systems of the nation-states) or that there is sufficient confidence in the maintenance of the principles so as to prevent recourse to free riding. The other two principles - hegemony and negotiation - lead to distinct outcomes with important implications for the constraints on national trade policy-making. Hegemony may generate effective leadership to help 'produce' the public good of an international trading order. Such leadership can 'buy off' the danger of free riding

by spending resources and employing other 'sweeteners' (2) to overcome the hesitations of other countries to make binding commitments. However, merely being rich is unlikely to suffice; leadership requires such influence that 'free riding' could provoke costly sanctions and that expectations of policy makers are shaped accordingly. Thus, it assumes a predominance in international trade, monetary and other affairs (security!) that may render deviating behaviour costly (i.e. make independent riding anything but 'free') to trading partners. But there are at least two serious weaknesses in the hegemony approach: (1) the hegemon's capacity to 'provide' the international public good may vary and it would take rather extreme assumptions to expect a watertight set of constitutional rules as the outcome; (2) the hegemon's exceptional position as the provider of the public good, incurring transaction and monitoring costs, may on the one hand lead to accepted prerogatives but should not on the other hand degenerate into very substantial or repeated violations of the principles of the trading order. The two weaknesses together yield the inference that the trading order will almost certainly contain numerous loopholes and escape clauses and that its effectiveness hinges both on the permanence of hegemony and the avoidance of its abuse. This inference is crucial to understand and assess the recent surge of protectionism. (3)

Negotiation is unlikely to be an efficacious principle to establish a world trading order, if it is not combined with at least some elements of hegemony. In any bilateral or small-group negotiation, negotiation does not provide a solution to overcome the incentives for free riding for all others. Presumably, all others will make the possibility of foregoing (how much of?) free riding the subject of negotiations as well, which will fundamentally undermine the confidence that the eventual solution would be adhered to by all. Moreover, even in the unlikely event that such a result would be achieved, every temptation to take a free ride later would engender cumbersome negotiations about the sanctions to be imposed in order to make the system credible. A failure or too much delay would certainly induce some trading partners either to start free riding themselves (because 'it pays') or to impose individual sanctions.

The GATT is a rather imperfect and seriously incomplete outcome of the post-World War II period, combining automaticity-cum-hegemony with elements of negotiation. (4) Nevertheless, in the light of the previous

considerations its existence and its constraining effect on protection is already remarkable. For a good understanding of the political economy of trade policy, it is necessary to indicate very briefly the factors facilitating GATT's emergence, the historically unique acceptance of GATT commitments and the enormous growth in membership. The emergence of GATT was greatly facilitated by at least four factors:

- initially, all the main players shared to an appreciable extent the same market-oriented philosophy
- the players were relatively few in the beginning
- perceptions of participants were strongly influenced, initially, by two threatening alternatives (the 1930s and communism)
- the US had a hegemonial position and used it to some extent (while not abusing it initially).

The widespread acceptance of its commitments can largely be explained by the combination of strong leadership of the US, with six 'soft' properties of the GATT, reducing significantly the political costs of 'lost' autonomy or discretion for all Contracting Parties:

- there is no obligation to reduce protection; only the forms of protection are circumscribed
- the negotiations to actually reduce protection were fully discretionary decisions, and, moreover, were based on two principles (most-favoured nation treatment and reciprocity in bargaining results) that made free riding unattractive (yet, not preventing it altogether)
- there were many exceptions and safeguard/escape clauses making adherence less costly domestically
- the Agreement remained incomplete in many respects
- 'grandfather clauses' prevented a disruption of the 'stock' of protection of founding participants
- monitoring compliance was not accomplished by means of judicial review but through low-key diplomatic 'panels' or plain political negotiations.

The expansion of GATT membership was made possible by a depreciation of its public good character:

- new players were accepted by bending the rules or making exceptions especially for them, without any

obligation to eventually obey the rules
- new, vague Codes were adopted that created unsolvable compliance problems and, moreover, were neither adhered to by all Parties nor by a fixed subgroup.

That tariff reduction was so successful globally and that quantitative restrictions disappeared rapidly (though not entirely) during the 1950s should be attributed to the hegemonic role the US continued to play until, say, the late 1960s, both in the GATT framework (by means of Rounds) and outside (in its OEEC initiative, and bilateral relations with European countries, Japan and others). By the late 1960s, each player's stake in the system's maintenance had increased enormously, which is another way of saying that free riding for every country had become costly, as it would put at risk the other countries' commitments to keep markets open for the exports of the free riding country. Also, the gains of free riding were perhaps not so high in a time of economic growth and fairly tight labour markets, relative to the apparent gains resulting from the prevailing macroeconomic policies.

Participation in GATT in fact implies that a Contracting Party has accumulated a stock of commitments of a general nature as well as specific ones ('concessions') from other Parties in exchange for which it has made similar general commitments and a set of specific ones ('bound' tariffs, codes, etc.). The significance of the stock of GATT-related commitments for mutual market access becomes only intelligible if one relates it to the stock of available protectionist measures. The latter stock is not constant since bureaucratic, legal or political inventiveness may add new instruments without formally affecting the stock of GATT-commitments; variation is also possible with respect to product coverage and the number of trading partners. Trade policy at the national level can be defined as the alteration of the two stocks, autonomously or in negotiations with trading partners dependent on the various international constraints. Alterations of the GATT-related stock are difficult. The general commitments (i.e. the rules of the Agreement) have been regularly changed but only to facilitate membership for socialist countries or developing countries or to create plain exceptions to basic GATT principles. No new general commitments have been added that ipso facto would have further reduced national trade policy autonomy. Autonomy was decreased somewhat

(ceteris paribus) by precise procedural requirements for certain actions such as anti-dumping measures or customs valuation. The specific commitments have of course greatly increased over seven GATT Rounds, and occasionally due to unilateral liberalization (i.e. foregoing reciprocity, as Germany did in 1956/7 and Japan several times in the early 1980s). A decrease of the stock of specific GATT commitments has not been on the multilateral agenda and is very difficult unilaterally (the GATT prevents an autonomous decision to affect the stock of market-access commitments, in particular to raise (bound) tariffs and decrease quotas; this ratchet-effect is essential to prevent free riding within the GATT framework). Over the years transfers of unbounded instruments (from the national stock of autonomous measures) to the GATT-related stock has become increasingly difficult. Since tariffs came down and many quotas disappeared, the remaining national stock shrank drastically. Like a spring, resistance grew with continued reduction. Also, the incentives to invent new, autonomous instruments - not affecting the stock of commitments by others - increased. Since there is no judicial review in the GATT, this evasion of rules cannot be tested against general principles of trade law, unlike for instance the 'commerce clause' in the US constitution or the prohibition of 'measures with equivalent effect as quantitative restrictions' in the EEC Treaty (Art. 30). As is demonstrated by the process of market integration in the EC, authoritative judicial review is indispensable for a transfer of competence to be credible and not to be eroded.

A market for trade policy measures?

Given the GATT constraints, trade policy measures can be seen as the outcome of 'demand' and 'supply' factors in the national process of policy-making. The demand for free trade and for protection has long been recognized as originating from pressure groups of specific 'classes', sectors or enterprises. This tradition in economic history has meanwhile been enriched by a quickly growing literature built on public choice analyses, including empirical tests of the determinants identified in this literature. These approaches are heavily biased towards protection; they tend to ignore the possibility that (reciprocal!) trade liberalisation can also have, in part, a private-good

character.

Free trade is conceived as a public good for which the median voter would vote, were it not for other pressures, etc. Furthermore the incentives to press for free trade, say, with consumers, are much weaker than for import competing industries to lobby for specific protection, and capturing the rents (and this the more exclusively, the harder entry in the sector and the more industry-specific labour skills are). It is correct that consumer unions would have to incur high transaction and monitoring costs if they would wish to prevent numerous product-specific measures that may signify only a miniscule reduction of the individual household budget (that may itself increase due to economic growth). Although these arguments are convincing, they do not exhaustively deal with the matter. First, pressures for free trade or against protection need not only come from consumer unions. Additional pressures may well arise from user-industries, shop-chains, wholesalers and large stores that may be more effective in their lobbying. Second, once enmeshed in a network of trade interdependence, backed up by efficient communications, export interests will ramify through the economy and tend to resist protectionist trends. The requested supply of protection must either affect the GATT-related stock of commitments, the costs of which would be enormous or add to the national stock of autonomous measures but even then given trade flows will be affected, causing frictions with other countries. Thus, in a well-established (though far from perfect) trade order having engendered a network of interdependencies, the supply of protection or even the threat of it will be signalled rather quickly and this will lead to pressures from other countries and from domestic export interests to forego the measures. It is usually argued that domestic concerns are raised in a general fashion and that this is no match for the greater resources (giving expression of the greater incentives) of protectionist lobbies. Again, this is not always correct. Thus, multinationals with a large amount of intra-firm trade and with procurement all over the world will have relatively great incentives to lobby in favour of freer trade. (5) In a remarkably effective way the multinationals Philips, Ford and Fiat have recently launched campaigns for the so-called 'completion' of the Internal Market of the European Community, a highly ambitious form of free, non-distortive trade among Member States.

The supply of liberalization and/or protection can be

related to the objective functions of the two domestic actors: the politicians and the civil servants. Both, but particularly the latter, will be profoundly aware of the stock of GATT-related commitments, and the advantages for the economy as a whole drawn from it. In case of a specific demand for protection, they would tend to begin with considering this stock as a given constraint and merely reflect on the possible use of the autonomous stock. Whether they would in fact supply protection or not is determined by very many possible elements in the objective function, that may differ over time, between countries and between types of economic order. Also, the constraints from diplomacy or counterpressures from abroad may differ between small and big countries and between countries having a small autonomous stock and a large one (i.e. different traditions, creating different perceptions about the marginal utility of counterlobbying). Concentrating on additional protectionist pressures (and ignoring solid elements of the autonomous stock such as US protection of shipbuilding and shipping or the EC's Common Agricultural Policy), politicians are likely to employ, what Corden (1974) has called, a conservative social welfare function: 'any significant absolute reductions in real incomes of any significant section of the community should be avoided'. In a time of economic growth, full employment and moderate inflation, trade policy protection either need not be supplied or can remain flexible and temporary since natural decline and intersectoral mobility may prevent negative political effects. In the last ten years or so, unemployment has gone up considerably while economic growth has no longer been secure. Given such a social welfare function, pressure for protection is bound to increase sharply in declining sectors and it becomes politically less unattractive to respond positively. This could possibly be related to financial instabilities.

Complications

At that point it is important to distinguish the discretion at the political level, given the actual assignments of competences in the country, as compared with that of the civil servants, and, where relevant, the courts. The stock of GATT-related commitments is 'managed' differently, in Japan, the EC and the US, as well as in many LDCs. In

Japan, the bureaucracy is overwhelmingly dominant and highly discretionary and there are few serious possibilities for legal (or political) redress. In the EC the stock is managed by the EC Commission (with redress at the Court in anti-dumping and countervailing duty cases only) but its discretion is severely diminished by the lack of an EC customs and at times insufficient cooperative attitudes of Member States. Still, the surveillance of the Commission (and the Court) - with the purpose of maintaining the 'unity' of the common market and the credibility of the EC institutions - helps considerably to adhere more scrupulously to the stock of GATT-commitments. In the US trade policy is much more politicised, given the district system, the two-year rotation of parts of the Senate and the permanent struggle between the executive and Congress. In fact, the general GATT-stock is a problem in itself as it is an 'executive agreement' of the president. On the other hand, where elements of the stock have been adopted in US law, the process is highly legalized and technical, with only the final decision in the hands of the executive again. Thus, whereas stability of the formal GATT-stock is not at issue in Japan or the EC, this is less certain in the US. It is obvious that both demand and supply incentives will then differ.

There is of course the possibility to add to the national, autonomous stock. But here domestic constraints in the US are much greater than in the EC or Japan, for two reasons. First, the economic orders of the three are distinct, with domestic interventions supplementing or substituting border measures in Japan and the EC, and only rarely so in the US, except for public procurement. The degree in which this supplementation or substitution takes place is itself highly discretionary. Hence, in the cases of Japan and the EC it is much more difficult to assess the variations of the autonomous stock than in the US. A difference between the EC and Japan is that the former subjects Member States to an additional constraint that can be very severe in some cases: judicial review of autonomous measures by the Court of Justice of the EC, for reasons of distortion of competition and/or breaking the unity of the common market. Outside the EC it is insufficiently realized that EC judicial review of domestic interventions and border measures serves in fact as a formidable handmaiden to the GATT. Second, in declining order of importance the US, the EC and Japan will encounter legal and institutional

obstacles when adding to the autonomous stock of protection. Although in Japan this resistance is least impressive, one should not ignore it, as became clear during the recent wave of liberalisation programmes that entailed a flurry of legal adaptations, amendments and new laws. Again in the Community the 'acquis Communautaire' and the cumbersome decision-making in the Council of Ministers create considerable barriers that have to be overcome before addition to the stock of protectionist measures can be achieved. However, this is hardly true for numerous implementation measures and parts of dumping/countervailing duty procedures that leave some discretion to the Commission.

In contrast, the US drive for 'juridification' stands out as a more rigid obstacle against political catering for special interests and against backdoor-deals. (6) One drawback is that the tail-end of the procedures being political tends to enhance rather than decrease 'politicisation'. A subtle but much exploited disadvantage is that enterprise initiate cases through formal, technical procedures in the firm knowledge that this will put a strain on US commercial diplomacy.

General and perhaps somewhat abstract as these arguments may be they explain quite well the popularity in the US of the 'bicycle theory' of trade liberalisation. According to this theory, GATT Rounds are needed to withstand domestic demands for protection: if the 'bicycle' of trade liberalization would stand still, it would fall.

At civil servants level the starting point will naturally be to consider the constraints of the GATT-related stock of commitments as given. The experienced trade diplomats and civil servants in the capital will frequently associate themselves with these outcomes and will try to avoid undermining these arrangements. With greater politicisation, however, this is no longer necessarily so. Congressmen or parliamentarians will wish to be seen as defenders of a regional/sectoral cause and pressure may build from logrolling and other deals. If legal/technical procedures will be completed and political decisions (say) on anti-dumping/countervailing duties will have to be taken (by the US president, or the EC Council of Ministers), the 'neutral' establishment of injury must be overridden in the 'general' interest and the subsequent frustrations of the defied lobby may well spill-over to the broader political arena.

On the other hand, trade policy in the EC is anything but transparent, except on truly big decisions. The European Parliament has hardly any role. Hundreds of trade policy decisions remain not well or not explained, whether by Council or by the Commission. Refusals of protectionist requests remain unknown to the public. Politicisation of trade policy is much more indirect and muted in the Community than in the US because

- it basically occurs through 12 national political processes
- every national government has the magnificent excuse of having been overruled in the Council (which is almost always true to some extent, of course)
- Member States dispose of considerable discretion to employ various domestic interventions so as to compensate the prudency at the Council level.

Thus, the US administration will embrace broad international initiatives that enable it to keep the domestic political pressure at bay, particularly because the administration can point to the good intentions of trading partners if they join a new Round. The EC on the other hand, is handicapped by its confederal mechanisms of decision-making to engage in new GATT Rounds while also being much less motivated because its trade policy is fairly steady and the variations in its autonomous stock are subject to intra-Community surveillance policies, infringements procedures and temporary exemptions, that render further compromising extremely difficult. (7)

It is only in this broad perspective of demand and supply of trade policy measures, constrained in complex ways by GATT-related commitments and complicated by differences in domestic political and institutional traditions, that the specific question about the influence of financial instabilities can be meaningfully addressed.

HOW INSTABILITIES MAY PROMPT PROTECTION

The actual objectives of trade policy are usually highly specific and remain all too frequent implicit. General trade policy declarations of the major players in world commerce are exceptional and the pronounced aims usually take the form of intentions or broad guidelines of conduct, while

testifying to their adherence to the principles of the multilateral trade system and to the latest communiqu* of the Western Economic Summit. That prime minister Nakasone is espousing free trade objectives in a permanent campaign is well known. But major speeches of President Reagan (8) and EC Commissioner De Clerq, (9) for instance, are equally firm. The communiqu*s of the Summits give short shrift to any plea in favour of protectionism. No less than 24 ministers have subscribed to the annual OECD trade pledges since 1974. But also various GATT and UNCTAD fora have repeatedly adhered to firm declarations about the necessity of freer and free trade.

Revelation of objectives therefore requires careful study. A few observations can nonetheless be made. Across-the-board protection is sometimes defended (and more frequently practiced) for development purposes in LDCs but most rarely in developed countries. This stylized fact puts the central question of the paper in a peculiar light. If financial instability can be considered as a macroeconomic phenomenon, (as we do in this paper) should one not expect policy reactions of a macroeconomic character rather than piecemeal measures at the product level? Apart from the academic and widely-rejected plea by the (English) Cambridge Group for across-the-board protection for the UK, which was not primarily prompted by financial instabilities, the only important and admittedly dangerous instance is overvaluation. In the early 1980s this was a US dollar problem. However, the threat of the US surcharge seems to have passed and, in any event, the idea was firmly rejected by the Reagan administration. It turns out that one must focus on more indirect processes in which financial instability affects certain interests disproportionately (in some political sense) that in turn, may engineer effective campaigns to obtain protection.

Microeconomic objectives of trade policy such as sectoral employment (or its rate of change), intersectoral income redistribution, a certain 'security' of domestic supply, infant industry development, but also low prices to consumers and users, a measure of competition and the improvement of technical efficiency of enterprises can all be affected by financial instabilities. There would be no need for the objectives to change but rather, given the present level and structure of protection, one would expect the pursuit of these implicit objectives to be disturbed, leading trade ministers to budge on occasion and provide for

protectionist relief. As suggested by the political economy approach this provision is influenced by pressure groups but in a varying and complex context that permits little generalisation.

Exchange rate volatility

Empirical economic analysis has failed to establish a negative impact of exchange rate volatility on the volume of aggregate trade. (10) This continues to raise eyebrows with many prominent policy-makers (11); it goes against theoretical expectations and against what were once widely perceived as the policy lessons from the 1930s. One should add that the conclusion does not go entirely unchallenged: there are studies focusing on bilateral flows or on somewhat longer-term fluctuations providing some support for the thesis that there is a negative impact on trade volumes. (12) But the longer-term the fluctuations are, the more the problem shifts to one of currency misalignments which has long been recognized as costly in several ways. While perhaps deterring the marginal, unexperienced trader - for reasons of information and transaction costs - international business seems to cope quite well with (short-term) exchange rate volatility through hedging, intra-firm denominations in one currency and long-term supply contracts. Thus, there is probably little systematic business pressure to reduce short-run volatility as such or to introduce trade policy measures to cushion its effects. The major exception is within (potential) currency blocs where countries are not merely open but openness is concentrated on a few trading partners so that volatility may cause much wider swings in profits (given the maintenance of trade links, which are unlikely to be severed) that may hamper investment. Within the EC, scale-driven production of components or final products may lead to export/output ratio's of enterprises of 50% or higher and the resource costs of alternating lay-offs and overtime as well as mistaken (expansion) investments might well be intolerable. Of course for such open economies volatility would also, and primarily affect the capacity for macro-economic stabilisation, and hence the case for exchange rate stability (not: fixity) within the EMS. A recent paper by de Grauwe and de Bellefroid (1986) has studied long-run variability of (real) exchange rates, on the basis of yearly data. The

authors claim that, whereas short-term volatility assumes properties of insurable risks, long-run variability has more the character of a not-insurable form of uncertainty. The authors found that some 20%-30% of the observed decline of the growth rate of international trade among industrialized countries (1973-1984) can be attributed to the substantial increase of the long-run variability of real exchange rates (as separate from trade integration effects and output effects). The appropriate response is of course to reduce volatility in the yearly trends and this cannot possibly be an assignment for trade policy. The implied uncertainty, however, is likely to have added to a worsening of the economic climate and this might indirectly have contributed to greater pressures for protectionism.

Currency misalignments

The contrast of currency misalignments with exchange rate volatility is sharp. Exchange rate volatility over short time spans may create some (ex-ante) risk about future spot rates, and hedging may obviate most of it. The longer a certain apparently over/undervalued spot rate can persist the more it will begin to erode/augment competitiveness of all export sectors. Ultimately, it may turn export sectors into import competing ones (or the opposite) and capacity utilisation rates may suddenly fall, causing losses and unemployment (or rise, and causing rationing and specific labour shortages). In the case of undervaluation, one would expect protectionist pressures to ease and liberalization to be promoted. This might explain the very positive response of EC countries to the Kennedy Round cuts, proposed by the US: EC countries ran trade surpluses during most of the 1960s. More striking examples are the unilateral liberalisations of Germany (1956/7) and Japan (early 1980s) that one might perhaps explain by undervaluations of their currencies at the initial level of protection.

The politically worrying scenario is, of course, overvaluation. Import competing sectors with small profit margins as well as traditional export sectors (especially those with relatively homogeneous products) will be severely hit. In a climate of prevailing unemployment this is bound to lead to a build-up of protectionist pressure. The disquieting contribution by Bergsten and Williamson (1983) sets out a ratchet effect of higher protection as the left-over of each

round of temporary but prolonged dollar overvaluation in the past. But it would be mistaken to think that this is a typical US phenomenon. Countries may employ trade policy to put a brake on depreciation or prevent incipient devaluation: Italy's infamous import deposit scheme of 1974 and France's initiatives in the autumn of 1982 can be mentioned. This seemed to bring to life Art. 12 of GATT in a flexible exchange rate system, not unlike when the UK maintained a surcharge on imports after 1964 in order to prevent the 1967 devaluation, but then in a pegged exchange rate system. Nevertheless, one has to separate purposefully macro measures (such as Wilson's surcharge in 1964 and Italy's scheme in 1974) from a greater inclination to use protection on a case-by-case basis at the micro level (US, in the early and mid-1980s; France, autumn 1982). The first ones were perhaps consistent with GATT although the instruments employed were not; the second ones were clearly additions to the autonomous stock of protectionist measures.

Developing countries frequently maintain a curious combination of overvalued currencies (due to heavy trade and financial restrictions) and very high tariffs. Both export-led growth and fiscal targets may well be served better by substantial depreciation and quotas with much lower tariffs. But there is little evidence, it seems, that such misalignments are related to system-wide financial instability. (13)

In all likelihood, trade policy does not normally encompass macroeconomic objectives and this does not change with misalignments. The root of the problem is that the combination of the monetary/fiscal policy mix at home and abroad is difficult to alter, which is to say that the domestic monetary/fiscal policy mix takes a sacrosanct priority for dogmatic or non-economic reasons. When the political costs of this policy rigidity appear to become (too?) high, the incentives for politicians to be seen as 'active' will increase, with the consequence that protection might be employed as a last resort. But it will be selective protection, with the choice of sectors being a function of the overall size of the sector (i.e. number of jobs), the concentration of the industry, the resources invested in lobbying, the spread over regions in the economy and the rate of increase of import penetration (not necessarily the degree of import penetration). Clifton (1985) employed industry-specific real exchange rates for the industries textiles, clothing, steel and transport equipment and found

that the real value of trade and the real exchange rate (as defined) are significant determinants of the import penetration ratio for the US and Germany. By employing his equations but keeping the import volume of an industry as given (because of volume protection), the author shows that increasing demand can generate high rents. Telling is his example of the 1983 records profits of the US car industry on a sales volume similar to that of 1980 (when large losses were made): in fact, the depreciation of the 'shadow' real exchange rate of the car industry amounted to roughly 25% by mid-1984, when using Clifton's analysis. The five factors mentioned for the choice of sectors clearly apply for the car industry, of course.

The nature of the instrument will depend on the relevance of GATT-related commitments, the tradition whether or not to employ domestic interventions and the retaliatory power of the main exporting countries. Voluntary export restraints (VERs) are of course an ideal candidate in political terms because they do not entail budgetary costs, are not formally infringing the GATT-commitments, provide rents to the exporting countries and are temporary which means that the later depreciation will obviate explicit renewal. Still, there are many degrees of stringency of VERs. Some may so drastically curtail import penetration on the basis of 'permitted' market share that they may well create political entitlements in the future (steel in the US). Rather than merely adding to the autonomous stock of protection and not effecting the GATT-commitment not to impose quotas, such strict VERs are in fact imposed and assume all the inimical properties of traditional quotas (i.e. a rising tariff equivalent with increasing domestic demand; no adaptation over time; no moderation of import growth but a plain ceiling in volume terms). It is hard to convince other countries, in such cases, that GATT-commitments are not infringed. This fact alone undermines the very foundation of the trading order: no free rides on the stock of GATT-related commitments.

The costs of overvaluation can therefore be high on two accounts: first, the perception of GATT Members that GATT is incomplete will strengthen because the stock of autonomous measures of the country with the overvalued currency will quickly grow; second, and dangerous indeed, the conviction will spread that the GATT-stock of commitments is seriously imperfect in preventing free rides.

Debt crisis

The debt crisis is, of course, a general label for a complex set of sequential as well as interacting phenomena. Yet, it seems a tenable proposition that 'the' debt crisis has strongly influenced trade policy objectives in developing countries and hardly those in developed countries. The most immediate impact is straightforward: many LDCs, and particularly the heavily endebted one, have been forced to employ trade policy for the generation of large trade surpluses in very short time periods, as from 1981 or 1982 onwards. Much of the burden of this emergency adjustment has fallen on the import side, by means of tightening quotas or by imposing import bans (or/and sharp devaluations). At the same time LDCs have made desperate efforts to augment exports, or at least to sustain them, both in North-South trade and in South-South trade (oil, especially). They have employed various instruments to achieve this, against the tides of falling aggregate or specific import demand in the OECD (especially Western Europe), for example such as countertrade and covert export subsidies.

The response of developed countries' trade policies to the debt crisis has been purely at the declaratory level. It is only too obvious that the debt servicing capacity of LDCs is seriously hampered when OECD countries maintain or increase protection, even more so if this protection is biased towards comparative advantage goods for developing countries. Thus, statements to this effect have appeared in the communiqués of all the major gatherings of the IMF, World Bank, GATT and the OECD as well as in those of the Economic Summits of the Seven (plus the president of the EC Commission) for several years. But the very same institutions (and UNCTAD) have all published attempts to measure or assess current protectionism and their unanimous conclusion is that it has increased (see further), particularly vis-à-vis exports of developing countries. Hence, the most favourable inference would be that the assumption of a firmer stance against protection for reasons of the debt crisis (and its repercussions on the national commercial banks, or the financial system at large) has merely helped to put a brake on the rise of protectionism. But even that conclusion is hard to accept, except perhaps in a few bilateral cases between the US and Latin American countries.

That there is unlikely to exist a firm link between trade

policy objectives and the debt crisis in the case of developed countries is also apparent from export promotion policies. Whereas one would expect export credit subsidy rates at least not to decrease and risk classification of countries not to change so as to avoid adding to the financial burdens of endebted countries, it is clear that precisely the opposite happened, in response to frictions among OECD countries themselves and domestic pressures to reduce budget contributions to export credit institutions. (14)

In theory the Baker plan may alter this. The $20 billion additional private lending and the $9 billion additional multilateral agencies' lending is unlikely to remove the earnestness of the debt crisis. Reducing interest rates may well be more important. But it cannot be denied that the Baker plan is a kind of U-turn of great symbolic importance. The US at least is no longer in a position to disregard the debt problem in any policy, certainly not trade policy. Moreover, a crucial element of the Baker plan is the adoption of comprehensive macroeconomic and structural adjustment perspectives, which is propagated as a significant move towards 'market-conformity'. It would be more than embarrassing if the US - but other countries of the Group of Ten as well - were to increase protection on exports of heavily endebted countries that have accepted to let markets and comparative advantages work. If, of course, the Baker plan will be supported in Congress.

Macroeconomic policy failure

The question may arise what precisely the 'financial instability' is if one associates it with macroeconomic policy failure (in the sense of undesirable peaks in inflation, unemployment or both). After all, exchange rate volatility may well be the result of different rates of inflation with differential changes over time, especially if interest rates in various countries are also volatile. Similarly, currency misalignments are likely to be related to policy failure as well. The debt crisis itself is undoubtedly a consequence of irresponsible macroeonomic policies in many LDCs, particularly with respect to the financing of budget deficits.

Of course it is impossible to address all these relationships in this paper. No matter why macroeconomic policy failure has arisen, it can be argued that

- high inflation, in combination with great political priority to keep unemployment at least stable (if not, decrease it), will tend to lead to 'vicious circles' of depreciating currencies that will augment inflation even further, whereas monetary contraction could only prevent that at the cost of giving up the unemployment targets; in such circumstances, depreciation can be slowed down by protection (and capital flow controls);
- high unemployment significantly raises the costs of adjusting to the permanent shifts in the world division of labour; Corden's 'conservative social welfare function' may well be amended in Europe by substituting job-losses for income-losses (given social security commitments). Apart from the so-enhanced political sensitivity to additional unemployment, the economic case for maintaining free trade weakens considerably (in the short run) because static welfare gains might be offset by adjustment costs. This would seem to apply especially to workers with industry-specific skills who might have no prospect of finding jobs unless they discount career-ruptures and accept serious wage decreases (and even then it may be difficult). In such a climate, protectionism - especially in the form of domestic interventions or VERs - may be difficult to resist politically.

During the 1970s, high inflation has been a recurring problem in many OECD countries while unemployment increases were contained by accommodating policies (except in countries like Switzerland and Germany, and Japan). European countries like Italy, France and the UK employed capital export and other exchange controls to avoid a depreciation determined by the capital account. In addition Italy employed protectionist trade measures of a macro-character such as the import-deposit scheme. Also indirect mechanisms might have been at work. One might surmise that countries caught in the vicious circle for a while (Italy; the UK) might have suffered more than proportionately from longer-term exchange rate volatility, which is costly within the EC. With hindsight it can be observed that intra-EC trade growth sharply fell after 1973 and never really returned to the rates of the 1960s. This may have contributed to the decreased willingness to invest, caused by uncertainty about future domestic inflation as well as the future prices of exports in other EC countries. In turn,

economic growth and employment might well have been lower (c.p.). Furthermore, to the extent that depreciation was slowed down, external competitiveness must have worsened which probably led to increased pressure for protection in ailing industries.

At present inflation is disappearing in OECD countries and, after some spectacular money and price reforms, decelerating in Latin America. Western Europe's problem today is that of unemployment at a rate of 11%-12%, with room for fiscal stimulus in some countries (Germany) and certainly not in others (Italy, Belgium, Netherlands, Ireland, Greece, Spain) given large budget deficits. The latter deficits are higher as a % of GNP than at present in the US. Japan does not suffer from policy failure as defined here. The US inflation is low and unemployment is not alarmingly high; with a much lower dollar and (slowly) falling interest rates, both exports and related investments may pick up soon.

The early 1980s have witnessed good old Keynesian fiscal stimulus in the US (starting, however, from a small budget deficit), decreasing unemployment (and increasing employment even faster), compared to contractionary policies in Europe leading to soaring unemployment that has stabilized only recently under the influence of a growth rate of around 2.5%. As noted above, high inflation has been unable to prevent unemployment to rise already in the 1970s and it may indirectly have contributed to its increase. The severely disinflationary policy-shock after 1980 led to a sharp increase in business failures. With stagnant or declining demand in many low- and medium-tech sectors - high-tech sectors continued to experience buoyant demand, even during the recession (15) - rising import penetration is equivalent to shrinking domestic market shares and negative growth of sales. Since initially, the US was also in recession, export outlets had to be found in third markets such as LDCs that had just begun to cut back drastically on imports (especially in capital goods and up-market, high quality goods). The need for adjustment - frequently already delayed by subsidies in sectors such as steel, textiles and clothing, synthetic fibres, cars, leather, shipbuilding - could no longer be concealed and the only way out for the sectoral interests was to sharply increase the demand for protection. The arguments used by politicians to supply at least some protection reflect the amended social-welfare function, especially since labour-shedding in the ailing sectors was

taking place at much higher speeds (16) than before. Thus, it could be maintained that, while adjustment was necessary, various protectionist means (subsidies and VERs, mainly) had to be employed to render the rate of job-losses socially acceptable. France added nationalisations to its armoury of instruments with the clear intention to be 'in full control' of the rate of forced labour exit.

Still, the relation is not permanent, but short run. 'Positive adjustment', market conformity and supply side policies became more and more popular as unemployment continued to rise, or refused to decline. Austerity programmes were launched in France, Belgium and Denmark, privatisation programmes were attempted in several countries and the EC Commission began to be much more severe in its subsidy surveillance. Capacity cutbacks in the EC steel sector were accepted together with an ad hoc subsidy code, leading to rapidly falling subsidies in steel. The Multi-Fibre Agreement, number three, was still adding further restrictions on the part of EC countries, but today's EC position is less protectionist. The sensitivity vis-à-vis Japanese exports increased during the 1980s but it may be questioned to what extent the general unemployment situation plays a role here. The European car market is quickly approaching saturation so demand will not grow very rapidly any more. This implies that Japanese import penetration has sharply increased the overcapacity problem of the EC car industry which has led to a battle about market shares. The subsequent losses have been covered by subsidies in some cases, helped by VERs on a national basis. Adjustment by further concentration, robotisation, greater reliance on subcontracting and new materials is under way. Volume protection in Italy (vis-à-vis Japanese car exports) predates the recent unemployment crisis by twenty years, and the British VER is from 1977. The French VER is from 1981 but has ultimately not prevented labour-shedding. Therefore, it would seem that pressure group characteristics (such as a sector's large employment; high concentration) have determined the supply of protection much more than overall unemployment. In consumer electronics labour exit has been low (but employment growth negative) and the problem is predominantly one of highly specific Japanese export drives that make European R&D investments worthless and threaten the retention of specific advanced technologies.

PROTECTIONIST TRENDS AND IMPUTABLE FACTORS

There is widespread concern that, while tariffs are reduced further to uninteresting levels with every GATT Round, non-tariff protection is steadily on the rise ever since the early 1970s. Can one maintain that this increase is to some extent due to protectionist pressures arising from financial instabilities?

There are at least three important reasons to cast serious doubt on the notion of 'protectionist trends'. First, non-tariff protection is difficult to measure or even to detect. What we know about non-tariff measures has not been constant over the last one-and-a half decades, but drastically improved from very poor levels of factual information in the beginning of the 1970s. In Anjaria et al. (1985, Table 8, pp.106/7) 29 broad types of non-tariff instruments other than quantitative restrictions are listed, which have been notified to the GATT. The list contains broad categories such as 'restrictive practices', 'technical barriers general', 'technical regulations and standards', and 'emergency action' which are impossible to interpret economically without a great deal of detailed information. How can we assess these notifications over time, in response to, say, financial instabilities? Furthermore, categories such as government aids, government procurement, exchange controls and state trading comprise enormous ranges of discretion; actual variation in the intensity of use is impossible to come by with present methods of monitoring and comparative (non-)description.

Second, the crude proxies that have been employed in despair vary so widely that inferences become very hard to compare. Consider the following selection of frequency indices taken from Anjaria et al. (1985) and OECD (1985):

- UNCTAD and the World Bank have found that industrial countries applied non-tariff measures to 13% of their imports (incidence weighted by world trade; specification of barrier at the 4-digit product level)
- Balassa and Balassa found a coverage of 6%, 11% and 7% of imports for respectively the US, EC and Japan, which is lower than the UNCTAD measurement; over 1981-1983 6½% were added for the US and 4% for the EC. Surprisingly, liberalisation measures during this period were ignored.
- Cline found much higher percentages of imports

covered: US 45%; Germany 28%; France 40%; the UK 26% and Japan 22%.

- Page employed the term 'managed' trade: already in 1974 she found a coverage of 40% for 122 countries. Another 8% were added by 1980.
- Japan and four East Asian NICs saw 15% of their 1980 exports to OECD countries somehow restricted by non-tariff means and 32% in 1983.

Other detailed attempts can be found such as UNCTAD (1985, Table A.9) for 145 4-digit products imported into industrial markets, with 19 distinct barriers indicated.

The point is that, if the level of protection in terms of measures described, is so difficult to establish, it is not possible to make general empirical statements about the increase of protection supplied in such a way that it can be meaningfully related to financial instability. What we need is more standardization and more sophistication in the measurement of protection over time. Recent work in the World Bank might perhaps constitute the beginning. In Finger and Olechowski (1986) it is claimed that the import value for industrial countries covered by (their) non-tariff barriers has increased from 17.3% in 1981 to 17.6% in 1984. When decomposing this very small increase, they find, however, that new barriers added 2.4 percentage points (a weighted average of 1.5 for intra-OECD trade and 2.6 for North-South trade) while eliminated barriers subtracted only 0.6 percentage points. So, a net increase in barriers can be found. At the same time, imports subject to non-tariff barriers increased less rapidly than other imports so that their share in total contracted: this is the reason for the very small import-value increase of 0.3% over the three years. The question thus shifts to the reasons behind the growth differential in import value: is it due to the restrictive effects of protection, to sectoral demand differences or to falling (relative) prices?

Third, the economic incidence of non-tariff protection is badly known for two reasons. Except for very large industries, information at the product category or product group level is not available to make even the roughest estimate. But a second reason is much less recognized: many formally existing measures have no or virtually no restrictive effects, either because they are not enforced (!) or because demand and/or supply factors make protection irrelevant. Examples of the former may be found in the EC

where a number of national quota remain formally within the 'reserved' powers of Member States but have not been enforced since 1970. (17) Also the infamous 'surge mechanism', introduced into the Multi-Fibre Agreement (MFA) n° III on the insistence of the Community, has in fact never been invoked in the four years since 1982. With respect to the second factor, subsidies in Member States have occasionally been disbursed two, three or four years after the demand for protection had politically been granted. The EC steel quotas for Brazil, Rumania and South Korea (the only three LDCs having quotas under the 'crisis' regime) have never been filled up to 80%, but usually far below 50% (compared with near 100% for their export quotas to the US).

This scepticism on the proper reading of protectionist trends should not be interpreted as downplaying the dangers of protectionism or the strong intuitive assessment that the supply of protection has increased. But with the trend assessment being hazardous, the imputation to specific causes becomes even more difficult. I shall briefly discuss a few instruments and relate the four manifestations of financial instability to them, where relevant, for the case of the European Community.

Voluntary export restraints

The EC and/or its Member States have introduced new VERs since 1979/80 in a number of sectors, but highly targeted to specific countries. Japan has been hit in early 1983 by Community VERs in ten products ranging from cars and forklift trucks to motorcycles, quartz watches and video-tape recorders. However, these 'agreements' are only loosely monitored and regularly 'discussed' in bilateral meetings, with one notable exception: video-tape recorders, which has been subjected to what in fact amounts to quota protection. In cars, motorcycles, steel and colour TV tubes these are (or were already) backed up by one (or two) Member States having imposed quota protection, sometimes dating back to the mid-1970s or even earlier. It is highly unlikely that exchange rate volatility or overvaluation has played a role. The debt crisis being irrelevant here, one is left with the general unemployment problem as a possible reason. As noted for cars and consumer electronics this argument is at best subsidiary to specific reasons of insufficient sectoral

competitiveness, caused by insufficiently apt management and sluggish adjustment. Unemployment does, of course tend to put a brake on adjustment as resistance against lay-offs will be even greater both within firms and at the political level.

Other VERs refer to a few highly specific cases against South Korea and Taiwan (footwear, for instance) and the steel sector (where especially Spain was badly hit). In steel, (regional) unemployment has been the dominant reason and a host of measures has been cumulated, of which VERs - coupled to a basic price system, minus 6% - were meant to allow maintenance of 'existing' trade flows. But there is profound awareness at Commission and Member State level that even a high rate of economic growth and decreasing unemployment will not but marginally improve capacity utilisation. Hence, capacity reduction must go on. These decisions are entirely politicised (witness Belgium, Italy and France) and progress will therefore be slow, no matter what can be achieved in terms of job creation more generally.

Quotas

In the European Community quotas tend not to have emerged in response to financial instability, with one curious exception. In 1980 the Council authorized the UK to restrict temporarily the import of synthetic carpets from the US on account of three factors reinforcing each other for a brief period: a very low dollar, a very high pound (risen sharply vis-à-vis the ECU since the beginning of the EMS) and subsidised user rates for natural gas in the US.

Within the framework of the MFA the EC had tightened the bilateral quota regime in 1976/7 and 1982 in terms of import growing rates and raised the number of countries covered, in response to rapidly rising import penetration rates. Since 1982 import penetration has risen again quite considerably and labour exit has increased - partly because of adjustment - yet the present negotiation position of the EC has eased. Unfortunately, this does not mean that protectionist sentiment has disappeared as Turkey (with rapid export growth in textiles) and Bangladesh (with export success in a few clothing products only!) experienced in 1985/6. Outside the MFA, the remaining quotas in the EC Member States amount to a fixed stock of political 'entitlements' that are hard to remove but also hard to make

more restrictive. Since early 1982 the EC Commission attempts to change them into Community quotas (with the apparent hope of softening their impact as well) but progress hitherto has been strictly formal.

Subsidies

The major response to adjustment problems in the EC is to give or maintain subsidies. There is no doubt that subsidies have increased enormously ever since the mid-1970s (see, for instance, OECD, 1985). Significantly, there is no quantitative analysis available from the EC Commission with respect to the subsidy level, rate of increase, sectoral breakdown, etc. Only in the recent White Paper on the Internal Market (EC, 1985) the Commission has promised a report. It should be realized that subsidies are a much greater problem for intra-EC trade - stronger, even for intra-Member State trade - than for the external trade of the Community. Clearly, in a political economy approach to explain subsidisation as a means of supplying protection, the particular features of the (weak, but improving) surveillance of the Commission and Court need to be given much greater weight than the GATT Code or the threat of countervailing duties of the US. (18) Also, it is important to realize that subsidisation is on the decline in the EC, partly as a result of budgetary pressures at the national level, partly because apprehension about the subsidy waste has increased, partly because political preferences have shifted to subsidies to growth industries (so called 'pre-competitive' subsidies). With delay, the traditional economic preference for subsidies above border protection is weakly echoed here: eventually, the visibility of subsidies for the European tax payers generated some countervailing power to reduce them. Nevertheless, subsidisation is evidence of the conservative social welfare function in Europe and the discretionary and multivariate nature of subsidies will always appear attractive for national governments. The most effective way of dealing with it is therefore to strengthen surveillance at Community level and insert as much as possible in a GATT Code based on these criteria.

CONCLUSIONS

Financial instability appears to influence protectionism through indirect mechanisms, some of which are hard to distinguish from sectoral or structural changes that may happen to work in the same direction. Exchange rate volatility in the short run is probably not a major determinant of the demand for protection, but the longer a currency misalignment persists, the more rapid import penetration increases, and such 'surges' tend to lead to protection in particular industries. Choice of industries and nature of instruments can be understood in a political economy perspective, with due attention to differences in institutions and in the economic order among the US, the EC and Japan. A serious worry remains about its reversibility: if the misalignment is corrected, will the 'temporary' protection disappear?

The debt crisis, having led to serious additional trade restrictions on LDC imports, has not provoked concrete attempts to liberalize or at least stabilize market access of LDCs in the OECD. The problem may well be precisely that the debt crisis is conceived as a strictly financial phenomenon. However, debt rescheduling must be based somehow on export forecasts of the LDCs involved, and this must imply assumptions about future access to OECD markets. Yet, there are no mechanisms, as far as I know, that ensure some form of coordination of trade policies with official rescheduling programmes. In the crucial years 1983-85 this omission has been compensated by the overvaluation of the dollar, leading to surges of LDC exports to the US. Now that this bonanza is over, the problem may well come back although perhaps muted by the fall of the oil bill (but this would not apply to Mexico) and lower interest rates. Hitherto the awareness seems purely declaratory. In bilateral VER negotiations or the preparations on the fourth Multi-Fibre Agreement no connection with endebtedness appears to be made. In steel, for instance, Venezuela exports to the US were cut with some 60% in 1985, compared to 1984.

The fourth manifestation of financial instability - peaks of high unemployment and/or high inflation - has probably contributed to the protectionist climate although there are indications that longer-term unemployment is not preventing cautious moves towards renewed liberalisation.

Preventing financial instabilities is of course the best

way to avoid their inimical protectionist consequences. This is not the subject of this paper. However, one should not underestimate the difficulties of reducing exchange rate volatility and misalignments. If central bankers or Ministers of Finance 'talk the dollar down', possibly with marginal interventions, the market must have strong economic indications that this direction is basically sound. Can one expect a coordinated monetary policy in the Group of Ten? Would the composition of the 'world's' money supply be changed with a mere voluntary consultative mechanism? Is there no political economy of monetary policy, just like there is one for trade policy? And stronger, can budgetary policies, dependent on domestic politics, genuinely respond to demands for international coordination?

Neither can one think too lightly about solving the debt crisis or unemployment, especially in Europe. The debt crisis is now used to impose a sort of 'graduation' on the more advanced LDCs that they formally don't wish to negotiate in the framework of GATT. Of course, this is putting different LDCs under different pressures of trade liberalisation, without there being a legal connection to the GATT framework. On the other hand, lending countries should commit themselves to a detailed and well-monitored standstill in protectionism vis-à-vis LDCs in general, and the endebted ones in particular.

Quite irrespective of whether developed countries solve financial instabilities, as defined, there is nonetheless a strong case to alter the GATT into a more active international organisation that can supervise bilateral talks as well, can collaborate more closely with the IMF and the World Bank, and can assume a much more active surveillance role. It should be noted that the GATT rules can also be tightened and made more ambitious (as the Leutwiler report of 1985 proposed) but first of all the GATT should be given a much more active organisational, analytical, monitoring and intermediating role. Today, the GATT is hardly more than a loose network. Without leadership or hegemony, a network cannot but fail to maintain the ties binding members if it has to act under such strains. Even without significant improvements of the rules binding Contracting Parties, the starting point ought to be that a permanent forum for world trade matters, governed at the highest political level, should be created. With greatly improved flows of factual and analytical information about trade policy and permanent consultations

about notifications, including faster and more appropriate dispute settlements procedures, one may begin to contain the exceptions, exemptions and evasions now practiced bilaterally, without the GATT even being told.

NOTES

1. See Cohen, 1978, for an application of these principles to the international monetary system.
2. A term employed by Hirsch and Doyle (1977). See also Pelkmans (1979).
3. The debate about the hegemony explanation is not finished. For a classic exposition, see Kindleberger (1981). See also the essays in Krasner (ed.), (1983); Stein (1984); Conybeare (1984); and Yarbrough and Yarbrough (1985). Insightful recent additions include Keohane (1984) and Snidal (1985). See also Kindleberger (1986).
4. See Pelkmans (1979; 1980).
5. See Helleiner (1977).
6. See the excellent exposition in Jackson (1984).
7. These points are elaborated in Pelkmans (1986b).
8. Text of remarks by President Reagan to business leaders and members of the President's Export Council and Advisory Committee for Trade Negotiations, Washington, 23 September 1985; Business America, September 30, 1985, pp.2ff.
9. EC Commission Willy de Clerq, Firms and their public environment: the commercial policy of the EC, in: Europe, News Agency, Documents no. 1370 of 21 September 1985 (Brussels).
10. See IMF (1984), for a survey; also Akhtar and Hilton (1984); Goutur (1985).
11. In IMF (1984) a number of such citations open the Occasional Paper.
12. See, for instance, Thursby and Thursby, in: S. Arndt, R. Sweeney and T. Willet, (eds.), (1985) for empirical results on the pattern of trade, based on bilateral flows analysis; see Crockett (1985) for emphasis on the longer term.
13. For instance, see Wickham (1985) and Khan and Zahler (1985).
14. According to Dr Jacques Polak, however, it is also true that cover has been restored quickly for those countries having adopted credible adjustment programmes. IMF

Survey, January 6, 1986, p.7.

15. See Buigues and Goybet (1985), various tables.

16. Idem.

17. The complexities of the EC quota 'non-system' are set out in some detail in Pelkmans (1986a).

18. For instance Grilly and La Noce (1983) ignore this point entirely. In the EC of today this seems less and less appropriate.

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PERSPECTIVE

Stephen D. Krasner

Jacques Pelkmans' analysis offers an excellent review of the links between various financial and monetary developments and trade policy. The mechanism which ties trade policy and finance is interest groups pressures modified or controlled by the preferences the central decision makers and the rules of the GATT. This perspective focuses on the prospects for stability of the global trading system rather than trade policy. The basic argument is that the bicycle image of the international trading system which sees systemic instability arising from the proliferation of specific protectionist measures is misconceived. If the trading system does collapse it will be because of some systemic shock which affects many countries and sectors at the same time. The most obvious source of such a shock is the financial system.

Especially in the United States, the trading system is viewed as a bicycle being ridden along the crest of a slippery slope. If the bike slows down, if trade liberalization falters, it will tumble over and skid down the slippery slope into the oblivion of beggar-thy-neighbor policies and mutual retaliation. American policymakers put great energy into keeping the bicycle moving by maintaining some high saliency item on the agenda for international negotiations, such as trade in services, a tactic which, it is thought, will keep protectionist forces off balance. Specific measures which violate liberal precepts are decried not simply because they impose a welfare loss on the world economy, but because they may precipitate a spiral of retaliation.

There is little empirical support for the bicycle image. If the global trading system does collapse it is much more likely to be because of financial rather than 'real'

developments. The postwar trading system has been extremely resilient despite a wide range of departures from liberal trading practices. Despite a wide range of restrictive measures, some of them stretching back to the origins of the postwar trading regime, there has been a dramatic growth in the international movement of goods. The experience of the last forty years suggests that protectionism in one area does not spill over into protectionism in others. International trade has grown despite a welter of specific rules and practices which vary across countries and issue areas.

Jacques Pelkmans effectively points out that the GATT itself was not an ideal embodiment of orthodox liberalism. Existing protectionist practices were grandfathered in. Provisions were made for escape clause actions which provided time, often a fairly long time, for adjustment. (1) States did not undertake a priori obligations to reduce trade barriers. There was no elaborate international mechanism for monitoring compliance, nor was there judicial review of infractions.

This situation has not improved with time. If anything, revisions of the GATT have legitimated exceptions to orthodox liberalism as much as they have expanded the scope of openness. Various provisions for Third World states support special and differential treatment. The non-tariff barrier codes negotiated during the Tokyo Round of multilateral trade talks violate unconditional most-favored-nation treatment. The benefits of the codes are, in almost all cases, limited to signatories.

With regard to geographic reach, neither communist nor developing countries have been fully integrated into the liberal order. Although several Eastern bloc countries are members of the GATT, trade with the Communist bloc has never been left to private actors motivated by their own desire to maximize profits. Systematic efforts to control exports to the Soviet Union were established in the early 1950s. Security concerns have been given precedence over economic optimality. The state has closely scrutinized the activities of private actors.

The Third World has systematically challenged the liberal rules favored by the West, especially the United States. Beginning in the late 1940s Raul Prebisch; then with the Economic Commission for Latin America, argued that the rules advocated by the West systematically discriminated against poorer countries. (2) Other theorists

also pointed out that the conditions necessary for the conclusions of the theory of comparative advantage to hold often were violated in developing countries. International trade resulted in unequal exchange. (3) This inequity could only be rectified, according to the South, by providing for special and differential treatment. While the North has not acceded to all of the demands of the developing countries some concessions have been made. The Third World secured the passage of a new section of the GATT dealing with problems of trade and development. The United Nations Conference on Trade and Development (UNCTAD) was established as a permanent organization. Some version of the Generalized System of Preferences (GSP) has been adopted by almost all Northern states. The special status of developing countries was recognised in the non-tariff barrier codes negotiated during the Tokyo Round. The South has been treated differently. Policies that have been accepted as a result of pressure from the Third World do violate the reciprocity and non-discrimination provisions of the GATT, the core norms of the contemporary regime. (4)

Even among advanced industrialized states there are a variety of trade related practices and rules. The GATT does allow for the creation of common markets in which a group of countries removes all trade barriers. The Common Market comes closest to approximating this ideal although many non-tariff barriers still remain. But other trading arrangements have not moved to eliminate all internal barriers. The United States is negotiating free trade areas with Canada and Israel, a practice which is in some tension with the most-favored-nation provision of the GATT.

Violations of the precepts of free trade have also abounded for specific classes of commodities. Agricultural trade has always been heavily influenced by state intervention. In 1954 the United States secured a GATT exception for trade restrictions on dairy products. Commodity agreements, whose impact has varied over time, have been enacted for wheat, coffee, cocoa and rubber. European exports and imports have been influenced by the Common Agricultural Policy. The Japanese have restricted imports of rice, citrus and other agricultural products.

Trade in textiles has been circumscribed since the mid 1950s by a series of formal international agreements that began with bilateral arrangements with Japan for cotton exports. The Multi-Fibre Agreement, which covers a wide range of natural and man-made products, severely

constrains the annual growth in exports from producing countries. (5) In the last decade the use of orderly marketing agreements (OMAs) and voluntary export restraints (VERs) has increased. International trade in steel is virtually everywhere restricted by formal agreements. The United States and Europe have limited automobile imports from Japan. International trade in consumer electronics products such as television sets and VCRs has been limited by VERs, customs procedures and safety standards. As Pelkmans points out, although quantitative indices are difficult to construct various non-tariff barriers have almost certainly increased in recent years.

Products with obvious military significance have never been left to the free play of the market. No state has been willing to treat components for the construction of a nuclear power plant in the same way as concentrated orange juice. International arms sales are matters of authoritative state decisions not simply the economic calculus of private firms.

Hence, despite the wide range of constraints on specific products and the various departures from liberal precepts, there is no indication that the openness of the international trading system, as measured by the actual movement of goods, has been significantly compromised.

Despite the fact that trading relations involving a large number of products and countries have not been governed by orthodox liberal principles and norms, the international trading system has not unravelled. The elasticity of exports with respect to production, that is the percentage change in exports divided by the percentage change in production, was the same for the period 1973-83 as it was for 1963-73.

Susan Strange has recently argued that the international trading system ought to be understood as a web of contracts rather than an international liberal regime. (6) Individual actors make specific deals in specific issue areas. It is difficult, she argues, to detect any underlying set of norms and principles that inform the international movement of goods. Without trying to resolve the question of whether liberal principles and norms have had an impact on trade, it is manifestly obvious that there has been a great deal of variation in the trading regime. The available empirical evidence does not support the bicycle at the edge of the slippery slope image of the international trading system. Restrictions in one area have not led to restrictions in others. Trade barriers have not necessarily been

permanent. (7) The exclusion of very important products, agricultural goods and textiles, has not inexorably spread to other products or compromised the stability of the system as a whole. The incremental accumulation of tariff and non-tariff barriers is not likely to lead to the collapse of the international trading system. The success or failure of a new round of multilateral trade negotiations may have important implications for specific products but will not determine the future of the trading system as a whole. The overall stability of the international trading system is much more likely to be determined by developments in international finance than by specific trade policies. If global trade does collapse it will be because of a systemic shock which affects all areas of trade at the same time. The most obvious source of such a shock, although not the only one, would be some kind of financial crisis. In his seminal analysis of the depression of the 1930s Charles Kindleberger points out that financial factors play a critical role. (8) Inter-bank lending quickly transmitted the failure of one institution to others. The United States was the only player capable of acting as a lender of last resort. But American policymakers and institutions were not prepared to accept this responsibility. The failure of the trading system was heavily influenced by the failure of finance. (9)

Could such a crisis occur today? Institutionally, the advanced industrialized countries are much more prepared to deal with such an eventuality. The central banks of the leading states are completely committed to maintaining the integrity of their domestic financial systems. International arrangements are, however, less well worked out. The United States did intervene decisively to prevent Brazilian and Mexican default in the early 1980s. But the prime mover in this effort, Paul Volcker (the head of the Federal Reserve system), had to overcome the resistance or passivity of other officials. Various agreements for dealing with international crises have been worked out through the Bank for International Settlements, but they have not yet been tested. It is not clear whether the Japanese, who have rapidly become the world's leading creditor, have either the intellectual or institutional framework to undertake a leading role in the international financial system. To date Japan has not exercised important leadership in any area of the world economy.

To summarize: the most important threats to the international trading system are external not internal.

Protectionist measures directed at specific countries or specific commodities can be insulated. Restrictions on trade are not necessarily permanent. The international trading system has four wheels on a flat surface: it is not a bicycle at the edge of a slippery slope. Trade is much more likely to be severely constrained as a result of some general shock to the system. The most obvious candidate for such a shock is a financial crisis. Such a crisis is not likely because central banks are prepared to act as lenders of last resort. But the danger cannot be completely ignored because international responsibilities have not been fully delineated and because the world's largest creditor country, Japan, has no experience acting as a lender of last resort for the world system. In a crisis situation, where stakes are high and time is short, effective leadership by a single country may be critical; it is not possible to be fully confident that such leadership would be forthcoming.

NOTES

1. John Ruggie has argued that the postwar system was never in fact an orthodox liberal regime. It was rather, he maintains, a regime of embedded liberalism in which international openness was always weighed against domestic stability. See John G. Ruggie, 'Embedded Liberalism:' in Stephen D. Krasner (ed.) (1983).

2. Prebisch's argument can be found in Raul Prebisch (1959).

3. The importance of the concept of unequal exchange as a unifying concept for the South is brought out by Jeffrey Hart (1983).

4. It is true that the North has chosen to interpret the exceptions that have been granted to the Third World as a manifestation of a policy of graduation. As countries become more developed they 'graduate' into the same status as the industrialized states and will then be expected to follow the same rules. The Third World interprets the current situation not as a manifestation of a policy of graduation but rather as an effort to rectify the inequities inherent in the contemporary liberal trading regime. For a general discussion of the Third World's program, see Stephen D. Krasner (1985).

5. For an explication of the evolution of the international regime for textiles, see Vinod Aggarwal (1985).

6. Susan Strange (1985).

7. For an analysis of various types of trade barriers which relates their permanence to market conditions and industrial structure, see Vinod Aggarwal, Robert Keohane and David Yoffie (1986).

8. Charles Kindleberger (1973).

9. Susan Strange makes a similar argument about the impact of financial crisis on the trading system. See Strange (1985).

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Chapter Six

MUDDLING THROUGH: AMERICAN INTERESTS IN A CHANGING INTERNATIONAL ECONOMY (1)

Stephen Cohen and John Zysman

Following World War II, America, the pre-eminent industrial nation, thought its interests lay in an open international system for trade and finance. In the two generations that followed, the American position in the international economy has radically changed. Its unchallenged industrial supremacy has been lost and, in a broad range of industrial sectors, American firms are on the defensive. The volume and composition of the flood of imports into the American markets are but the most popular indication of the change in position.

Despite the objective changes our expression of our interests has not changed radically. American policymakers have continued to express support for the ideal of a multilateral trade regime with ever reduced barriers to trade and monetary flows. American financial policy, certainly, has pursued ever more liberal international markets at the same time we move in a haphazard way toward domestic deregulation. While there is a rhetoric of open trade, a continuing commitment to its principles, there is also a spate of seemingly protectionist decisions in sectors like textiles - apparel, steel and even automobiles. Yet those decisions, some contend, have only the form of protectionism, but not the substance. (2) Imports have not been stopped. Do we then characterize American policy as increasingly protectionist or as a subtle continuation of the past? How do we explain it? And how do we anticipate the directions in which it might move?

We must begin at the beginning and proceed deliberately through four questions. First, how has the American international economic position changed? Second,

since interests depend on the perception of a situation and the cast of advantage in it, we must also ask what the lenses are through which groups in the economy and the government have tried to define their situation and their interests. Third, how do we characterize the mix of American policy? The simple categories of protectionism and free trade are no longer adequate and even suggest the wrong questions. Indeed the direction of American financial and trade policy might be thought to be moving in different directions, following different political logics. Fourth, American institutions and ideologies entrench the principles and rhetoric of open trade. Of course, policies, both institutions and the ideologies, change with shifts in the interests and political balance of those in the political community. Will the change in America's position change its policies as the situation and needs of groups in the economy evolve?

AMERICA'S CHANGED POSITION IN THE WORLD ECONOMY (3)

While the fact of a change in the American position in the international economy cannot be disputed, the nature and cause of that change is now widely debated. In one formulation the question is whether the United States has lost its hegemonic position and thus no longer has the resources to manage the world economy alone. (4) In another the question is whether the United States is 'deindustrializing'. (5) In still another the issue is whether America has lost 'competitiveness'. (6) Let us consider the data, and then decide how wish to characterize the change.

In an era of fundamental industrial transition when the production base of all industries is being radically redrawn, American producers are not doing very well. The underlying problem is a loss of American competitiveness in basic manufacturing skills which shows up throughout the trade data and is evident in any examination of particular cases. (7) The problem cannot be understood simply as a misalignment of exchange rates. Nor can the problems in industry be compensated by an expansion of service trade. The underlying base of trade in services is simply too small. There is a dispute over the precise size of service trade, but whatever the actual numbers, it would take a radical increase in service trade - not just our exports of services -

to generate a surplus sufficient to compensate for the deficit in manufacturing. Much of our so-called service trade is really payments for past investment. Much of that investment base is suspect and as our net position becomes that of a substantial debtor the direction of financial flows may shift. Moreover, our competitive advantage in international services is itself suspect. (8)

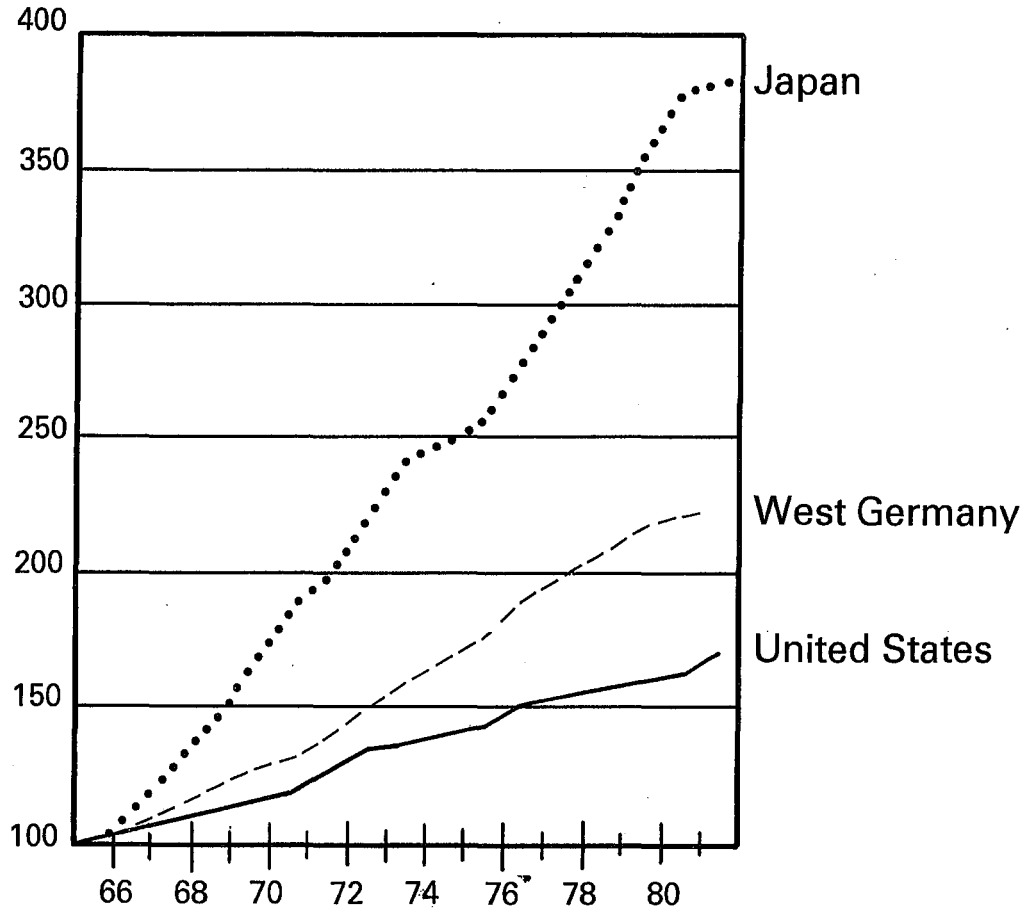
Our international economic position will continue to rest on our position in industry. Measured each of seven different ways, there is evidence that there is a problem. Taken together they suggest a serious difficulty that is deeper than our exchange rates. One obvious measure of trouble is the trade balance. The US merchandise trade balance was positive from 1893 to 1970, turned negative in 1971, and except for 1973 and 1975, has stayed that way, growing worse and worse, until it reached the catastrophic levels of 1984 and 1985. The dramatic magnitude of the US deficit in the last two years is unquestionably attached to the overvaluation of the dollar. In classical trade theory there is no such thing as a sustained overvaluation of a floating currency. Trade deficits, as we are taught in class, have as a counterpart the piling up of the deficit country's currency abroad, which eventually lowers its value until trade flows come back into balance. In recent years, however, dollar exchange rates reflect financial flows as much if not more than trade flows. Consequently the automatic adjustment mechanism no longer functions. The dollar stays overvalued. The trade deficit is an imperfect indicator of American industrial competitiveness. But during the period 1972-80 after the Nixon-Connally devaluation of the dollar - while the dollar was appreciably undervalued - the US was still unable to sustain a trade surplus in manufactured goods.

A counterpart to the trade deficit is share of world exports. America's share has sharply and clearly dropped, falling in value terms from 26% of world markets in 1960 to 18% in 1980, before the dollar aggravated matters. It would seem we are doing very badly, but does this measure really show we have a problem? As with any single measure of competitiveness, there are problems with this measure. Setting aside the question of precisely how we calculate trade share, it can mean one of two things. If the total sum of trade in the world were constant, then a decline in share of exports would indicate a direct loss. A trade competitor would be directly taking sales away. However, the total of

world trade has been growing. Consequently, America's declining share of world exports means only that our exports are growing more slowly than world exports. Maybe a decade ago we could explain such data as a result of the rest of the world catching up to our standards of product and production. That is no longer the case. Our competitors such as Japan and Germany are pushing ahead, not just catching up with us. And they are gaining market share even in a growing world economy.

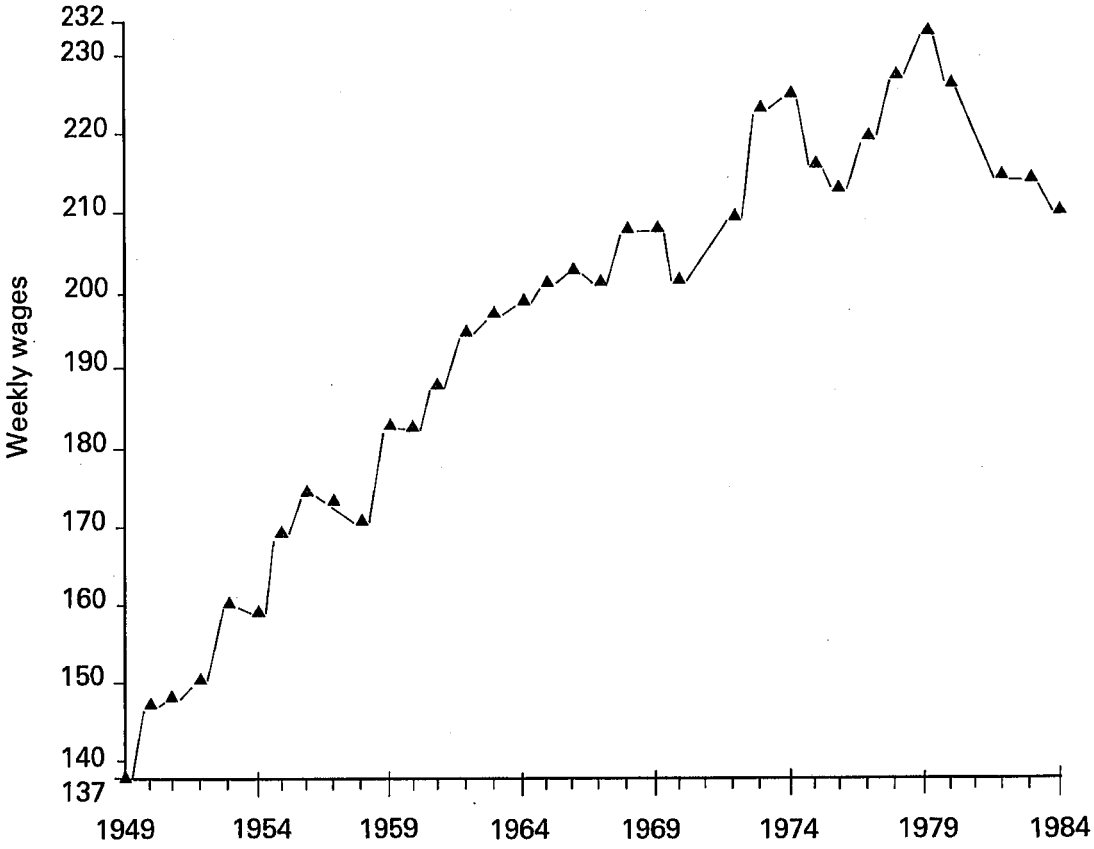
The third measure of declining US competitiveness is that for several years now, productivity in manufacturing has been growing much more slowly in the US than in its major competitor nations. Over time, only rising productivity can raise levels of income and, with productivity growing more slowly than our competitors', our incomes will have to grow more slowly than theirs or even decline in order to keep our goods competitive. (See Table 6.1.)

Table 6.1: Manufacturing Productivity, Japan, US and West Germany, 1965-81 (Index, 1965 = 100)



Source: The DRI Report on US Manufacturing

Table 6.2: US Real Wages, Manufacturing, 1949-83, in 1977 Dollars



Source: US Department of Labor, Bureau of Labor Statistics

The next indicator should, therefore, be no surprise. Real wages in the United States have declined in the ten years 1973 to 1983. The contrast with the American past is stark: during the previous ten years 1963 to 1973 and the ten years 1953-63, average weekly earnings in manufacturing (gross pay, in constant prices) rose steadily, year after year. (See Table 6.2.)

Of course, declining real wages might suggest nothing more complicated than a simple shift in income from wages to profits. But declining real wages have not permitted management to increase profits, and part of the loss in competitiveness has come out of profits: the pre-tax rate of

return on assets in the manufacturing sector has declined steadily since 1978.

Sixth, and more technically, the price elasticity of imports has increased. That is, a given price advantage for imports, whether created by exchange rate movements or differential rates of productivity growth, translates into larger sales volume in the United States. (9) What this means is that foreign products are more and more like US products. Ours are no longer so different and superior as to be insensitive to price competition.

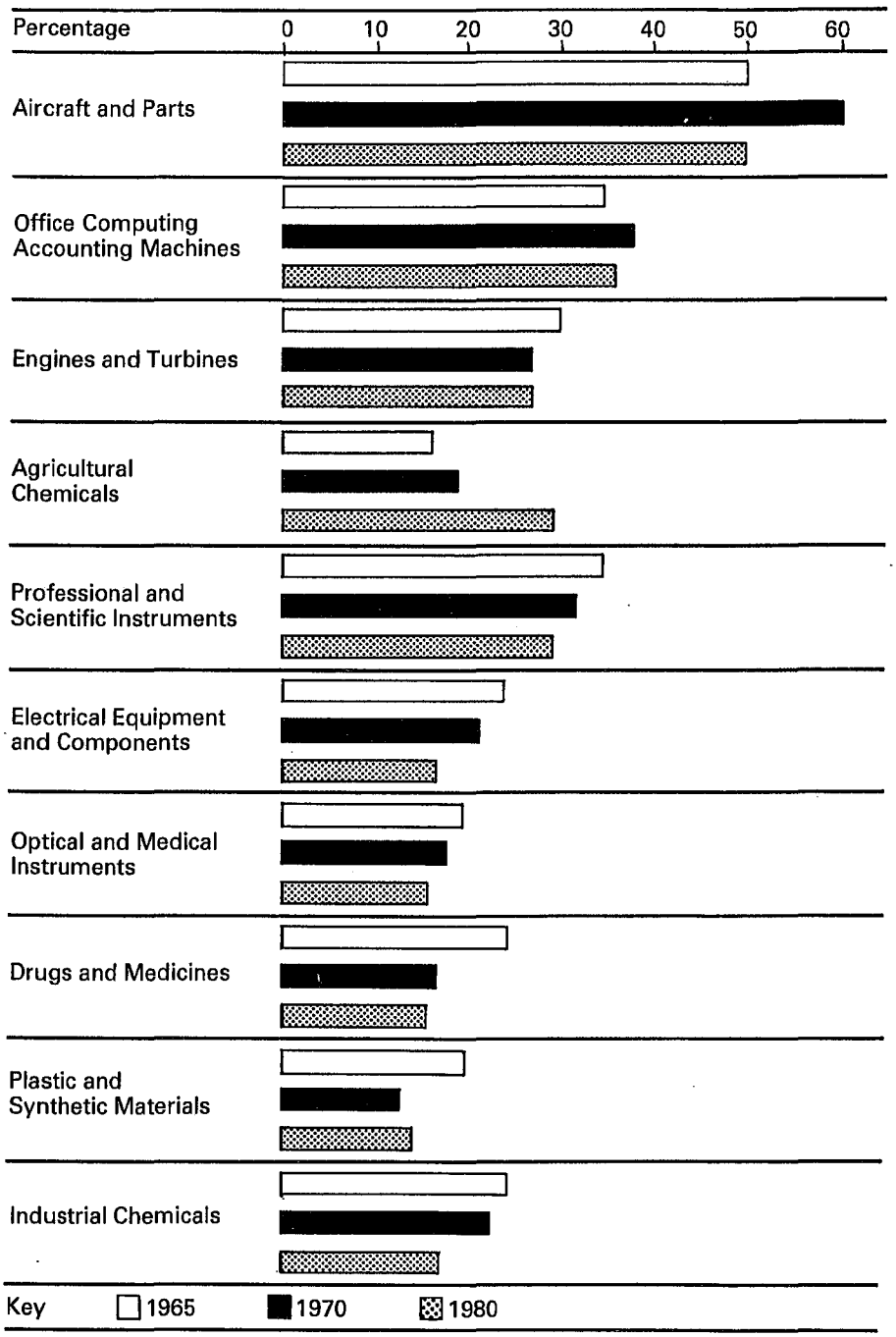
Some analysts, such as Robert Z. Lawrence of Brookings, take comfort that high technology exports have grown in importance for the United States. (10) They see that as a sign of a healthy, normal development process in which American producers cede the lower value added and less technology based sectors and position themselves in the sectors of tomorrow. Where Lawrence finds comfort in the expansion of the high-tech categories, others find a more somber picture: As Bruce Scott and George Lodge argue, the data 'do not show a broad based pattern of adjusting exports toward high technology areas.'

We find a troubling if not openly disturbing picture. Let us look more closely. The range of high technology sectors from which a surplus is generated is quite narrow. The data show the expansion of exports in high technology is concentrated in a limited number of sectors - aircraft, computers and agricultural chemicals. (See Table 6.3.)

Moreover, a substantial portion of high technology exports in these sectors are military goods, which indicates the character of America's strategic ties more than its industrial competitiveness. At a minimum, the price of such goods for export often comes as part of a strategic package in which the decision to buy reflects everything but commercial calculus. If we adopt a slightly broader definition of high technology that includes a broader range of goods we find an even more disturbing picture. The analyses of the French Center for International Economic Forecasting (CEPII) show that America has a much lower trade surplus in high-tech goods throughout the last ten years than most studies suggest. By 1983 the surplus is gone altogether. (11)

The high-tech trade problem appears worse as we proceed. Using the even narrower definition of high technology goods, CEPII analyses show that Japan's actual trade balance in high technology goods is as high as that of

Table 6.3: United States Shares of World High Technology Exports



Source: United States Department of Commerce

From: 'National Strategies: Key to International Competition'. Bruce R. Scott, in Scott and Lodge (eds.), U.S. Competitiveness in the World Economy, p.29. The Scott table is in turn based on Department of Commerce, International Trade Administration, 'An Assessment of U.S. Competitiveness in High Technology Industries,' February 1983, p.10.

the United States.

America appears to have a 'comparative' advantage in high technology goods because we have a trade deficit in everything else. Japan has trade surpluses in medium and low technology goods, so its 'comparative' advantage in high technology is defined as less, and less than ours. Using comparative advantage to say something about the real world is a way to hide the fact that in competitive terms Japan is as strong as we are in high technology and stronger in the rest of manufacturing.

CEPII analyses show even the enormous trade surpluses in so-called medium technology goods run by Japan and Germany throughout the 1970s.

This is not a phenomenon of the high valued dollar. The French also ran a surplus in such products throughout the period. Now Japan may have lower wage rates than the United States, but the Germans and French certainly did not for the period in question that were so much lower as to account for this pattern. Japan may have lower capital costs than the United States, but the Germans and French have had to hold their interest rates in relation to the United States. Only the sharp drop in the American position after 1981 can be attributed to the exchange rate. Let us turn to non-high-technology goods. Here the Japanese and Germans run substantial surpluses, with the Japanese surplus growing steadily since 1973 even as its wage rates have gone up relative to ours.

Clearly something is very wrong. In our view we must reconsider what we mean by medium technology (what we earlier called products in which competitiveness depends on skills in complex manufacturing) and even low technology goods in which labor costs are important. When we look at a sectoral level, we find a constant reorganization of manufacturing processes and constant innovation in product to incorporate new machines and new production knowhow. Clearly, effective diffusion of production knowhow and advanced technology in the production processes and even products of simpler goods can create competitive advantage.

What our so-called comparative advantage in high technology may suggest is a radical inability, relative to our competitors, to apply high technology to traditional goods and to maintain our competitive position by diffusing technology and know-how widely throughout the manufacturing economy. If this is the case - and we believe

it to be so not just on the basis of these data but on the basis of sector studies, both the series conducted by BRIE and the research of others - then our trade problem is deep and serious. We note with pessimism that the boom in textile productivity in the United States was the result of introducing imported textile machinery. We were, the optimists tell us, able to draw on the stock of textile technology developed in Europe and Japan. We were able to get productivity growth by buying the machines without investing in the technology. Isn't this what Japan and Europe did when they borrowed technology from us, some ask? Not at all, we reply. It would not disturb us if we were exchanging production equipment in textiles. The Europeans and Japanese were moving in the other direction, from being borrowers to developers of technology. Yet can we sustain that productivity growth - or match the growth abroad - if we are entirely dependent on foreign machine developments, which result from the interplay between foreign users and machine developers? The trade data suggest not. Certainly trade in the tools of production is good for us all. Yet we note with trepidation that shuttleless looms are no longer produced in the United States and that the American machine tool industry has lost 50% of the American market in numerically-controlled machine tools during the last years. We cannot sustain growth in industrial productivity if the United States loses its position as a major developer of the equipment that makes increased output possible.

What does this mean? The United States imports high value added production equipment, equipment that embodies high wage labor, and we export textiles which are a lower value added and consequently lower wage product. It is not a matter of deindustrialization, but of the reorganization of the American industrial base in a manner which cannot sustain our national wealth or power.

In sum, it is misleading to conclude that America's comparative advantage in high technology goods translates into a secure position in international trade in high technology, let alone in manufactures in general. Comparative advantage means, at the end, the thing you do less worse than do others - not the thing at which you are better than your foreign competitors. The twist in the definition, while useful for some purposes, can be deeply deceiving America's position. It is misleading to conclude that since there is no rapid 'deindustrialization' the path along which American manufacturing is evolving is healthy

or secure. American adjustment to the new world economy is quite troubled.

In the end, we will discover that the United States market has not simply become a smaller piece of the world economy, but that the composition of activities within the American economy will have changed. It is not a matter of deindustrialising or competitiveness as such. Rather, the problem is that the composition of production is changing to our disadvantage, the mix of high and low value activities is changing. Moreover, the change in the mix of activities today is eroding our capacity to sustain the development of and our international position in high value added activities. Finally, we will discover that the cost - in terms of national effort - of maintaining our security position will grow. In the end, eroding industrial competitiveness will affect our capacity to sustain our military position. America's shifting industrial position will ultimately be felt in the structure of the international system.

CHANGING UNDERSTANDINGS OF THE WORLD ECONOMY

How American interests are defined depend on how we understand the workings of the international economy. Importantly, although there are mutterings in the business community, there has been no sustained and systematic defense of protectionism. However, several reinterpretations of our trade position and of trade dynamics can be heard in the US. There is a 'new school' of trade theorists, building within the neo-classical model, that emphasizes the consequences of market imperfections for trade dynamics. We and Laura Tyson have been more concerned with the role of manufacturing skills in shaping trade flows, that is, the importance of different technologies in production - with the possibility of conflict rather than mutual gain in trade, and with the role of government in shaping trade patterns, and with the consequences of market imperfections for our understanding of trade. In the 1960s it was thought that production costs and production structures in the advanced countries were converging and that the expansion of trade would therefore lead to greater specialization within sectors. Intra-industry trade would grow. In the machine tool industry, for example, Germany would capture a large share of the market for some tools, while the United States

would become increasingly dominant in other areas of the tool market. Expanded exchange would lead to increased company specialization and produce higher incomes for both trading nations. International trade, it appeared, could grow without precipitating massive dislocations of workers and firms; the domestic political costs of expanded trade were low. There would only be winners in the trade game. (12)

The analysis of the 1960s hinged on a simplification. That simplification proved to be wrong. Production technologies, given the same levels of capital investment, were assumed to be the same in all countries. Consequently, it was thought that as capital and labor costs converged, so would production costs. The implication - as we said - was that the advanced countries would make similar products in similar ways and trade amongst them would hinge on product variety and specialization within industries.

However, in the 1980s it has become clear that production technologies are not the same across firms or nations. The economists' analytic simplification now hides the importance of the organization of manufacturing and production skills to economic outcomes. That simplification misleads us about the nature and results of trade. Rapidly expanding production volumes generate not just the advantages of large scale production, economies of scale, but the benefits of learning from doing, learning curve economies. Thus we now talk glibly about one firm being further down the learning curve than its competitors, and some extend the notion to talk about a nation's position on the learning curve. What is learned from rapidly expanding production becomes embedded in modified capital equipment, the tools of production. In other cases that learning is embedded in the social organization of production, entrenched in the way the machines are used. Equally, new approaches to production have proven extremely successful. These new approaches involve changes on the shopfloor and in the ties between production units, not strictly speaking in the capital equipment.

When the American automobile industry finally acknowledged that Japanese firms had established a real production advantage based on the more effective use of capital and not on low cost labor, a critical point was reached. Suddenly the possibility had to be faced that production costs amongst the advanced countries may diverge as one nation gains a real advantage, an advantage that cannot be rapidly imitated abroad because it becomes

embedded in machinery and social organization. We have been slower to realize that equally significant changes are occurring in places like Italy.

The market problem is more complex than we might first have thought. The advanced countries cannot just run away from low cost competition by moving into high technology. First, all the advanced countries are trying to squeeze into the same range of businesses, not just computers, but also speciality steels, sophisticated chemicals, and high fashion garments. All the advanced countries face the need to produce the high value added production machinery, indispensable medical equipment, and speciality consumer goods if they are to buy the products made in the NICs by low cost labour using those machines. Suddenly, specialization among firms of different nations, which was assumed would leave trade a congenial sport not a deadly combat, does not appear inevitable. It is equally likely - at least for the moment of this transition - that real production advantages will give some competitors real and enduring advantages in a wide range of products. While our attention was focused in the late 1970s and early 1980s on the dream of high technology, manufacturing skills may have become more important than ever to international competition. There are not sunrise and sunset industries. There will be only those industries or firms that successfully incorporate the new potentials for product and production processes implicit in the new technologies ... and those firms that do not. (13)

There are really three sets of the international market pressures to which American firms like industries in all the advanced economies must respond and to which new technologies must be adapted. First, the low cost labor of the newly industrializing countries has permitted firms in those nations to penetrate the markets of the advanced countries. In labor intensive goods that are sold on the basis of low cost, advanced country produces cannot survive without basic shifts in strategy and production organization. They must either reorganize production, making labor intensive production into a game of automation, or alter their mix of products, and with it marketing and corporate strategies. Second, in consumer durables industries such as automobiles and televisions, competitive advantage rests on the mastery of complex manufacturing processes, as well as on distinct product and marketing strategies. Those productive processes are being revolutionized by micro-

electronics. They are also being radically altered by reorganization with plants and in the links between steps in the production process. Finally, in the advanced technology sectors, the ability to implement new engineering and scientific knowledge in products and production is critical. The ability to successfully commercialize these ideas is the basis of enduring market advantage.

Common to these three categories of competition is the importance of manufacturing processes, of production skills, to retaining industrial competitiveness. The ability to produce competitively stands out decisively. The impending revolution in manufacturing is as important as the often touted acceleration in the pace of product innovation. Indeed, rapid product innovation depends on the ability to bring product from lab to factory to market. When pressed by producers using cheap labor to achieve low costs, American companies can sometimes transform a labor-intensive production process into one that is capital and technology intensive. This, of course, involves substantial displacement of labor, a reorganization of the labor which remains, and changes in corporate habits. Sharp dislocations of workers and communities have generally produced political trouble that disrupts the adjustment process. The evidence around the world suggests such dislocations can be avoided in three ways - diffusing the pressures, outright suppression of the losers when they complain (which is altogether improper and quite unpleasant), and negotiating the terms of change so that there are not winners and losers in the process of adjustment. At any rate, competitive position over time, in a broad range of products, such as consumer durables, rests squarely on the ability to master the most advanced manufacturing techniques. Even in the so-called haven of high technology, the long-run competitiveness of firms and the national economy will rest on translating product advantage into enduring market position through manufacturing expertise.

Let us consider this in concrete cases. In the 1980s American semiconductor manufacturers found themselves caught in a competition with Japan. The manufacturing skills of Japanese firms allow them to enter new markets rapidly, even those product areas where they have design weaknesses. They have contained the market share gains of foreign firms and diminished the profits from product innovation. It then becomes harder for American firms to reinvest in innovation and indeed in manufacturing

processes. In order to remain competitive, American firms, which have a clear design and innovation advantage, have had to dramatically improve the manufacturing skills. (14) Twenty years ago, American color television manufacturers were beaten by Japanese producers for a mix of reasons. (15) Important among those reasons were Japanese manufacturing costs advantages, partly a product of labour differentials but most importantly the result of real innovation in production processes. Indeed, the Japanese entered the market through a niche. Small black and white sets could be built inexpensively using the then radically new transistors instead of tubes. Transistor components also facilitated manufacturing innovation, and the Japanese invested in automated equipment. The American producers focused on the wage differential. They believed cheap wages were at the core of Japanese advantage. They did not recognize that fundamental manufacturing innovation was really at the heart of the Japanese advantage. The American producers were replaced - even in the US market - as the dominant force in consumer electronics.

There were at least two important consequences of the consumer electronics story. One was that the American consumer electronic goods companies lost a base from which to innovate in the next generation of products. Manufacturing skills trumped product design. The Japanese became design leaders from a manufacturing base. A second result was that the semiconductor industry was denied experience with products important in consumer electronics but which became critical in computers. Manufacturing production mattered directly to the ability to sustain innovation. A strong product position and a strong market position were eroded by a manufacturing weakness.

However much government policies and export strategies mattered, in the end the Japanese entrenched themselves through innovation in the production system. We are concerned, consequently, when American firms move off-shore, without reflection on how to maintain over the years a competitive production position, to seek lower labor costs or avoid the disadvantages of producing in the United States when the exchange rate makes American goods expensive. The short term palliative has been tried. We believe it can provide only temporary relief. If the move off-shore is a substitute for production innovation, it may represent a long term disaster, both for the firms and the nation.

Let us look more closely at a second industry story. In the late 1970s the semiconductor division of a major electronics producer tried to figure out why they were always late - relative to their competitors - in the release of integrated circuits that they themselves had designed. The story was told to us this way. 'What we discovered was that we were actually doing better designs than our competitors, but our manufacturing technology was old.' (16) The company had not invested in manufacturing technology because it did not have the volume of product to make manufacturing investment pay off. Design advantage was undermined by manufacturing weakness. The story should stop there, but there is another and fascinating chapter. The firm decided to invest in manufacturing technology, though they did not then have the volume to show a financial payback that would in conventional terms justify the investment. 'The gamble paid off. Now we have one of the best IC design teams in the world. In fact the design team got so good that they did enough parts to eventually make the manufacturing investment pay off.' Improved manufacturing permitted a design advantage to create the volumes needed to support the production investments.

Indeed manufacturing expertise permitted the Japanese to establish a substantial position in the semiconductor industry in the first place and is now the basis of their advantage in many product lines.

The semiconductor story is a critical case for our argument. This is a high-tech industry par excellence. The industry itself was created by fundamental product innovations - the transistor, the integrated circuit, the microprocessor. Continuous product innovation based on design and software skills is a fundamental feature of competition. Yet, in this quintessential high-tech industry, dependent on its laboratories and innovations, manufacturing proves decisive.

If innovation is not sufficient in high technology, then manufacturing skills are vital in each of the categories of industrial competition - high technology, products depending on complex manufacturing processes, and those where low cost labor has been the basis of foreign competition. We have already examined consumer electronics and semiconductors. We could add story after story from our own research and that of others. (17)

The message is clear to us. Only real manufacturing innovation, using our innovative skills to leapfrog in

manufacturing, can assure American firms an enduring competitive position in international competition. Once we recognize the importance of manufacturing in establishing competitive position and shaping trade flows even in high technology or R&D based industries we must reinterpret our understanding of trade data. The reinterpretation suggests that America's position in world markets is much weaker than we might otherwise have thought.

The importance of manufacturing skills in industrial competition requires that we advance our understanding of technological development and product innovation in creating competitive advantage. We must reformulate our understanding of the influence of product innovation in trade to incorporate the importance of manufacturing advantage. Product cycle theory has been the way most analysts conceive the role of technology and innovation in the dynamics of trade. According to this theory trade in manufactured goods typically follows a set pattern; a country that introduces a good becomes at first a net exporter of it but eventually loses its net export position when production of the good becomes standardized and moves to those countries that have the capacities to produce it and the mix of resources that make such production of standard product attractive. The innovating company may use its initial position in export markets to open manufacturing facilities in countries to which it sells, but the location of manufacturing will move. We should not, in this view, worry about the move off-shore of production of goods originally produced in the United States or of the emergence of foreign producers. This suggests that industry in an innovative country can make its living by initiating a series of new products.

We need to add a new twist to the theory. The benefit to the nation of a product innovation depends on the volume of exports and the length of time that the innovators hold an advantage if not a monopoly. Let us imagine a national innovation-based export stream. We might therefore imagine each innovation as the beginning of a stream of production, an arrow. We need be concerned not just with the speed of innovation or the number of innovations - represented in Figure 6.1a by the number of starting points - but with the total innovation-based export stream. (See Figure 6.1b.) Such an export stream can be described by the length and width of the export arrow generated by an innovation. The longer a producer can hold onto an

Figure 6.1a: National Innovations: Starting Points

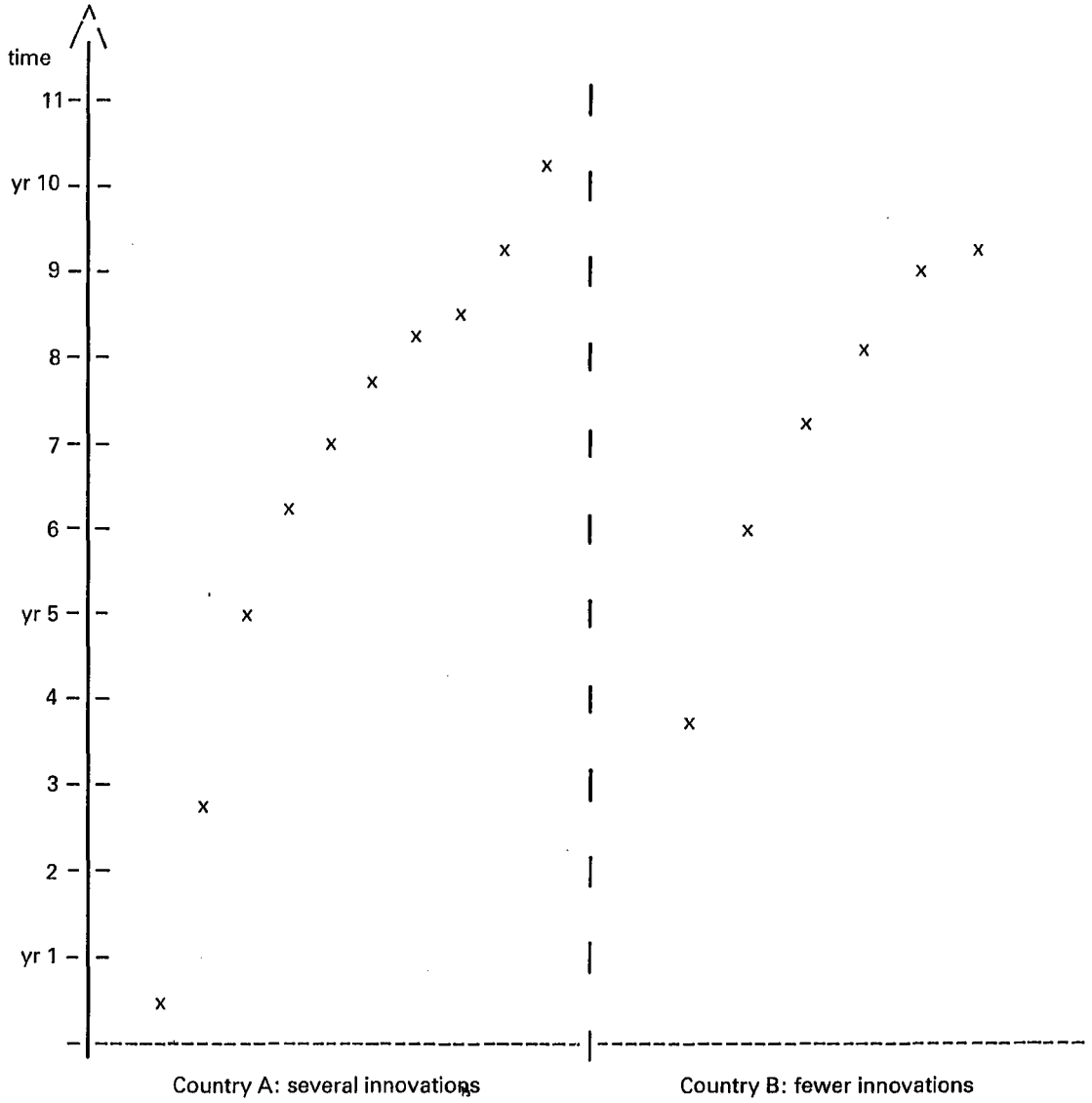
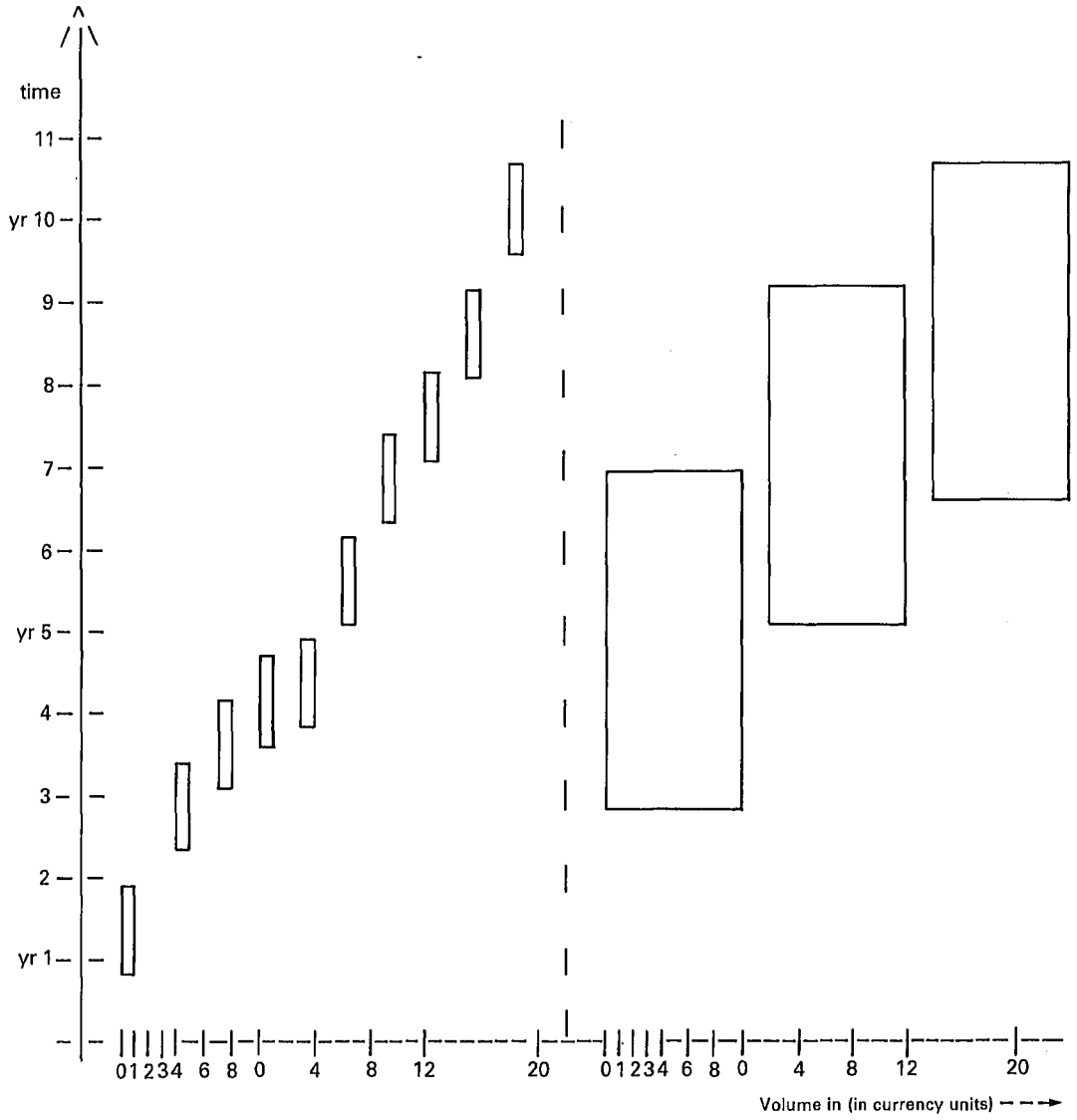


Figure 6.1b: Innovation-Based Export Streams: Volume, and Duration of Advantage



Country A: Many innovations, short periods of control, small volumes.

Country B: Few innovations, long periods of control, large volumes.

advantage and the greater the volume during that period, the greater the national innovation-based export stream. Obviously a few big export winners can make up for a great number of short term successes, though the broad portfolio of successes will give stability to the export stream. Simply, the pace of the product cycle matters.

The speed with which a competitor establishes a strong position in its national market previously dominated by a foreign firm that moved abroad on the basis of product innovation - and thereby limits the gains to product innovation - is crucial. The pace at which the rents of innovation are eaten away clearly depends on two things. First, and obviously, it depends on the speed with which the product itself can be imitated. Secondly, and crucially, it hinges on the speed that a competitive manufacturing position can be built. There are some obvious conclusions. If an innovator's manufacturing skills are weaker than those of its competitors', then it will lose part of the potential gain from its innovation. More broadly, a manufacturing disadvantage can ultimately undermine a product advantage and block continued product innovation. (18)

Let us go one step further. America cannot maintain its high wage economy by trying to play the role as laboratory for the world, producing the ideas and prototypes while others make the products. First, if we cannot make the products our technology edge will erode. After several rounds of product innovation, the innovative initiative will pass to the firms that make the products. They end up understanding the market and the product in a way that permits them to become the technology leader. Experience in steel, consumer electronics, and automobiles alone ought to convince us of this. Even if American firms could keep up technically without manufacturing, there is another problem, equally serious. The rents from innovation - that is the exceptional gains on which high profits and high value added are based - are realized in producing the goods, not in selling the technology.

To understand the problem let us ask a simple question. How do you value a technology if you want to buy or sell it? If you want to buy a car to drive to work or a modem to hook your computer at home up to your office network, you probably have an idea of what the product can do and what the value is to you of various accessories on the car or extra features for the modem. Neither the function nor the value is obvious when selling new high technology products, let

alone the value of raw technological knowledge. Fixing a price can then be extremely difficult.

Let us summarize our position as a simple proposition. Lose control of the manufacturing or production process of your product and you risk losing control of both the technology and the final markets. A firm of a nation's industry cannot survive at a substantial production disadvantage to its major competitors.

WILL AMERICAN POLICY CHANGE?

Has American policy responded in any systematic or coherent way to the sharp shifts in the position of American industry in international markets? In our view, it has neither moved toward aggressive protectionism nor toward determined efforts to reassert the national competitive position. We have been increasingly unable to shape the international rules of trade and money to our own purposes. We have, rather, muddled through with a series of ad hoc choices to restrict access to our market. What then is this pattern of drift? Will it continue or give way to a clean change of direction and emphasis?

We must distinguish three dimensions of American policy. First, can the United States still act to shape the rules of international money and trade? More precisely, can it, short of collapsing the system, determine the character of the rules of play. We think not, but this issue is not of central concern here and it has been dealt with in other parts of this book. Second, will the United States leave its markets open to foreign goods or will it systematically begin to close access to foreign producers? The pattern has been increasingly one of a rhetoric of openness and a reality of sectoral closures. Are those closures largely symbolic payments to domestic industry with limited real consequences or are they substantive closure? Will the individual closure finally accumulate to change the principles of American trade? Third, will the United States act, through domestic and international policies, to reassert the competitive position of American industry?

The pattern of policy does seem clear and many have noted it. Overall, the general thrust of American policy since the war has been aimed at creating a world that favors free trade - meaning the free flow of goods and finance (labor is a notable exception in all our policies). Yet from

many cases it is clear that in specific manufacturing sectors, policies have run a different course. (19) The exceptions are more numerous than one would have expected from the rhetoric (see Table 6.4). Promotion of American interests abroad came in the form of general rules to encourage the expansion of international trade, which was thought to favor American companies. Importantly, alongside international agreements to free the flow of goods were policies to support the multinationalization of American business. More precisely, American rules were structures to favor direct foreign investment. Two forms of support were crucial: first, the tax laws tended to encourage overseas investment rather than domestic adjustment; and second, the trade laws were arranged to allow American firms to invest overseas, producing part of their product at these offshore locations, and to be taxed on only the value added abroad when the goods re-entered the American market. A third element of support for direct foreign investment was provided by US aid programs that helped the developing countries establish export platforms.

Sector-specific policies, in contrast, have largely protected rather than promoted. Policies conceived to respond to particular sectoral problems have served mainly to insulate American firms from foreign goods and producers. Yet given the general commitment to free trade, restrictive policies have been established on narrow ground and for purposes as limited as political pressure would permit. There has been a tension between the specific pressures, often channelled through the Commerce Department, and the general commitment embodied by the Treasury.

The origins of the American commitment to an open trade system have been clearly depicted. It begins with a reaction to the extremes of protectionism that led to the repeal of the Smoot Hawley Act. Smoot Hawley had made protectionism the principle, forcing exceptions to it. New legislation after the war reversed that and began to make open trade and principles to which exceptions must be made. Beggar-thy-neighbor policies became associated with the Great Depression. In the years after World War II there was a clear and powerful coalition in support of this commitment to open trade. The economic base of that coalition consisted of American financial institutions, exporters, and multinationals. (20) American industrial producers and financial institutions were dominant in the

Table 6.4: External and internal US policies in regard to various industries

Policy	Textiles	Apparel	Footwear
External Protection	Extensive, ending with Multifiber	Extensive	Extensive, mostly OMAs
Direct foreign Investment	Yes; crucial to pattern of adjustment in US markets	Yes	Yes
Promotion of trade abroad	No	No	No
Internal Financial protection	No	No	No
Intervention to promote domestic industry	Nominal	Nominal	Nominal

Table 6.4: continued

Steel	Automobiles	Television	Integrated circuits
Trigger pricing, aimed first at Japan, then at Europe	No	Limited to 807 clauses	807, but not important
No	No	Yes	Yes
No	No	No	No
No	Chrysler Loan Act	No	No
No	No	No	Military until 1970 and since 1980; military proportionally small now

post-war years, and the reasons they favored open trade are evident. At the same time, at the end of the war American officials had a real foreign policy interest in constituting an international economic system that could serve to pull America's allies together under her leadership. (21) International political and domestic interests were joined. A free trade ideology emphasizing the mutual gains from trade, really a popularisation of traditional neo-classical interpretation of the advantages of open trade, became entrenched. The ideology was embedded in a network of domestic institutions and laws, as well as international agreements. (22) There were in essence three lines of defense for free trade: a broad ideological commitment to the idea that open trade was in the collective interest, a set of institutions created and staffed to implement that ideal, and a broad political coalition supporting the institutions and ideology.

As the American position has shifted, neither the institutional commitments to open trade nor the broadly based ideological bias in that direction have truly changed. Such a change would, in our view, require a change in coalitional or political basis of trade policy. Will such a shift away from open trade actually occur? We think such a shift is not improbable, and if it occurs the key will be in the position taken by agriculture.

While the coalition for open trade has continued, we suspect its composition has changed importantly in the last years. (The base of support could be defined by the positions of the various economic groups, the pattern of congressional votes, and the positions taken by different administrative institutions.) The position of American industry in international markets deteriorated, but American agriculture and large American financial institutions are more dependent than ever on open markets. While we have not systematically tested this argument, discussion in Washington with congressional staff suggest it is correct. The pattern of shift could be shown by a sampling of opinion in trade journals and an analysis of votes on crucial trade and monetary issues. There is nothing very mysterious.

In the 1950s American agriculture slowly became a major exporter. By the mid-1970s exports had become crucial. Our guess is that agriculture moves from neutrality or indifference to active support for open trade. As international financial markets expanded and American banks became vital agents in financing the recycling of oil

money and the development ambitions throughout the world, the attachment of financial interests to open markets becomes even deeper. The repayment of that debt, it is evident, hinges on open markets for the exports of the debtor countries.

The position of American industry is quite mixed. Not only are the positions of industries quite different, but interests within particular sectors divided. Often, in fact many firms find themselves divided. What is obvious is that the balance of support for open trade has dwindled. The number of sectors that see themselves harmed by imports has grown. Equally important, labour intensive sectors such as apparel were joined by capital intensive sectors like steel. Those two have been joined by a range of complex manufacturing sectors and high technology industries. Indeed, the recent discussions in the electronics industry of limits on imports of certain semiconductor products are startling. While the semiconductor firms are leading the chorus, many of the equipment manufacturers are supporting the effort. While the balance of business and labor opinion has unquestionably shifted, a broad move toward protectionism seems unlikely to emerge from industry.

Only if there were a shift in the position of agriculture or finance can we imagine a real change in policy. Moreover, such a coalition would probably require an alternative formulation on which to base a broad change in policy. As we suggested above, the basic ideas of open trade are not being fundamentally challenged. In sum, we suspect that the coalition supporting open trade has changed over the years, but that it will not hold.

Yet even if rhetoric and principles of policy are not undermined, we do believe that policy within sectors and the rules for entry to the American market may change in important ways.

The list is long of sectors in which there is some form of formal restriction, generally in the form of a bilateral orderly market: shoes, apparel, textiles, steel, automobiles come quickly to mind. In the case of textiles the arrangements have now become multilateral, what some would call a separate trade regime. In the case of steel the United States has several times and in different forms unilaterally declared terms of restriction on its market, the most recent being a balancing of the interests of its allies and newest competitors. In automobiles the Japanese

continue to restrict exports to prevent a resurgence of legislative anger. That a multitude of exceptions to our principles have abounded should not surprise us: all trade agreements have escape clauses to permit governments to remedy economic harm and salve political wounds.

The exceptions in the United States are produced in a very different way than the general principles. The act and reality of providing import relief to mobilized groups might be seen as a means of letting off political steam to preserve the more general application of basic policy. Indeed, while the exceptions do serve that function they are generated through legal actions or administrative actions in a judicial setting. Politics, in the sense of group pressure on the legislature, serves to influence the treatment of these judicial or administrative actions. Certainly, the political resources of the industries is important to the outcomes over time. It appears that in those sectors in which industry and unions are united, or for the period of time which they are united, the industry's political position is much stronger. When the firms in the industry can move offshore in pursuit of cost advantage, as was the case with the color television industry, the domestic coalition splits. In general, domestic politics favors protection, while international commitments and objectives favor openness. This is very evident in particular cases such as the Houdaille Machine tool petition where a recommendation of action was made to the President, but commitments to Japan and reportedly a phone call from Nakasone led to no action being taken.

While there are a variety of legal channels available to industries seeking relief, their treatment all have a number of common features. (23) First, the government does not pursue a general industry wide adjustment solution. The objective is to provide equity under the law, not directly to promote the sectors. Second, government officials, partly a consequence of the task of narrowly deciding the cases, have little knowledge of the real competitive conditions in the industry nor do the agencies they direct have the analytical capability to interpret the information about the industry. Certainly this makes the government dependent in international negotiations on information from the industry. Third, because the Treasury often simply delayed action on trade relief petitions, rapid action is now mandated in many cases. This forces decisions but precludes strategies of adjustment. Fourth, the government responds to petitions from industry. Occasionally a senior official may signal that

a petition would be viewed favorably, thereby inducing action. Nonetheless, such actions are very expensive. More importantly, the pattern of suits does not follow an economic logic or strategy. Fifth, the possible penalties from administrative judgements are - with few exceptions - limited. Civil suits, such as the one brought by Zenith against the Japanese television manufacturers, is still in the courts after a dozen years. Quick action through administrative channels brings limited remedies. More substantial remedies require long and expensive legal strategies. The consequence of these five features is that the pattern of exceptions cannot accumulate into a general challenge to the principles of open trade, whatever apparent hypocrisy outsiders may see. However, the decisions - protectionist in form and substance - can create real havoc in international markets and negotiations. Equally the trade apparatus as currently organized cannot be used effectively as an instrument of conscious industrial promotion.

How substantive is the relief really granted through these mechanisms? The question is a good one. How do we measure relief? When Japanese car sales take 25% of the US market, it is hard to talk about restriction when it has long been informal French policy to restrict sales of Japanese cars to 3% of registrations and a formal agreement exists between Italy and Japan limiting car sales to several thousand each. When, despite a series of restrictive programs, imports grow in textiles and steel to substantial shares of the American market, the protection does not appear nominal, a political symbol not an economic reality. Judy Goldstein in her quite excellent work argues that the protection is symbolic, a political handout to avoid real action. (24) In this view the commitment to free trade principle in fact translates in the actual application of trade remedies into very limited real protection.

But is that really the case? Michael Borrus offered an alternative argument. The year after the US imposed a revised trigger price arrangement, the profits of US Steel jumped a thousand-fold. The justification of the protection was to permit the profits needed for corporate management to re-establish a competitive position. As is well known the company used the funds to buy Marathon Oil, deciding to get out of steel rather than reinvest in it. In the years following the Orderly Marketing Agreement in televisions, American producers moved offshore seeking competitive advantage in low cost assembly. Since American producers pay duty only

on the value added abroad, the American market for US offshore producers was protected. As the history of the industry shows, they misjudged the market, the products, and the production technology. Yet importantly, the protection of their market did give them a substantial chance at adjustment. Various studies of protection in the textile and apparel industry show the very real costs to the consumer of the protection. Estimates are that protection of the steel industry adds substantially to the cost of each car bought in the US. The protection is real, but it is not aimed at creating a particular market structure or competitive outcome. It has the consequence of raising profits for both American and foreign producers. Borrus and Millstein argue that the policy has the effect of 'protecting profits' rather than domestic production and jobs. (25)

Was this the intention of policy. We would need to review systematically the pattern of policy, not just the level but the form the policy took and the consequences for companies and labor. We do not know of any such analysis, so we can only speculate on what an analysis would show. First, there is limited effort to truly keep production and jobs in the United States. Second, in a few sectors including textiles and steel where there are organized political coalitions, policy attempts to sustain profits for the major producers. Third, the form of policy will reflect the interests of the politically dominant producers in the industry. Fourth, the value of those restrictions depends on the ability of firms to adjust on their own to changing markets. That adjustment may mean production innovation, offshore production, product redesign and market repositioning, or an outright exit from the industry. Fifth, there will be moving 'trigger levels' within each industry. As imports reach those levels concerted efforts to maintain American producers will be triggered.

This basic pattern will continue, but be altered by three developments. First, the number of industries affected by imports has grown. The demands for relief will grow and be more insistent. Second, a wider range of sectors is developing the political skills to play the political/judicial/administrative game effectively. Consequently, one would expect the extent of this 'exceptional' protection to grow. Critically, as we argued above, this burgeoning of exceptions will not - in itself - accumulate into a change in the general principles. Any change would follow the different logic we discussed above.

Critically, we do think that there is the potential of changes in the rules of play in the American market, even if that market is not formally closed. That is, laws and mechanisms for enforcing them will change the logic of entry for foreign producers. There is real concern in many business circles that a number of foreign practices are 'unfair' and that the necessary responses to them on the part of American companies are precluded. There is no legislative agenda; but we sense proposals along the following lines. First, firms in a range of industries face what they consider to be predatory dumping as an entry strategy, particularly from Japanese companies. Legislation raising the potential risk of such entry strategies is possible. At the moment administrative action can force firms found to have dumped to raise their prices, but there is no remedy for the gains achieved by dumping. More serious penalties are envisioned. Second, a number of direct foreign supports for exports and technological development - the so-called targeting - are of concern to American firms. Third, American firms fear that joint efforts on their part to respond - in such areas as marketing or technological development - are precluded by antitrust laws. Changes in how markets are defined for the legal purpose of American antitrust would make a number of these projects appear more feasible. In sum, there will not be a break with past frameworks and principles of policy.

Finally, will American policy begin to promote actively something call 'competitiveness'? While there are murmurs of a debate on this issue, political support is at the moment extremely weak. Indeed on balance we can argue that, whether the issue is technological development, the deregulation of telecommunications, or the tax bill, no attention is paid to American competitiveness. The issue of competitiveness did not emerge at all in the tax debate. The deregulation of telecommunications have moved forward with a complete indifference to the international trade consequences of unilaterally opening the American market without demanding reciprocity. The problems of sustaining a commercial position in emerging technologies from microelectronics through programmable automation and new materials is subordinated entirely to concern with exotic military technologies. In a period when education and skills are being understood as an element of international industrial competition we are cutting our national commitment in those directions.

Can such a coalition emerge, a coalition that will attempt to use domestic and international policy to promote development? Certainly the advocates of industrial policy in the democratic party and a coalition of republicans and democrats arguing for a policy of competitiveness would suggest there is a political potential. Though personally we share these concerns, we doubt any action will emerge. Simply, divisions over what the problem is and how to address it are likely to fragment the bipartisan group that shares common instincts that a problem of some sort exists. On the one hand, industrial policy implies a growth of government authority. On the other, policies to increase investment raise the question of whose investment, for what purposes, and for whose gain. In England, similar issues decided a potential coalition for development. (26) There is a potential coalition for competitiveness, but it will require political leadership than can weld an industry, agriculture, labor coalition. Neither the issues on which to organize the coalition nor the leadership is evident.

The consequence of this analysis is clear. The American position in the international economy has changed without a radical redefinition of American interests. The underlying commitments in trade and finance to an open system are likely to continue. There does not appear to be a coalition for either closure or a 'developmental' strategy. We are likely to continue to muddle through on a case by case basis, with internationally organized muddling through playing a role on many an occasion. Our own concern though is that such a policy is one of keeping the rudder steady while the ship sinks.

NOTES

1. It is difficult for us to separate our work in this paper from the articles we have written with and the discussions we have had with Michael Borrus and Laura Tyson.

2. Judith Goldstein (1984).

3. This section draws very heavily on two manuscripts. Competitiveness by Stephen Cohen, David Teece, Laura Tyson and John Zysman, prepared as Volume III of the President's Commission on Industrial Competitiveness; Stephen Cohen and John Zysman (1987), particularly Part III. Moreover many of the ideas have been

developed jointly with Laura Tyson.

4. Stephen Krasner (1977).

5. Barry Bluestone and Bennett Harrison (1982). See also Robert Z. Lawrence (1985).

6. See Bruce R. Scott and George C. Lodge (eds.) (1985).

7. Stephen Cohen and John Zysman (1987), op.cit.; see also Elizabeth Kremp and Jacques Mistral (1985).

8. Stephen Cohen, ibid.

9. Elizabeth Kremp and Jacques Mistral, op.cit.

10. See Robert Z. Lawrence, op.cit., pp. 64ff.

11. Elizabeth Kremp and Jacques Mistral, op.cit.

12. See John Zysman (1983).

13. For an examination of the interplay of state policy, technological diffusion, and corporate product and production innovation in France, see John Zysman, 'Innovation Policy in France,' paper prepared for the OECD Examination of French Innovation Policy, 1985.

14. See for instance the analysis provided in the case of high-technology competitiveness by Michael Borrus (1984).

15. See the television sector study by James E. Millstein (1983).

16. Obtained during a private interview.

17. There are a host of sector studies available which point out the critical role of manufacturing skills in the maintenance of competitiveness. See, for instance, Laura Tyson and John Zysman (eds) (1983); Taizo Yakushiji and Robert E. Cole (eds) (1984); Alan Altschuler et al. (1984); Carol Parsons et al. (1985).

18. David Teece (1986a).

19. See Laura Tyson and John Zysman (eds) (1983).

20. Fred Block (1977).

21. Stephen Krasner, op.cit.

22. A.M. Wolff in Bruce Scott and George Lodge (eds) (1985).

23. See A.M. Wolff, 'The Role of America's Trade Policy in the International Competitiveness of American Industry', ms. paper presented at a Harvard Business School seminar, February 1984.

24. Judith Goldstein, op.cit.; see also Judith Goldstein, 'A Re-examination of U.S. Trade Policy: An Inquiry into the Causes of Protectionism,' unpublished dissertation, Los Angeles: UCLA (1983).

25. See Michael Borrus, 'The Politics of Competitive

Erosion in the U.S. Steel Industry,' and James E. Millstein, op.cit., in Laura Tyson and John Zysman (eds) op. cit.

26. See John Zysman (1983) ff.

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PERSPECTIVE

Innocenzo Cipolletta

For an Italian economist to read and to discuss a paper on industrial policy in the United States is indeed extremely stimulating: for years, even the possibility of speculating in terms of industrial policy in the United States has been denied.

In Europe, and therefore in Italy as well, an attempt to overcome a strictly sectoral view of industrial policy is in progress. The result is necessarily a broader policy spectrum, which is close to macro policy, but which involves the efficiency of the state in providing the right environment for allowing business to grow. On the contrary, in the United States the debate is still concentrated on the industrial consequences for specific sectors and for industry as a whole of fundamental macroeconomic choices, rather than on the analysis of the effects of specific measures.

This is reflected, in my opinion, in the paper by Prof. Zysman, which not only reports on specific cases, but also discusses the influence on the productive system of technical and ideological choices (in particular the choice of free trade), and the feedback effects on the policies to be adopted.

I will not repeat - or even worse, 'explain' - the many interesting sections of Zysman's paper. Instead, as an Italian economist, I would like to state my reactions to such an approach, and to some of the main conclusions which have been reached.

The US case, as represented by Zysman's, seems like a mirror image of the Italian one. As a matter of fact, Zysman's approach is very similar to what many Italian authors have utilized for Italy. (1) However, the policy

conclusions are different, and in many cases are just exactly the opposite. This does not undermine the analyses carried out for the US and for Italy. On the contrary, it shows that in a rapidly changing world relative positions and specific advantages are unstable. Indeed, each advantage carries with it a disadvantage and both must be taken into account in order to appreciate the overall position of an economic system and to define the most suitable policies.

The analyses, which have been carried out on the Italian industry and on its international position (in particular during the last few years), have shown an increasing interdependency of the productive process. Such a phenomenon has affected inter-industrial, inter-sectoral and international aspects. By decentralizing production, industry has become more and more integrated. This process can be considered the Italian answer to the flexibility imposed by the oil crisis, or it can be interpreted as the consequence of the diffusion of new technologies, or else as a reaction to various fiscal policies. In any case, the industrial system has been subdivided into subsystems, numerous new enterprises have been created, and the sizes of the enterprises, which were already small, (2) have been further reduced. A peculiar feature of such a process has been the subcontract. In order to reduce production costs, a wide network of specialized suppliers for specific production phases (often with high quality standards) has emerged. It was not a splitting of production into family-size micro units.

Such a phenomenon has not been limited to industry and has affected other sectors as well. In such a way intersectoral interdependency has increased, thus contributing to the growth of the service sector, which all industrial economies have experienced. Indeed, the growth of services clearly shows the difference between the family-firm model (which greatly contributed to the underground economy and to the black labor market during the last decades) and the new model of decentralized production. Because of the specialized nature of many services - such as accounting, management consulting, technical services, data processing, R&D, etc. - a network of enterprises has emerged. They often originated from the professional knowledge of large-size industrial enterprises, and by offering high-quality services they created a market which did not exist before. The result has been that employment in productive services grew, during the last few years, at an annual rate higher than 15%.

In such a context, the decentralization of production was not constrained by national boundaries and has led to a sharp increase of international interdependency. In fact the sharp increase of intra-industry trade and the increasing incidence of semi-finished intermediate imports can be explained by the internationalization of productive processes: Italian enterprises import intermediate goods to be incorporated into their products, and, in turn, provide materials for foreign enterprises.

These phenomena have many determinants, but we cannot analyse them here in detail. We should only mention that the analyses of structural change in Italy have concluded that: (i) the foreign dependency of the Italian economy has increased, (ii) the movements of the exchange rate are less and less under the control of the authorities, and (iii) in a highly interdependent world it might be more advantageous to buy abroad what cannot be produced (or is not profitable to be produced) domestically.

Furthermore, the contributions emphasize organizational innovations, but recognise the delays and deficiencies in the restructuring of production activities, especially with reference to research and development. Innovation in Italy has indeed affected processes more than products. Certainly, the process-product distinction is very narrow, and its usefulness in industrial analyses has not yet been fully proved. What is true is that, because of industrial restructuring, Italian industry:

(i) has increased productivity and competitiveness in the so called traditional sectors;
(ii) has taken advantage of important technological innovations, which are now incorporated into mature products (via a more efficient machinery and more sophisticated intermediate inputs);
(iii) has maintained (or increased) international market shares;
(iv) has renewed its own productive capacity by means of an accelerated substitution of equipment;
(v) has developed original and efficient ways of marketing and selling.

It is also true that a low R&D activity has increased Italian dependency in many high-technology products which are bound to be imported from those countries (the United States in particular) which - as Zysman analysis points out -

have favored labs vis-$\frac{1}{4}$-vis plants. Moreover, restructuring activities have reduced the risk of becoming not competitive in those traditional products which can be produced at lower costs in the new industrialized countries.

In conclusion, the main concern in Italy is the risk of becoming good sellers and organizers of foreign ideas and products: which is just the opposite of what Zysman's analysis seems to point out when it emphasizes the risk of the United States to become a laboratory for the world and it underlines the need to develop both production and marketing strategies.

NOTES

1. See the recent Report on Industrial Policy in Italy, by CER-IRS, and published by Il Mulino.
2. In fact, this process is the result of the size reduction of large firms, and the corresponding decrease of very small enterprises, with a tendency towards medium size enterprises.

PERSPECTIVE

Sergio Bruno

Given the subject of interdependencies in, and of, industrial policies, telecommunications (TLC) constitute one of the best cases in point. The reason for this is simple. TLC services constitute rather strict national markets; this is why, if some country happens to introduce some major innovation in the production process of TLC services, there is no need, in principle, for other countries, which compete with the former one on other grounds, to introduce, in their turn, the same or equivalent innovation.

Two major reasons are usually indicated against the validity of the above statement: (1) TLC services constitute strategic and pervasive inputs for the competitiveness of other internationally marketable commodities, or, more in general, for the competitiveness of the economic system as a whole. Personally, I have not found so far convincing arguments in this direction. There is no evidence up to now that better TLC services could contribute either to the lowering of the costs of commodities or to the improvement of their quality in a degree such as to change in a significant way the system's relative competitivity. (2) The TLC market constitutes a strategic captive market for industrial sectors which produce technologies, that is, equipments and software, both for the network and for the users. It is basically the manufacture industry which produces the innovations which are embodied in the market for the TLC services. These innovations are cumulative, that is, in order to be and remain competitive the manufacture industry must stay in a path in which it competes with other foreign industries in inventing, testing, selling equipment which embody innovations. Therefore, should a national sector of

TLC services fail to adopt innovations in the development and management of its network, this would result in a severe obstacle for the corresponding national manufacturing industry to develop innovations and to be competitive.

I believe that this latter argument is very strong indeed. It could be reinforced by the following considerations. Any innovation constitutes a bet in the face of an uncertain future. Nobody could know in advance the final result of the bet, but the more and more important are the players who decide to play the game, the more likely is that the bet itself would result successfully. The innovations in TLC equipment and services open a broader innovation path, which puts into motion dynamic learning interactions, whose result might be that of making the whole system more competitive. The risk for the system to be cut out from this result may be considered as too high to be accepted. Notice that this argument strongly differs from the argument (1) mentioned above: in fact, we are not considering here the systemic improvement which could be carried on by the new TLC services in themselves, but instead the possible, although now unforeseeable, effects which could follow the diffuse adoption of those services.

The TLC services industry has been affected in most recent years by a set of technological ruptures.

In TLC's two are the major technological ruptures which have to be considered: (a) the possibility of associating informatic activities with the transmission of messages on TLC networks (telematics); (b) a relevant improvement in the technology of the transmission of messages (optical fibers, microwaves, satellites, commutation techniques). The two ruptures are, from the economic point of view, complementary: (a) allows to generate a volume of messages (in the form of data, that is, sets of binary impulses) which would have been impossible to conceive in an environment based upon only voice messages; (b) allows to satisfy, both from a qualitative and quantitative point of view and at acceptable costs, the traffic volume induced by (a).

The above perspective is not commonly accepted. In fact, on this issue, there is a strong technical conflict which hides, according to me, a twofold conflict of economic nature. The possibility of separating the transmission of the message from the elaboration of the content of the message implies the possibility of activating two separate markets:

the first one dealing with the management of the network (transmission of messages), the second one dealing with the elaboration of the contents of the messages (the so-called 'valued added' services).

The first source of conflict is the following: rupture (b) allows relevant savings in transmission costs; this makes it more convenient than in the past to enter the market of communications services; this market, on the other hand, is becoming potentially wider and richer than in the past, because of rupture (a), which induces the environment to generate a real leap in the traffic volume. Furthermore, rupture (a) opens a completely new market - that of value added services - in which several companies would like to enter. The existing carriers, on the other hand, are on one side interested in defending the market of communication services, in which they already operate, and on the other side to monopolize the new market for value added services.

This explains why the existing carriers tend to defend the reasons in favour of a monopolistic choice together with the hypothesis, which has a technical nature, that is not possible or convenient to separate the activities of transmission of messages and those of elaboration of the content of the message: in their philosophy, therefore, the services operated 'in connection' with the transmission network tend to become services 'of' the network itself.

The attitude of the existing carriers could lead to a second type of conflict, which cannot be reduced to a commercial one but is relevant at the level of strategic choices. The philosophy of 'non-separability' tends, wherever possible, to become a practice of 'non-separation', in so far as it reflects itself in the choice and design of a certain type of network architecture. This strategy obviously leads to embodying the maximum of intelligence in the network, which implies the possibility of keeping the level of intelligence embodied in the users' premises as low as possible.

However, the network carriers are not in the condition of controlling the tendencies of the intelligence embodied in users' equipments and facilities (which are instead decided by the companies who produce computers and the associated softwares). Since the present tendency is that of having rather intelligent equipment - the minimum one being that of a PC - there is a strong risk of duplicating the intelligence which is embodied in the comprehensive system 'network/users' equipments'. There is, therefore, a risk of

wasting investments in a situation in which the maximum saving of them would be otherwise required.

The set of arguments developed above militate in favour of a sort of 'compromise' strategy, at least for the countries well decided not to 'deregulate'. The solution is that of maintaining the monopoly only over the management of the network, leaving the market for value added services to private firms within a strict and effective regulation of technical standards.

This solution should be pursued in a broader strategy approach which could couple an initial policy of low fares for the traffic (fares which could be increased later on, once the market has been consolidated) with the maximum of complementarity and collaboration among the monopolistic carriers and the companies which provide the services.

In this way, not only the financial problem of finding the capitals which are necessary to make the due amount of investments would be eased, but the consolidation of the new markets would be highly accelerated, allowing then, within a time span of 10-15 years, a fair pay-off of the system's financial efforts.

The failure to adopt this strategy or, worse, the likely adoption of ambiguous policies, would result instead in a high risk of not synchronising the development of the network and that of the market for the traffic associated to the development of the market for value added services. In such a situation bottlenecks in the network would slow down the growth of value added services, while the low level of traffic would forestall the pay-offs of the investments made both upon the network and in the services, as it is usual in all the cases in which a problem of threshold is involved.

Chapter Seven

CHANGES IN THE STRUCTURE OF TRADE AND NEW FORMS OF ADJUSTMENT POLICIES

Colin I. Bradford, Jr.

INTRODUCTION

One of the most significant changes in the world economy over the last fifteen years has been the change in the structure of trade relations resulting from the emergence of the newly industrializing countries (NICs) as exporters of manufactured goods on a global scale. The success of the East Asian NICs - South Korea, Taiwan, Hong Kong and Singapore - has been heralded as a triumph of outward oriented, open economy, market driven development strategies and of demand management, price determined adjustment policies. On the basis of the East Asian cases, the new orthodoxy of outward oriented development promoted by the World Bank meshes with the old orthodoxy of IMF stabilization programs. More than this, the Reagan administration has found a happy fit between its own domestic visions favoring private enterprise and free markets and the stylized version of the East Asian success stories, launching a global ideology of growth with stabilization, enshrining market oriented economic policies as the centerpiece of the Baker Plan for handling the world debt problem.

These perorations constitute what Keohane calls 'intermediate injunctions' that he takes as 'the essence of international regimes' (Keohane 1984, p.59). They appear to be consistent with the liberal international order of the post-Bretton Woods era. Growth with stabilization is more than a rhetorical device, however. It is indeed an attempt to conceive and implement new forms of adjustment policies whether of market oriented varieties of the Baker Plan or

what Tony Killick and others have called a 'real economy strategy' (Killick 1984). It goes to the heart of our thinking about and understanding of the dynamics of economic policy.

This paper will examine the development strategies, adjustment patterns and stabilization policies of two East Asian and two Latin American NICs: South Korea and Taiwan; and Brazil and Mexico. The political economy approach taken here is consistent with the main themes of this volume. The main focus will be the interaction of market forces and national economic policies, the balance of real and financial variables and the relationship of long and short run policies and patterns in shaping global models and ideologies of adjustment.

There seem to be two fundamental questions within this focus which need to be addressed interactively: one is the nature of successful models of development and adjustment; the other is the nature of the international regime itself. The mythology has it that market-oriented, outward-looking open economy countries have done better in economic terms in part because of the inherent efficiency of the policy regimes they have adopted and in part because of the consistency of it with what is perceived to be the dominant liberal international regime prevailing since Bretton Woods. This paper raises two questions regarding this widely accepted set of views.

The first is an inquiry into the real versus the apparent nature of the policy regime adopted by the East Asian NICs which have served since the mid-1970s as models of development, adjustment and stabilization. Most of this paper is devoted to this issue. The second issue, given less emphasis here, is the real versus the apparent nature of the current international regime and whether state intervention in economic policy by the NICs has not introduced new non-market elements into international trade and finance which have contributed to markedly transforming the global order.

DEVELOPMENT STRATEGIES AND STRUCTURAL CHANGE

As mentioned at the outset, there is something of a global consensus on the efficacy of outward oriented, market driven, export led economic policies identified with the East Asian NICs over the inward looking, interventionist, import

substituting policies (ISI) identified with Latin America. The former are seen theoretically as fitting neatly in the traditional small, open economy paradigm where outward orientation is identified with internal liberalization such that internal prices equal world market prices. This policy model applied to a small open economy implies that it is sufficient for an export promotion strategy to remove the bias against exports (implicit in an import substitution strategy) 'rather than reverse it' (Bhagwati 1978, pp.207-8). The Latin American cases, on the other hand, are seen as fitting the nearly-closed economy paradigm with the panoply of economic policies determining the real effective exchange rate under ISI creating a bias in favor of the production of importables and against exports.

Quite apart from the degree to which these paradigms and policy regimes capture the salient facts of the East Asian or the Latin American NICs, there are two problems at the theoretical level. As Ralph Bryant has pointed out the small open economy paradigm and the nearly closed paradigm share certain characteristics.

> One cannot fault the small and open paradigm for ignoring or de-emphasizing international influences. Indeed, certain of those influences take pride of place over all other aspects of the analysis. Note, on the other hand, that the international influences still run in only one direction. The rest-of-the-world economy plays a large role in driving the national economy; but nothing that happens in the national economy can have any impact on the rest of the world. On closer inspection, therefore, the small and open paradigm is not as dissimilar from the nearly closed paradigm as might appear at first glance. Both paradigms are designed to enable their users to ignore reciprocal international interactions. One postulates virtual independence, while the other assumes a large measure of dependence. Neither allows for or attempts to analyze genuine interdependence. (Bryant 1980, p.140).

Secondly, Jagdish Bhagwati pointed out some time ago that export promotion (EP) is not symmetric with ISI in that EP only offsets the ISI bias (EERx = EERm) rather than reflecting a set of policies which create overall a bias towards exports (EERx > EERm).

> The reason for this asymmetrical choice of definition of the EP strategy is that the countries that are popularly regarded as 'export promoting' because of their successful export performance happen to offset, rather than turn on its head, the export bias implied by EERx < EERm. This is possibly one of the important reasons, as we shall presently see, for their successful economic performance. (Note that all definitions are essentially arbitrary and must be chosen so as to reflect analytical convenience.) (Bhagwati 1978, pp.208, 217).

Offsetting rather than turning on its head the negative export bias is a necessary, not an 'arbitrary', construct in order that EP fit with the small open economy paradigm. For internal prices to equal world market prices, EERx must equal, not exceed, EERm. In the small open economy paradigm, the state has no independent price setting role (Bryant 1980, pp.138-9). The price setter is the world market. In most of the literature up to the present there is only one type of outward orientation. This literature defines outward orientation as internal liberalization and export promotion as an exhaustive category.

I have postulated elsewhere (Bradford and Branson 1978, Chapter 1) a set of typologies of development strategies which creates a new category within the general policy regime of outward orientation which presumes an active role of the state in determining policy parameters that create an export bias where the net result of various policies result in EERx greater than EERm. This I identify as 'export push' and distinguish it from the EP strategy in the literature which I label as 'open economy' outward orientation. Export push is more consistent with Bryant's intermediate interdependence paradigm in which national economic policy is the critical focus, international influences are two-way, and national policy autonomy is possible. In this paradigm each economy is embedded in the world economy, both affecting it and being affected by it. (Bryant 1980, figure 10-4 and pp.135-50). It is this degree of interdependence that in principle raises the interactive issues of the relationship of national policy regimes to the prevailing international regime.

The 'export push' national policy regime constitutes an alternative theory of the successful development, adjustment and stabilization path followed by the East Asian and Latin American NICSs. It turns the stylized contrasts

between the two regions on its head and finds more similarities than differences in policy regimes adopted by Korea, Taiwan, Brazil and Mexico.

Underlying this export push development model is an assumption which economists rarely deal with but which undoubtedly is a primordial motivation for economic policy: the use of national power and policy autonomy to enhance each other. Stephen Krasner (1985) identifies this as a 'structural' approach to international policies. Governments of countries of the South 'are behaving the way states have always behaved: they are trying to maximize their power - their ability to control their own destinies' (Krasner 1985, p.12).

The alternative theory of the successful export strategies of the NICs finds a major role for the State in using economic policy instruments to affect the productive structure of the economy and the volume and composition of exports (Bradford 1986b). There is evidence of a strong association between rates of structural change and rates of growth in value added in manufacturing between 1965 and 1980, on the one hand, and criteria used to identify NICs, such as volume and rate of growth of exports of manufactures, on the other. There is also evidence in most transitional economies of considerable change in the composition of exports according to factor intensities following a general pattern from natural resource intensive exports to unskilled labor-intensive exports to physical and human capital intensive exports. These patterns of dynamic structural change internally and externally seem to suggest a strong role for the state in accelerating these dimensions of the development process. Hong Kong is interestingly the exception with a lower index of structural change and a lower average rate of growth value added in manufacturing from 1965 to 1980 than the averages for developing countries as a whole along with a relatively static pattern in the composition of exports between 1967 and 1978.

Not surprisingly, the principal instrument variable for affecting these supply-side changes is investment. There is evidence using data from the UN International Price Comparison Project (Kravis, Heston and Summers 1982) that investment goods prices are lower than government and consumption goods prices within transitional economies and lower in transitional than in non-transitional economies. This seems to suggest that underpricing investment goods (which would be expected to accelerate the structural

changes identified with the NICs above) is associated with the high growth and dynamic export performance of the NICs (Bradford 1986b). As a result, monetary and fiscal policies become important elements supporting the export push development strategy of the NICs in facilitating structural adjustment. (See Buiter 1986, pp.1-6 for delineations between stabilization and structural adjustment policies.)

Case study materials (Bradford and Branson 1987, especially Hong (1987) on Korea; Wade (1984) on Taiwan; and Bryant (1985) on Singapore, summarized in Bradford (1986a)) provide evidence of selective policy intervention in Korea, Taiwan and Singapore. Interest rate subsidies and credit allocations in Korea, fiscal subsidies in Taiwan and tax incentives in Singapore have been deployed on behalf of sectoral strategies for industrialization and manufactured exports in these three countries. The state has had a highly specific strategic design internally and externally and has marshalled policy instruments and engaged the private sector to achieve it. One familiar with Latin America over the last twenty-five years is struck by the similarities in the conceptual approach of these strategies in East Asia and development planning efforts in Latin America. The difference appears to be less in intellectual approach than in capacity to implement.

From this summary of recent research emerges a pattern of investment-led structural change leading to dynamic supply side export push in which the state has played the crucial catalytic role in achieving the development success associated with the NICs. The overall effect has been to produce a bias toward exports (EERx > EERm), which is consistent with the extraordinary export growth rates of the NICs in the 1970s and 1980s. This state-led, structural change, export-push theory of dynamic development stands in contrast to the open economy, internal liberalization version of outward orientation in which competitive exports are responsive to and driven by world demand. It moves us from seeing the NICs as either small, open economies or large, nearly-closed economies to seeing them as they indeed seem to be, as new powers in the world economy consistent with Bryant's intermediate interdependence paradigm.

This theory of dynamic change is more in line with what Nelson and Winter call inductive 'appreciative theorizing' (Nelson and Winter 1982, p.46) than it is with deductive,

formal neo-classical theory. Nelson's and Winter's 'evolutionary theory of economic change' substitutes a 'search and selection' mechanism for profit maximization and equilibrium conditions. The emphasis here on sectoral priorities and strategic investment allocations is consistent with it. 'The production set was not well defined in the appropriate direction from existing practice. It had to be explored and created'. (p.228) The essence of dynamic development in the theory presented here is the choice of priority industrial sectors and exports and the structural change that follows therefrom. It is interesting that this analysis highlights the importance of capital formation, production sets and sectoral choice in which the state has a large role where other analyses assume away these variables (Khan and Zahler 1983). The 'assumption of a given transformation curve (exogenously) was made to avoid consideration of sectoral production functions ... In the short run - capital formation, technical progress, etc. are unaffected by liberalization policy' (p.231).

PATTERNS OF ADJUSTMENT: 1980-84

If the East Asian and Latin American NICs are more similar to each other than previously thought in having adopted broadly comparable state-led development models, then it would be expected that they would have similar patterns of development and adjustment associated with dynamic industrialization and manufactured export growth. Trends in structural economic variables would be anticipated to be quite similar deriving from their similar development strategies. If the East Asian NICs have indeed shown greater capacity to implement the state-led development model, than the Latin American NICs, then economic performance might be poorer in Latin America even though the main lines of economic direction were similar.

In the period since the second oil shock and the interest rate shock in 1979, most economies and the world economy itself experienced major adjustment. Korea, Taiwan, Brazil and Mexico showed a strikingly sharp shift in their trade balances of between 9 and 14 percentage points of GDP since 1979 (see Table 7.1). This is a major shift of GDP shares in a relatively short period. For Korea, Brazil and Mexico growth in export shares were between two and three times more important than contraction in import shares of

GDP in correcting the trade balance. Korea began with a trade deficit of 7 per cent of GDP in 1979-80 while the other three NICs had trade deficits of 1-2 per cent of GDP in that interim. By 1984, Korea had achieved trade balance and the others had obtained sizeable trade surpluses: Taiwan 11.6 per cent, Brazil 5.5 per cent and Mexico 10.1 per cent of GDP. The one divergence from the general patterns characteristic of the four NICs in this period is that Taiwan achieved its massive trade surplus more through restricting imports than expanding exports. Nevertheless, all four countries registered export growth rates of between 13 and 23 per cent.

To move from a trade deficit in which a surplus of goods is available to the domestic economy through imports to a trade surplus in which a surplus of goods is supplied to the world economy through exports requires an offsetting internal adjustment. Table 8.1 shows that in the four NICs the burden of the internal adjustment was largely borne by a contraction of the GDP share of investment. There is essentially a common pattern as between the two East Asian and the two Latin American NICs. Instead of a classic case of overheating with excess demand triggering an adjustment that requires contraction in consumption and government spending, the NIC pattern is one of adjustment through shifts in the key instrument variable in the NIC development model.

This pattern in the 1980-84 period reverses the common NIC pattern discerned for the 1974-79 period (Bradford 1982, Sachs 1981, Diaz-Alejandro 1984, Van Wijnbergen 1984). The NIC pattern in the earlier period was one in which investment growth outpaced GDP growth pulling in capital goods imports from the OECD for industrialization and export capacity with the resulting current account deficits being financed by recycling the OPEC surplus. Whereas savings as a share of GDP increased in East Asia and Latin America in the adjustment period following the first oil shock, the investment share increased even more rapidly with the gap being filled by external savings. In this period, external adjustment facilitated internal transformation in economies with strong public policy commitments to industrialization and exports. In the wake of the 1979 shocks, these patterns reversed themselves with the adjustment in the external accounts forcing a dramatic contraction in investment.

Nevertheless, this contraction did not disrupt the

Table 7.1: NIC Adjustment Patterns: 1980-84 Shifts in GDP Shares (% points of GDP)

	+ X 197-84	- M 1980-84	Total Shift Trade Balance	- I 1980-84	- C +(- G) 1980-84	Total Internal Adjustment (% of Trade Balance Shift)
Korea	+10.40	-3.54	13.94	-6.72	-1.19	7.91 (57%)
Taiwan	+4.11	-8.05	12.16	-12.80	+0.04	12.76 (105%)
Brazil	+7.08	-2.23	9.29	-6.12	-1.47	7.59 (82%)
Mexico	+8.29	-4.22	12.51	-7.80	-3.13	10.99 (96%)

Source: IMF, IPS November 1985 Summary of Country Data

Table 7.2: GDP Growth 1980-84.

% Annual Growth Rates of GDP 1980 Prices in National Currency

	1967-70	1980	1981	1982	1983	1984	Average 1981-84
Developing Countries	6.0	3.4	2.4	1.6	1.5	3.7	2.3
Industrial Countries	3.7	1.3	1.6	-0.2	2.6	4.9	2.2
Korea		-3.0	6.9	5.5	9.5	7.9	7.5
Taiwan		7.1	5.7	3.3	7.9	10.5	6.9
Brazil		7.2	-1.6	0.9	-3.2	4.5	0.4
Mexico		8.3	8.0	-0.6	-5.3	3.5	1.4

Source: IMF, IFS November 1985. IMF World Economic Outlook, April 1985.

Table 7.3: Macroeconomic Trends

	1979	1980	1981	1982	1983	1984
Fiscal Deficit (% GDP)						
Mexico	-3.32	-3.12	-6.68	-15.43	n.a.	n.a.
Brazil	comparable data: none available					
Korea	-1.75	-2.24	-3.39	-3.13	-1.11	n.a.
Taiwan	-1.70	-0.60	-0.30	-1.00	-1.10	0.10
Money Supply Growth						
Mexico	35.70	36.50	49.50	70.70	63.00	66.90
Brazil	73.10	61.05	94.42	85.11	136.01	259.84
Korea	24.60	26.90	25.00	27.00	15.20	7.70
Taiwan	-	21.90	19.20	24.30	25.60	20.30
Domestic Credit Growth						
Mexico	34.90	36.50	49.50	113.10	49.40	50.70
Brazil	87.10	82.00	94.70	106.60	177.20	175.50
Korea	35.70	40.60	31.10	25.10	16.00	13.10
Taiwan	-	30.40	21.40	19.30	15.80	11.50
GDP Growth Nominal						
Mexico	31.20	39.40	37.40	60.30	82.00	71.70
Brazil	67.70	108.50	94.70	98.20	136.70	221.80
Korea	30.00	21.10	23.70	13.00	12.70	12.60
Taiwan	-	24.50	19.00	6.30	9.80	10.50
GDP Growth Real						
Mexico	9.20	8.30	7.90	-0.60	-5.30	3.50
Brazil	6.40	7.20	-1.60	0.90	-3.20	4.50
Korea	7.30	-3.00	6.90	5.50	9.50	7.90
Taiwan	-	7.10	5.70	3.30	7.90	10.50

CPI % Change						
Mexico	18.10	26.40	27.90	59.00	101.80	65.50
Brazil	52.80	82.80	105.60	98.00	142.00	196.70
Korea	18.30	28.70	21.30	7.30	3.30	2.30
Taiwan	-	19.00	16.30	3.00	1.40	-0.00
X Rate % Change						
Mexico	0.40	2.00	12.80	267.80	49.00	33.90
Brazil	103.30	54.10	95.10	97.70	289.40	223.60
Korea	-	36.30	6.20	6.90	6.20	4.00
Taiwan	-	-0.30	+5.10	+5.50	+0.90	-2.00
Current Account (US$)						
Mexico	-5459	-6162	-13899	-6218	+5326	+3966
Brazil	-10478	-12806	-11751	-16312	-6637	42
Korea	-4151	-5321	-4646	-2650	-1606	-1371
Taiwan	+181	-918	+519	+2246	+4412	+6922
Trade Balance						
Mexico	-2830	-2630	-4099	6795	13.762	12.799
Brazil	-2717	-2823	1185	778	6.369	13.086
Korea	-4395	-4384	-3628	-2594	-1763	-1036
Taiwan	+1320	+77	+1825	+3646	+6268	+9233

Source: IMF, IFS Nov. 1985, IMF Occasional Paper 39 (External Debt), The Central Bank of China - Financial Statistics - Taiwan District, The Republic of China - October 1985.

capacity to generate an export surplus. In fact, evidence of supply push export capacity by these NICs is shown by the fact that the export growth rates for the 1980-84 period for the four NICs is well above the average export growth rates for developing countries and for industrial countries in addition to being well above the average growth in world trade. The NIC adjustment pattern in the 1974-79 period was determined by capital goods imports and external savings, whereas adjustment in the 1980-84 period was achieved through exports.

MACROECONOMIC TRENDS: 1980-84

As pointed out above, even though the basic pattern and underlying dynamic may be similar as between the East Asian and Latin American NICs, there may well be differences in economic performance. These differences may derive more from differing capacities to implement a policy regime rather than from differences in the regimes adopted in the two regions. Differences in economic performance would be expected to reveal themselves in the macroeconomic trends in the four countries (see Table 7.3).

It is quite clear from Table 7.3 that Korea and Taiwan, with growth rates in the 7 to 7.5 percentage range, were able to sustain dynamic growth during the early 1980s when the rest of the world was growing at 2 to 2.5 per cent. Brazil and Mexico, on the other hand, suffered massive downturns in their growh rates in 1981 to 1983 with an average performance for 1981-84 well below the rest of the world. Korea and Taiwan were able to correct the trade balance and achieve high real rate of GDP growth whereas Brazil and Mexico were able to correct their trade balances but at the cost of GDP growth. A brief examination of macroeconomic trends in the 1980-84 period for the four countries reveals some interesting similarities and differences.

In Mexico the fiscal deficit increased to over 15 per cent of GDP by 1982 with growth rates in the money supply and domestic credit equal to or greater than nominal GDP growth from 1979 to 1982 (Table 7.2). Real GDP growth was sustained through 1981. Inflation increased while the exchange rate remained relatively fixed with a commensurate deterioration in both the trade balance and the current account, especially in 1981. In 1982 a massive

Table 7.4: Sectoral Shares of Domestic Credit: 1979-84 (as percentage of domestic credit)

	1979	1984
Korea		
Gov't (net)	6.8	8.9
Public enterprise	1.9	1.5
Private sector	91.3	89.6
Taiwan		
Gov't (net)	-13.4	-5.0
Public enterprise	19.0	16.4
Private sector	90.6	66.0
Brazil		
Gov't (net)	-6.6	-9.2
Public enterprise	10.3	28.8
Private sector	86.9	65.6
Local government	6.7	13.0
Mexico		
Gov't (net)	46.2	49.5
Public enterprise	2.4	10.0
Private sector	47.7	36.5

Source: IMF, IFS November 1985

devaluation of over 260 per cent turns around the trade balance, improves the current account and triggers a recession. From this data, Mexico appears to be a classic case of an overheating economy in this period.

Brazil presents a similar but somewhat more mixed picture. The data on the fiscal deficit do not include public enterprises and therefore do not give a full picture of the impact of government deficits on the economy. This is better seen in Table 7.4 which shows the change in sectoral shares of domestic credit from 1979 to 1984 in the four countries. Note that the percentage share of domestic credit in Taiwan in 1979 was 19 per cent compared to 10.3 per cent in Brazil and 2.4 per cent in Mexico. This confirms what other literature suggests, namely that public enterprises are important in Taiwan. From a performance perspective, the important point is that while the public sector share of domestic credit remained relatively constant in Taiwan and Korea between 1979 and 1984, it mushroomed

Table 7.5: External Debt and Debt Service

	1980	1981	1982	1983	1984	Total 1982-84
Korea						
+ Debt	+6.9	+5.2	+4.6	+3.1	+2.3	+10.0
Debt Service	4.4	5.5	5.8	5.7	6.8	-18.3
Brazil						
- Debt	+3.3	+34.6	+11.3	+8.3	+8.6	+28.2
Debt Service	7.9	16.7	19.5	14.4	12.2	-46.1
Mexico						
+ Debt	+4.3	+41.4	+10.0	+5.7	+3.1	+18.8
Debt Service	7.9	8.5	19.4	21.6	16.1	-57.1

Sources: Korea: IMF Occasional Paper No. 39. Brazil and Mexico: Inter American Development Bank, Economic and Social Progress in Latin America, Annual Reports 1982, 1984, 1985

in Brazil to 28.8 per cent and increased to 10 per cent in Mexico by 1984 with proportionate declines in the share of domestic credit going to the private sector.

Domestic credit growth in Brazil was greater than or equal to nominal GDP growth in four of the six years shown in Table 7.5, consistent with growing pressure from the public sector. Inflation accelerated. The exchange rate was adjusted and the trade balance actually improved beginning in 1981 but the current account deteriorated with a sharp increase in the current account deficit in 1982. A maxi-devaluation followed in 1983 with major improvements in both the current account and the trade balance in 1983 and 1984.

Korea took major adjustment measures much earlier than Brazil and Mexico. For a variety of reasons Korea's external position had deteriorated in the late 1970s. On top of this, the President of Korea was assassinated in late 1979. In January 1980, the exchange rate was devalued significantly and a stabilization program was put into effect. The result was a drop in the real rate of GDP growth from 7.3 per cent in 1979 to -3 per cent in 1980. This slump caused Korean policy makers to adopt an expansionary policy in 1981-82 with the fiscal deficit rising to over 3 per cent of GDP and the growth rates in the money supply and domestic credit running ahead of nominal GDP growth. Growth performance rebounded but the external accounts were slow to improve until more contractionary monetary and fiscal policies were adopted in 1983-84. The rate of inflation dropped continuously over the period and exchange rate adjustment kept pace with the inflation rate after 1980.

Taiwan presents a very different case indeed. The external accounts were in surplus throughout the period with the minor exception of a slight deficit in the current account in 1980. Inflation was high in 1980-81 but was brought immediately under control in 1982 with an accompanying drop in the real GDP growth rate to 3.3 per cent. Moderately expansionary fiscal and monetary policies were adopted in 1982-83 to bring up the growth rate.

Taiwan is a unique case among the four countries in a number of related respects. There is smooth and balanced adjustment to changing international circumstances. The external balance improved markedly in Taiwan to sizeable surpluses in both the current account and the trade balance more by cutting imports than expanding exports, unlike the

other three NICs. Domestic monetary and fiscal policy and performance were kept on track. The exchange rate was adjusted with the inflation rate which itself declined to the vanishing point. Taiwan is a case of smooth autonomous adjustment without significant recourse to external financing.

With the exception of Taiwan, the general pattern of the other three NICs seems to be that the oil and interest rate shocks in 1979 onward caused in each case a mushrooming of current account deficits (1981 in Mexico, 1982 in Brazil and to a lesser extent 1980 in Korea) followed by or occurring concurrently with a major devaluation (1982 in Mexico, 1983 in Brazil, 1980 in Korea). As the appendix Tables 1-1 to 1-2 showing the country data on adjustment illustrate, the year of the devaluation in each of the three NICs is the year in which the major portion of the adjustment in investment as a share of GDP occurs in Mexico, Brazil and Korea. Capital goods imports undoubtedly contracted with the devaluation while oil imports increased as a proportion of total imports.

The other common pattern seems to be that the interest rate shock drove debt service payments significantly above new loans (increments to debt) such that the external payments imbalance forced both a trade and a savings surplus. The need for a savings surplus beyond the trade surplus due to the increase in debt service payments put pressure on the government deficit and the money supply.

Ex-post, the following identity must hold:

$$(M-X) + F = Se = I-Sn$$

where
M = imports
X = exports
R = net factor payments (interest payments largely)
Se = external savings
I = total investment
Sn = national savings = private savings and governmental savings

The mechanism is that as interest payments (R) rise, and external savings (Se) fall (because banks are less willing to lend), then pressures build for the trade balance to generate a surplus and for investment to be reduced below the level

of national savings to compensate for these shortfalls. This is the pattern we have seen in the adjustment of all four NICs. If external savings becomes negative, an export surplus and a savings surplus must be generated to meet debt service obligations in excess of new loans. This creates strain on the entire system, ultimately putting pressure on the government to close the savings gap through taxation which is recessionary, or through domestic credit creation which is inflationary.

Therefore the fact that debt service payments exceeded new loans by $18 billion in the case of Brazil for the 1982-84 years (Table 7.5) and by nearly $40 billion for Mexico in the same interval, indicates the pressure the external sector has put on the domestic economy and the vulnerability of macroeconomic variables in these economies to change in external circumstances. In Korea the difference between debt service and new debt is $8 billion. Figures are not available for Taiwan. As a result, the differences in economic performance between Mexico and Brazil, on the one hand, and Korea and Taiwan, on the other, appear to be rooted in the vulnerability of macroeconomic policy variables to external shocks. Indeed during this period both Mexico and Brazil have been praised for having taken strong adjustment measures in the midst of adverse circumstances (Morgan Guaranty, May and July 1984). Their inability to sustain smooth macroeconomic performance consistent with their development thrust relative to Korea and Taiwan may derive from mismanagement in an earlier period, the study of which is beyond the scope of this paper, or may be consistent with the notion advanced earlier that the basic difference between the East Asian NICs and the Latin American NICs is their capacity to implement a coherent development design rather than differences in the design itself. Korea and Taiwan seem to have been more able to keep macroeconomic policy consistent with and supportive of the development thrust while Brazil and Mexico, despite having a similar thrust, were unable to keep macropolicy harnessed to it due to external economic and, undoubtedly, internal political pressures.

APPEARANCE AND REALITY IN NATIONAL AND INTERNATIONAL REGIMES

The foregoing line of argument suggests that we are

confronted by a paradox with significant implications. The paradox is that the model of development and adjustment, or growth with stabilization, upheld as the most effective based on the East Asian experience is a market oriented, demand driven, internal liberalization model whereas the actual model used by these countries is a state-led, structural change, export push model. Monetary policies in Korea, subsidizing interest rates with preferred allocation of credit to export oriented sectors, and fiscal subsidies in Taiwan, played a major role in the implementation of their export strategies in the 1970s. Growth oriented macropolicies supported the development thrust while achieving significant internal and external adjustment in the 1980s. The state played a major role in the design of the development strategy and in eliciting a positive private sector response to support it in Korea and Taiwan. The state achieved considerable policy space for itself by conceiving and executing an aggressive development strategy.

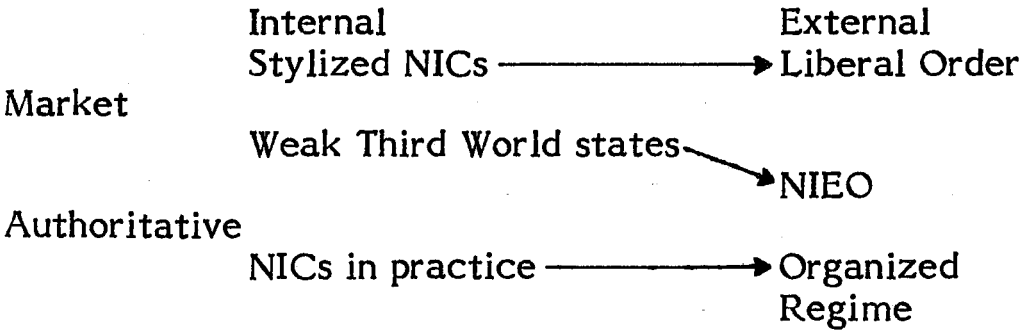
And yet the mythology is that the East Asian model is market oriented. 'Korea's achievements in adapting its economy to the turbulent world of the 1980s exemplify the benefits that can flow from an outward-looking, market-oriented strategy for economic adjustment and development ... There is much in Korea's experience that other countries can usefully seek to emulate' (Morgan Guaranty, March 1984). 'Korea's experience following the second wave of oil price increases is an excellent example of how orthodox stabilization policies, effectively implemented, can help a country adjust to domestic and external shocks' (IMF, August 1985). Secretary Baker's speech launching the 'Program for Sustained Growth' (The Baker Plan) at the Bank-Fund meetings in Seoul in October 1985, began by stating 'Korea's market-oriented approach and strong emphasis on private initiative are a lesson for us all' (Press Release No. 13, October 6, 1985).

The essence of the Baker Plan is derived from the stylized version of the East Asian success story.

As a result the form of adjustment policy preferred by the United States and adopted by the World Bank and the IMF is consistent with the liberal economic order symbolized by Bretton Woods. There is a great deal of pressure emanating from the norm-setting powers and institutions to play by the liberal rules of the game internally and externally. It is difficult to continue arguments in favor of trade liberalization internally and

internationally if one explicitly recognized that the 'success stories' did not play by those rules. The successful countries themselves have perhaps the greatest stake in being seen as conforming in their national policy regimes to the preferred international norm. The interplay of appearance and reality begins to become confused.

Stephen Krasner argues that Third World preference for an authoritative, as opposed to a market oriented, international regime in the form of The New International Economic Order (NIEO) derives from political weakness and vulnerability of most Third World countries. By contrast, although the stronger East Asian NICs 'have not rejected Third World proposals, they have not taken an active role in formulating or defending them in international forums' (Krasner 1985, p.58). The paradox is that weak Third World states, with no real chance to transform the international regime into an authoritative one, engage in a 'meta political strategy' rhetorically calling for the NIEO while the East Asian NICs stand by relatively silently implementing an authoritative national policy regime, de facto contributing to changing the global order, while the dominant powers interpret the East Asian model as market oriented.



Weak Third World states appear to challenge the liberal order while actually submitting to it. Strong Third World states, like the NICs, appear to play by the liberal rules while in reality transforming the structure of trade by adopting an authoritative national policy regime which contributes to fundamentally changing the means by which the global order operates both by the nature of the state-led, export push strategy used and by the 'managed trade' response it elicits from industrial countries. The 'market oriented' countries are in fact perhaps moving the world toward, what Paolo Guerrieri and Pietro Carlo Padoan have called, an 'organized regime' rather than enhancing the liberal global order as is so often supposed.

As John Zysman has pointed out, 'the premise of the rules of international trade, the GATT system, only awkwardly fit many of the new realities of international trade. The assumption - half truth and half fiction - that governments negotiate about the rules of trade, leaving the market to settle the outcomes, is increasingly less tenable. More than ever, governments are directly negotiating about outcomes' (Zysman 1983, p.15). Whether the existing international regime is a market or government regulated regime is at the very least an issue for debate and not a foregone conclusion.

CONCLUSIONS

The implications of this analysis for thinking about paradigms, policy models and international regimes seems quite clear though more complex. It has been argued here that the successful development of the East Asian and the Latin American NICs has transformed them from small open and large, nearly closed economies, respectively, into intermediate interdependent economies that both adapt well to and influence the world economy. This transformation has been derived from the adoption by the NICs of a state-led, structural change, export push model rather than a market oriented, demand driven, internal liberalization model. As a consequence, the international regime has been changed by the emergence of these new powers in the world economy and by the authoritative national policy regime used by them to achieve their insertion into the global order.

The implications for the search for new forms of adjustment which combine growth with stabilization would seem to be more pragmatic and selective recommendations for enhancing the interactions between the public and private sectors, rather than emphasizing one over the other, and for improving the balance between the real and the financial side of the economy, rather than allowing the financial requirements of the debt problem to drive the real economy into recession or inflation, eventually destabilizing macropolicy performance. Pragmatic acceptance and advocacy of a mixed economy model in which political leadership and the state have a major role in conjunction with the private sector are more accurate reflections of the lessons of the East Asian and Latin American experience in recent years than is the prevailing global ideology of the

dominance of market forces. Rather than growth with stabilization arising out of a consistent open economy, market oriented, price determined regime it arises out of an approach involving structurally oriented intervention by governments to spur supply-led, export push development strategies and more gradualistic, growth inducing macroeconomic stabilization policies.

Appendix 1-1: Pattern of Adjustment: Mexico
(Percentage Shares of GDP)

	1979	1980	1981	1982	1983	1984
C	64.41	62.00	61.00	61.33	60.41	n.a.
I	25.95	28.12	28.98	21.25	20.26	n.a.
G	10.89	10.82	11.65	11.23	9.27	n.a.
X	11.19	12.56	11.94	17.37	19.48	n.a.
M	-12.45	-13.51	-13.58	-11.19	-9.43	n.a.

Source: IMF, IFS November 1985. 1984 data not available.

Pattern of Adjustment: Brazil
(Percentage Shares of GDP)

	1979	1980	1981	1982	1983	1984
C	70.50	70.82	70.21	69.45	71.25	70.45av* 68.83
I	22.12	22.52	21.22	21.24	16.79	16.40
G	9.34	8.75	8.91	9.95	9.41	7.65* 9.27av
X	8.84	8.51	9.01	7.56	11.13	13.90
M	-8.80	-10.63	-9.37	-8.22	-8.78	-5.40

1984 data estimates are provided by the IMF staff. Source: IMF, IFS November 1985

Table 1.2: Pattern of Adjustment: Korea
(Percentage Shares of GDP)

	1979	1980	1981	1982	1983	1984
C	62.21	65.63	65.45	64.52	62.42	60.15
I	35.69	30.74	28.51	26.43	27.22	28.97
G	9.76	11.22	11.16	11.48	11.25	10.63
X	27.28	33.09	35.99	35.35	36.51	37.48
M	-34.51	-40.69	-41.29	-37.67	-37.36	-37.15

Source: IMF, IFS November 1985

Pattern of Adjustment: Taiwan

(Percentage Shares of GDP)

	1979	1980	1981	1982	1983	1984
C	50.19	51.14	51.55	52.55	51.56	50.76
I	33.32	34.28	30.29	25.17	22.99	21.48
G	15.33	15.78	16.09	17.01	16.44	16.20
X	53.48	52.89	52.15	50.63	53.99	57.59
M	-52.33	-54.09	-50.08	-45.37	-44.99	-46.04

Source: The Central Bank of China, Financial Statistics, Taiwan District, The Republic of China, October 1985. (Compiled in accordance with IFB format.)

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PERSPECTIVE

Enzo Grilli

Professor Bradford's paper is, to say the least, provocative. I have enjoyed reading it and thinking about it. The main proposition he puts forward is that the model of development (and adjustment to the recent crisis) followed by East Asian NICs - heralded as market oriented, (world) demand driven and internally liberal - is actually a state-led, structural-change, export-push model, substantially similar to that followed by Latin American NICs. Differences in growth and stabilization results achieved by these two sets of countries, he argues, stem more from the differences in their respective capacities to implement their development designs, rather than in fundamental variations in the designs themselves.

The iconoclastic nature of Prof. Bradford's thesis is quite evident and as such it deserves close attention. Yet, I cannot help feeling that in trying to stand 'current wisdom' on its head, the author has painted a picture of the 'new orthodoxy' that blurs the existing differences between its politics and its economics. I have no difficulty in admitting that during the past ten years economics has at times mournfully given way to sophistry and politics in the marketplace of ideas that ultimately generate actions at both the national and the international level. But to redress this imbalance, one must not, to the extent possible, build straw men that can be easily knocked down. The effort should be in the opposite direction: in trying to ascertain what is sound and replicable in the few country success stories that have emerged and what is unsound and avoidable in the many failures in growth (and adjustment) that we have witnessed.

I have trouble accepting a characterization of the development strategy of East Asian NICs in what I consider descriptive terms: market oriented, demand driven and internally liberal. I have almost the same trouble accepting a characterization of the development design followed by Latin American NICs, such as Mexico and Brazil, as simply inward looking, interventionist and import substituting. These characterizations are not very helpful if one does not specify their actual policy content. Their contours are not sufficiently well defined to mean the same things to everybody. I also find it difficult to accept Prof. Bradford's iconoclastic view that there are broad similarities in the development designs followed by East Asian and Latin American NICs (a state-led, export-push, industrialization design) and that the differences in actual outcomes can be attributed to the inferior capacity of Latin American governments to implement them.

The focus should not be, in my view, on trying to prove or disprove the role played by governments in the development process of East Asian and Latin American NICs. In all these countries governments played a key role. The focus should be, instead, on what role they actually played. The question is not whether they influenced the development process, but how they did it.

In all the countries and territories covered in Prof. Bradford's paper, rapid industrialization was a key strategic objective in the 1960s and 1970s, and government policies (trade regimes, exchange rates, internal credit, taxation, subsidies and so on) were of critical importance in fostering it. They largely determined not only the final outcomes, but also the efficiency and the long-run sustainability of the processes that were set in motion. Resource allocation is not only a tricky business, but each allocative path actually chosen has costs and benefits. Economic structures are set in place and they react to the set of incentives that govern their functioning, be they market or plan determined. It is on the set of incentives actually put in place that attention should be focused.

In all these countries and territories, industrial growth was very rapid during the 1960s and 1970s, if faster in Korea and Taiwan-China, whose industrial bases were smaller to begin with than those in Brazil and Mexico. Industry has now come to account for about 40% of GDP in all four of them.

Yet, the shares of manufactures' exports in total exports and, generally, of exports in GDP are now

considerably lower in Brazil and Mexico than in Korea and Taiwan-China. Exports account for about 40% of GDP in the two Asian NICs, while in Brazil and Mexico the share of exports in GDP is about 10%. This tells us something about the role that trade has played in the industrialization process of these countries: much greater in the case of the Asian NICs than in the Latin American NICs. Obviously, differences in size have had an effect on the degree of export orientation that was instrumental in achieving fast growth in industry (higher for the 'smaller' Asian NICs than for the 'larger' Brazil), but to account for the differences in actual outcomes one has to look also at national trade regimes and their effects.

Since protection of manufacturing is widespread in developing countries - and the four under review are no exception - and since changes in its structure have taken place over time, it is instructive to look at differences in net rates of protection and bias against exports across them in about the middle of the period considered here. In 1966-69, the net effective rate of protection afforded to domestic manufactures (vis-à-vis foreign manufactures) was the highest in Brazil and the lowest in Korea, with Mexico and Taiwan-China in the middle. If we look at the bias against exports (vis-à-vis domestic sales) again we find Brazil at the top of the list, Korea at the bottom, with Mexico and Taiwan-China in the middle range (Table 1). Brazil, therefore, not only protected heavily domestic manufactures against imports, but also discriminated most heavily in favor of domestic sales. Mexico did both of these things on a smaller scale. Taiwan-China and Korea discriminated the least between domestic and foreign manufactures and between domestic and foreign sales.

Table 1: Effective Protection of Manufactures in Brazil, Mexico, Korea and Taiwan-China (1966-69)

	Net Effective Protection	Bias Against Exports
Brazil	68	122
Mexico	16	87
Taiwan-China	9	26
Korea	-11	10

Source: Bela Balassa, Change and Challenge in the World Economy, London, Macmillan, 1985, p.27.

There is another set of policy indicators that is worth considering in detail, across the sample of countries covered in Prof. Bradford's paper. These are the real exchange rates and real interest rates.

Real exchange rates provide a measure of the incentives for domestic producers to supply tradeable goods and of the international competitiveness of domestically produced goods. On both accounts, supply effects and market competitiveness, the evolution of real exchange rates tells us something of relevance as to the set of price incentives (or disincentives) faced by domestic producers of exportable goods. Efficiency of resource allocation as well as export performance depends signficantly on the evolution of real exchange rates.

Aside from the long-term trends, another important aspect of policy is the short-term management of real exchange rates. Failure to adjust regularly nominal exchange rates for the differentials between domestic and world inflation generates shorter-run real exchange rate cycles that seriously complicate producers' decisions. Given the large positive differential between domestic and foreign inflation experienced by most developing countries (here included are the four NICs under review), the potential for short-term real exchange rate mismanagement is quite sizeable.

There are important differences in the real exchange rate performance of the four countries included in Prof. Bradford's sample, over the 1960s and 1970s, both in terms of trends and of cyclical variations. Korea and Taiwan-China have, on both accounts, done significantly better than Mexico and Brazil. The trend in real exchange rates between 1960 and the mid-1970s was positive for both Mexico and Brazil, indicating a sustained tendency towards appreciation, while it was virtually zero for Korea. Taiwan-China maintained a virtually constant real exchange rate until the early 1970s, adjusted it upward in 1972-75 and has kept it virtually flat on trend ever since. Since the mid-1970s, both Brazil and Mexico realigned downwards their real exchange rates to compensate for the appreciation that had previously occurred and, in recent years, to push exports in the face of rising debt service obligations. These adjustments have helped to improve market competitiveness, but are too recent to have had any substantive effect on enlarging significantly the capacity to produce exportables.

Moreover, in both Mexico and Brazil, real devaluations proceeded in leaps and bounds and with temporary reversals of direction. In fact, if one looks across the annual variability of real exchange rates since 1970, one finds that the coefficient of variation is higher for Brazil and Mexico (0.18 and 0.10 respectively) than for Korea and Taiwan-China (0.07 and 0.06 respectively).

Finally, here are some comparisons between real interest rates across the four countries. Distortions of domestic capital markets are widespread in developing countries and they are largely the result of government intervention. Real negative interest rates on deposits are often a key symptom of financial repression, the result of ceilings on lending rates, discretionary credit allocations and large reserve requirements imposed on bank deposits. The quality and quantity of real capital accumulation is adversely affected. Mexico and Brazil have maintained, even if in different degrees, low or negative real interest rates throughout most of the period under review. In Korea and Taiwan-China, on the contrary, real interest rates have been kept positive during most of the period under review. The exceptions, for both of these countries, pertain to the oil-shock years, when domestic inflation accelerated rapidly. Both countries are, of course, oil importing.

It is clear, moreover, that artificially low or negative real rates constitute a direct incentive to overt or covert outflows of domestic capital. Even if we restrict ourselves in recent years, for lack of consistent information over time about private capital outflows, it is apparent that negative real rates of interest (alone or in conjunction with overvalued exchange rates) have played a key role in fostering private capital flights from Mexico and, to a lesser extent, from Brazil. Little, if any, private capital left Korea where real interest rates remained positive for most of the period under review (Table 2).

There are other important aspects of comparative policy performance that would be interesting to examine across these four countries. Credit and fiscal policies fall into this category. It would be interesting to compare the relative efficiency of subsidies to private enterprises (prevalent in the Asian NICs) versus the direct government intervention in industry via state owned enterprises (prevalent in Latin American countries such as Mexico). In order to remain within my task of offering comments on Prof. Bradford's paper, I will sidestep here these aspects of

Table 2: Capital Flight Estimates

	1974-76	1977-79	1980-82	1983-85
		(billions US dollars)		
Mexico	5.9	2.9	23.9	16.2
Brazil	-	-0.9	1.1	6.6
Korea	-0.6	1.0	0.1	n.a.

- sign indicates a reverse flow.

Sources: J.T. Cuddington, 'Capital Flights: Estimates, Issues and Explanations', CPD Discussion Paper, Washington, D.C., 1985 and Morgan Guarantee, 'World Financial Markets', July 1985.

policy performance.

The observations made so far should, however, be sufficient to illustrate my point. The key aspect of the comparative economic performance of these four NICs does not lie in the communality or differences in the development strategies that were actually pursued. Nor does it lie, in my judgement, on how active a role governments played in the industrialization process of these countries. The key difference is to be found, instead, in how governments steered this process, that is in the policies that they followed: the set of incentives that they offered, their appropriateness, stability and efficacy. In Asian NICs, government intervention was such that internal (relative) prices were kept in line with the need to ensure growth of supply of exportables and external market price realities were constantly taken as binding. Steady, positive incentives to the production of tradeables were offered via the price system throughout the 1960s and 1970s. External price competitiveness was also maintained. Bias against export was minimal. Real capital accumulation was helped by positive real rewards to private savings. In Latin American NICs, though in widely different degrees, external market constraints were not always taken as binding, incentives to the domestic supply and foreign sale of exportables via the price system were not as strong and steady and external price competitiveness was not always maintained. Domestic real capital growth was not given much incentive. And in recent years capital outflows became very large.

Policy performance is what counts. Economic strategies have not been so important over the period under review to

become a strict boundary to policy formulations, witness, inter alia, the turns and twists in the trade and exchange rate policies of both Mexico and Brazil (which were not covered in detail in these comments). And it is on policy performance that the governments of the Asian NICs did, in my view, do much better than those of the Latin American NICs.

The subsidiary conclusion here is that there is a large scope for policy improvements not only among the NICs, but in most developing countries. Better trade, exchange rate, fiscal and financial policies offer considerable room for improvements in actual performance by developing countries. Given the sorry state of the international economy, policy reform possibilities (which are obviously not disconnected from external conditions) offer a ray of hope to most developing countries. They can and should be aggressively seized. All this does not say much about international cooperation, but as popular wisdom has it in my native region 'if you want larger bread loaves, bake them at home' (if you can).

Chapter Eight

INTERNATIONAL MACROECONOMIC POLICY COOPERATION: WHERE DO WE GO FROM HERE?

Stephen Marris

The meeting of the Ministers of the Group of Five at the Plaza Hotel in New York on September 22, 1985, appeared to confirm the diagnosis in a Financial Times editorial five months earlier that: '... the concept of international coordination of monetary, exchange rate and even fiscal policies is re-emerging from the obloquy and ridicule to which, for five years or more, it has been fashionably consigned.' (1) Indeed, it now seems quite possible that, seen in historical terms, 1985 marked the beginning of a swing in the pendulum away from the economic orthodoxy of the first half of the 1980s, which was that if the major countries followed 'sound' policies - as they chose to define them - then the world economy, and exchange rates, would look after themselves. (2) The purpose of this paper is to consider where we go from here, bearing in mind both the experience of the last five years and earlier periods of international macroeconomic policy cooperation. As will be evident, it draws heavily on my book Deficits and the Dollar: The World Economy at Risk (1985). The main conclusions reached are that:

- It would be easy to overestimate the change in attitudes that has so far taken place, and hence to underestimate the difficulties that still lie ahead.
- It may therefore be best to follow a relatively cautious and low profile approach to better international macroeconomic policy coordination over the next year or two while the present major disequilibrium in the world economy is being corrected.
- But it is not too soon to start exploring the economic,

political and institutional modalities of a more ambitious approach to the management of the world economy, organized, in part, around a system of target zones or adjustable pegs for the major currencies.

MANY DIFFICULTIES STILL LIE AHEAD

The Plaza meeting was much more important for the words used than for the policy decisions taken. In terms of the philosophy of international cooperation the important points were:

- Public recognition by the US administration that it had a policy objective vis-à-vis the dollar, namely to bring it down. By the time of the State of the Union Message in February 1986 this had become more specific: 'The constant expansion of our economy and exports requires ... reliable exchange rates around the world.'
- Public recognition by the Five - four of whom have been staunch supporters of floating exchange rates - that markets are not always right. Or in the words of the communiqué, that '... fundamental economic conditions ... have not been reflected fully in exchange markets.' Again, President Reagan put it more forcefully in his State of the Union Message: 'We must never again permit wild currency swings to cripple our farmers and other exporters'
- Recognition that bringing the dollar down and stabilizing it at a sensible level depends not only on US monetary and fiscal policy, but also on the macroeconomic policies of the other major countries. Indeed, the participants in the Plaza meeting took the rather unusual and solemn step of appending to their communiqué a set of 'policy commitments' to which each country had subscribed.

As subsequent events have shown this evidence that the United States, in particular, has moved sharply away from a position of benign neglect vis-à-vis the dollar has had a dramatic announcement effect on exchange rates and exchange rate expectations. But subsequent events have also shown little evidence of willingness to change the divergent macroeconomic policies which were the main cause of the excessive rise in the dollar and the massive deterioration in

the US trade and current balance in the first place. This is hardly surprising, since in reality the 'policy commitments' in the Plaza communiqué were to a large extent only a restatement and justification of existing policies.

The key point here is that satisfactory correction of the present disequilibrium between the United States and the rest of the world requires both a sharp decline in the dollar and a sharp reversal of the relation between the growth rates of domestic demand in the United States and in Europe and Japan. From 1982 to 1985 domestic demand in the United States rose strongly, by 18 per cent, sucking in imports from all over the world, while domestic demand rose by only 9 per cent in Japan and as little as 5 per cent in Europe over these three years. If this 'growth gap' is not reversed, the whole of the burden of adjustment would have to fall on the exchange rate, and thus would be a great mistake because of:

- The magnitude of the inflationary shock this would involve for the United States, and the risk that it would set off a domestic price/wage spiral that would undermine the trade gains expected from the lower dollar, and
- The danger that the negative impact of the improvement in the US trade balance on demand in Japan and Europe would lead to a sharp slowdown in growth outside the United States, which would also slow down the desired improvement in the US trade balance, and rekindle the debt crisis. (3)

Seen in this light it becomes apparent that what had been achieved by May 1986 was just the easy part. The dollar had come down a long way, but correction of the 'real' disequilibrium - the deficiency of domestic savings in the United States and the weakness of investment demand relative to domestic savings in Europe and Japan - had yet to get under way. Past experience suggests, moreover, that the financial strains associated with a major downward shift in the exchange rate only tend to build up momentum after the currency has gone most of the way down. Consider, for example, the last time the dollar was: 'talked down', by the Carter administration, starting in the second quarter of 1977. By early 1978 the dollar had already declined half way, but it was not until a year later that - despite heavy intervention and even though the US current account had

already substantially improved - the short term interest rate differential in favor of the dollar reached what was then a post-war record level. The more recent experience of the United Kingdom provides another example of how an initially welcomed depreciation of an overvalued currency can lead to a loss of confidence requiring interest rates to be pushed up to undesirably high levels.

HOW MUCH WILL LOWER OIL PRICES HELP?

There is of course the question of how far the dangers lying ahead may be mitigated by the sharp decline in oil prices. There are two reasons for caution on this score.

First, the net expansionary impact on demand in the world economy may be rather small. There will be a major redistribution of income. The question is whether the losers are able and willing to maintain their spending by running down assets or going further into debt to a greater extent than the winners decide not to increase their spending but rather to use their gains to acquire assets or pay off debt. On balance, they probably will, but not by all that much. For Europe and Japan it should also be borne in mind that more than half of the direct benefit from lower oil prices goes to companies rather than households. And, with pressure on profits from the fall in the dollar, companies may well be inclined to use lower oil prices to improve profit margins rather than pass on the benefits to consumers.

Second, the drop in the oil prices will do little to facilitate the necessarily painful adjustment process between the United States and the rest of the OECD area:

- To the extent that demand is stimulated, it will be stimulated in the United States as well as in Europe and Japan. Indeed, it is likely that the US economy will prove more responsive to lower interest rates than the Japanese and European economies. Thus lower oil prices and interest rates will not help much to bring about the reversal of the sharply divergent trends in domestic demand that caused the present disequilibrium.
- It is true that the drop in oil prices will reduce the inflationary impact of currency depreciation in the United States. But it will also add to the anti-inflationary impact of currency appreciation in Europe and Japan. It will not, therefore, do anything to prevent

the sharp adverse shift in the inflation differential between the United States and the other major financial centers, which is an inevitable consequence of the correction of the overvaluation of the dollar. Rational investors should be primarily interested in this inflation differential rather than the absolute level of US inflation. Nevertheless, it seems that, at least so far, the decline in US inflation, mainly due to the drop in oil prices, has helped to maintain confidence in the dollar.

- In itself the drop in oil prices will add to the disequilibrium in current account positions in that Japan and Europe, being more dependent on oil imports, stand to gain relatively more than the United States.

To sum up, in my view the drop in oil prices has not done much in and of itself to reduce the dangers of a hard landing set out at length in Deficits and the Dollar. It could, however, significantly increase the potential for faster non-inflationary growth in Europe and Japan, and hence the scope for a soft landing, if - but only if - the countries concerned are prepared to take the expansionary monetary and fiscal actions necessary to achieve such faster growth.

THE CASE FOR A CAUTIOUS APPROACH OVER THE NEXT YEAR OR TWO

Given the difficulties still lying ahead, and given that lower oil prices will not in themselves do much to resolve them, I believe it would be wise to adopt a relatively cautious and pragmatic approach in the period ahead, concentrating on managing the adjustment process rather than reforming the system. The two key objectives should be to prevent the dollar from overshooting, and to maintain something like a 3 per cent growth rate in the OECD area as a whole. Neither will be easy.

The potential for the dollar to overshoot is very great because of the size of the US current account deficit, the time it will take to reduce or eliminate it, and the amount of external debt the United States will have accumulated before then. Monetary policy clearly has an important role to play. The Bank of Japan played its cards rather well. By raising interest rates in October 1985, directly counter to its domestic concerns about slowing growth, it gave a strong

signal to the exchange markets - no doubt a lot stronger than would have been given by intervention alone. And the impact this had on exchange rate expectations created a situation in which the Bank of Japan had, by May 1986, been able to bring the discount rate down to 3.5 per cent, a rate only reached once before, in 1978.

I am very doubtful, however, whether it will prove possible to prevent the dollar from overshooting simply through skilful management of interest rate differentials. Intervention on a large scale is likely to be needed, and this will raise the question of whether, at some point, the exchange markets should be given some quantitative indication by the major central banks of the range within which they would like to stabilize the dollar.

This is a very tricky question about which I have mixed feelings. The public announcement of exchange rate targets can have a strong stabilizing impact on exchange rate expectations, and hence - as shown by the experience of the EMS - can significantly reduce the magnitude of the departures from domestic monetary objectives needed to maintain reasonably stable exchange rates. Thus, somewhere down the road I believe we should move to a publicly announced target zone, or even adjustable peg regime between the major currencies. But a premature move in this direction could have unfortunate consequences. If, soon after they had been announced, the targets were tested by the market and could not be held, the credibility of this type of regime would be seriously undermined. At some point this risk should be taken. But as of now the odds seem to me to be too unfavorable. One reason for this is that, on the basis of past experience, I suspect that it will prove difficult to reach agreement as to where the zones should be set, not so much for technical but for more fundamental reasons.

First, agreement on target zones requires a broad measure of agreement on the current account positions for the participating countries that would be 'sustainable' over the medium run. Unfortunately the regular process of analysis and consultation on consistent 'balance of payments aims' built up in the OECD and the IMF in the 1960s and early 1970s has been largely abandoned. In this respect the decision taken at the Tokyo Summit to strengthen the procedures for cooperation in the Group of Five are encouraging.

But as this process gets under way, the participants are likely to find that the United States - which had a very

relaxed attitude on its current account deficit until the middle of 1985 - has swung around and will argue that it needs to restore its creditor status and should be running a current account surplus. As, however, the other countries realize what a large negative swing this would involve for their current account positions, they will also change their tune and argue that a US current account deficit is not such a bad thing after all, and that the aim should simply be to hold it down to a somewhat lower level. This is in fact exactly what happened in the negotiations leading up to the Smithsonian agreement in December 1971, and was one of the reasons why the realignment agreed upon then proved insufficient. (4)

In the present context there is likely to be a second even more difficult problem. Suppose that agreement could be reached that the interim objective should be to bring the US current account roughly into balance by 1990 or shortly thereafter. The amount by which the dollar would have to decline to achieve this objective depends, however, to a significant extent on what happens to the growth rate in the United States relative to growth in the rest of the world in the intervening years. For example in the 'cooperative scenario' analyzed in Deficits and the Dollar, strong action to reduce the US budget deficit is coupled with a substantial temporary fiscal stimulus in Europe and Japan: GNP growth 1987-90 averages around 3 per cent in the United States against 4.5 per cent in Europe and Japan. With these growth rates the dollar would only have to fall by 5 to 10 per cent from its present (early May 1986) level to bring the US current balance into equilibrium by 1990, with the yen, for example, at around 160 and the DM around 1.80. (5) Suppose, however, that US growth averaged 3 per cent, but that Europe and Japan took no action to offset the negative impact on their growth of the improvement in the US current balance, in which case, according to the model used in Deficits and the Dollar, their growth might average something under 2 per cent. In this case the dollar would have to decline by a further 25 to 30 per cent from its May 1986 level to bring the US current balance into equilibrium by 1990.

This brings us to what will surely be the most controversial question likely to bedevil movement towards closer cooperation on macroeconomic policies over the next year or two: the role of fiscal policy. The German and Japanese governments, in particular, remain strongly

commited to the view that fiscal policy should be set in a medium-term context and should not be used for short-term demand management purposes. They are thus highly resistant to the idea that in order to facilitate US external adjustment and maintain a satisfactory growth rate in the OECD area as a whole they should take expansionary fiscal action. Even if this were designed to be temporary they believe it would involve a mistaken return to 'stop-go' policies. In their view, moreover, there will be no need for expansionary fiscal action. If the United States would only take strong action to reduce its budget deficit, then interest rates will continue to fall, and this, together with improved profitability resulting from wage moderation, and the real income gains resulting from lower oil prices, should lead to a spontaneous acceleration of domestic demand in the other OECD countries sufficient to offset the negative impact on export demand of the appreciation of their currencies against the dollar.

I believe these views are mistaken. The US current account deficit exceeds 3 per cent of US GNP. Scaled down, this is equivalent to around 2 per cent of the larger GNP of Europe and Japan. Elimination of this deficit will therefore have a negative impact on aggregate demand in Europe and Japan of the same or somewhat larger order of magnitude as the oil price shock of 1973-74. As argued above, now that the oil producers have raised their spending to match their higher income, the boost to domestic demand from lower oil prices may be largely offset by the loss of exports to the oil-producing countries. And for export-oriented economies such as Japan and Germany, the positive impact of lower interest rates is likely to be more than offset by the negative impact of weak export demand and sharply lower profit margins.

Only time will show who is right. For the time being it seems clear that neither the Germans nor Japanese will change their present views unless and until events prove them to be wrong. And it seems equally clear that what happens in this respect will have an important bearing on the scope and content of any move back towards closer macropolicy cooperation between the major countries.

One possibility is that the governments concerned feel that the course of events justifies their view that fiscal policy need not, and should not, be used for demand management purposes. This would then suggest the desirability of a relatively low profile approach to

macropolicy coordination. With fiscal policy locked into a medium term stance, attempts to achieve a significantly greater degree of exchange rate stability could put too much of a burden on monetary policy and involve unacceptably large deviations from appropriate domestic growth and inflation objectives. Inevitably, therefore, a good deal of the burden of adjustment would continue to fall on exchange rates.

The other possibility is that events demonstrate clearly the harmful consequences of continued large swings in real exchange rates for the real world of production and trade, and also demonstrate that achieving the desired degree of exchange-rate stability will require coordination of both monetary and fiscal policies. This would suggest the need for a more ambitious approach to 'managing' the world economy.

A MORE AMBITIOUS APPROACH

It may be useful to consider the main features of such a more ambitious approach in the light of the wide variety of experience since 1945.

A first question is whether or not there is need for a collective effort to manage world demand at the global level. Through most of the 'fixed' exchange rate period this was regarded as self-evident. (6) In the first place, since it was accepted there was a trade-off between growth and inflation, and that both inflation and recession could be transmitted from country to country, it followed that there was a collective responsibility to maintain the right balance between growth and inflation in the world as a whole. It was also necessary to have a collective judgement on whether the risks at the world level lay on the inflationary or the recessionary side, since this provided a criterion for allocating the responsibility for action between individual countries. If inflation was seen to be the main danger, it was the more inflationary (deficit) countries that should restrict demand; if it was recession, it was the (surplus) countries where demand was weak that should expand demand.

By the early 1980s, however, this approach had been almost entirely rejected. It was argued that with floating exchange rates each country could insulate itself from price developments and demand conditions in the rest of the world. There was thus no legitimate case for countries to

object to the macropolicies being followed by other countries, nor, a fortiori, any need for collective efforts to manage world demand. It was thought, moreover, that at both the national and international level attempts to 'fine tune' demand had been a mistake and had paved the way to the stagflation of the 1970s.

Where do we stand on these issues today? To be controversial, let me suggest the following:

- It is now quite clear that flexible exchange rates do not insulate countries from price and demand trends in the rest of the world (although the relationships tend to be more complex than with 'fixed' rates, and asymmetrical as between the United States and other countries).
- There is therefore a case for collective demand management. Indeed, this will become increasingly evident as the conflict intensifies between European and Japanese insistence on the need for sharp cuts in the US budget deficit, and American calls for more expansionary policies in Europe and Japan.
- The record also shows, however, the dangers of fine tuning. Thus, monetary policy should, over time, aim at a reasonably steady growth in the money supply. And fiscal policy should be set into a framework of medium term objectives which take into account the underlying trends in the private sector's propensity to save and invest, and the need to avoid excessive growth in public expenditure.

Even if these views are accepted, however, it can be plausibly argued that the major nations are simply not prepared to submit their monetary and fiscal policies to the degree of collective scrutiny and decision-making that would be required to exercise direct collective control over the level of world demand. This is no doubt the reason why, over the years, so much attention had been given to the idea of trying to control the level of world demand indirectly by controlling the supply of 'international liquidity' either through some automatic mechanism (the gold standard or a wider commodity standard) or through a collective decision-making process (SDRs).

Unfortunately, it now seems clear to me that this was and is a will-of-the-wisp. First, the record suggests that the relation between national policy making and international liquidity has been much looser than often assumed; in other

words, the velocity of circulation of international reserve money (however that may be defined) has been even more unstable and difficult to predict than the velocity of circulation of domestic money. Second, and more fundamentally, by a remarkable irony of history, just as we had succeeded in creating a collectively created reserve asset (the SDR) we moved rapidly from an asset settlement payments system to a liability settlement system, i.e. a system in which it was easy and more congenial to cover deficits by borrowing from the private market than by running down official reserves. Basically this happened because, as highly efficient international financial markets were developed, it became apparent that virtually all countries possessed a substantial margin of unused creditworthiness and so had no need to hold large and increasing quantities of reserve assets.

I can therefore see no alternative but to try to strengthen collective efforts to manage world demand directly, rather than indirectly through control over liquidity creation. Presumably, it was the same line of reasoning which led the Deputies of the Group of Ten, in their report on The Functioning of the International Monetary System, to propose that more emphasis should be given to discussion at the ministerial level of the IMF's World Economic Outlook.

More thought should be given to trying to put as much meat as possible on to this proposal. Should the Fund staff's analysis and assessment be more systematically reviewed against other assessments, perhaps including private sector or 'independent' sources? Should there be a more formal process of reviewing the performance of the world economy against 'objective indicators' of growth, inflation, commodity prices, growth of world trade, etc. (as suggested in the report of the Group of Twenty-four)? Should participation in the discussions be widened to include those responsible, for example, for employment and trade - or even the private sector interest groups most directly involved? How does one ensure that discussions in powerful small groups such as the Group of Five take sufficient account of the wider interests in the world economy as a whole?

The second main requirement for a return to more explicit macropolicy cooperation is a regular process by which a broad measure of agreement is sought on a consistent set of balance of payments aims. Normally this is

thought of as a set of consistent aims for countries' current account positions, and this has often led to the criticism that such an approach ignores capital movements. This criticism is obviously ill-founded, since a current account surplus must be matched by a capital outflow and vice versa; indeed, from the start it was clearly understood that what was basically involved was an assessment of the potential for sustainable capital flows in the world economy over the medium run.

Making such an assessment involves many analytical and empirical problems. But a number of useful lessons can be drawn from post-war experience. In retrospect, it is clear that with 'fixed' rates we were too often tempted to try to manipulate capital flows to match what was happening to current account positions, either by controls or by excessively expansionary or restrictive monetary and fiscal policies. It is now equally clear, however, that with flexible rates, there is too great a tendency for cyclical or policy-induced capital flows to force undesirably large swings in current account positions. The record also shows that structural shifts in underlying propensities to save and invest take place comparatively slowly compared with the large shorter-term cyclical and policy-induced fluctuations with flexible rates. (7) Thus, what is needed is a 'managed' exchange rate system which is more responsive to longer term structural factors than the pre-1973 regime, but quite a lot less responsive to short-term swings in capital movements than the present regime. For this purpose I believe that a relatively broad brush set of balance of payments aims could prove quite adequate. The two main principles on which it should be based are:

- In a properly managed world economy, rates of return are likely to be lower in the richer and more mature industrialized countries than in countries in the course of rapid economic development, generating capital flows from the former to the latter.
- Within this general framework, capital is also likely to flow to small and medium sized countries with unexploited natural resources.

It should be stressed that with both the elements discussed above:

- a modicum of global demand management, and

- broad agreement on a set of consistent balance of payments aims,

are necessary ingredients for a return to a more 'managed' exchange-rate regime. The first is necessary to provide participants with an assurance that in accepting responsibility for maintaining a more stable exchange rate they will not be forced into unduly expansionary or contractionary monetary and fiscal policies. The second is necessary in order to provide guidance as to whether adjustment calls for a movement in the exchange rate as opposed to a change in monetary and/or fiscal policy.

In the light of the above, it was a pleasant surprise to see that the summit leaders at their meeting in Tokyo in May 1986 agreed to strengthen the procedures for economic policy cooperation in the Group of Five. The most important step forward was agreement on the need to examine regularly quantified national forecasts and objectives for such key variables as growth rates, inflation, exchange rates and current balances, to see whether they are consistent with one another, and to provide a basis for monitoring each country's performance. As discussed above, developing such an agreed quantitative framework for policy cooperation will be far from easy. But it is essential if agreement is to be reached on at what levels exchange rates should be stabilized, and which countries should take what action if things go wrong.

This still leaves open the question of what type of managed exchange-rate regime we should be aiming for. Mr Baker, the US Secretary of the Treasury, is talking in terms of a 'managed float.' John Williamson, my colleague at the Institute for International Economics, has made a strong case for a system of target zones. My own instinct is that we might do best to aim over time for an adjustable-peg system modelled on the EMS, but with wider margins. This is because I am:

- Impressed by the direct stabilizing impact on exchange rate expectations that such a system can have if it is sensibly managed.
- Worried that a target zone system with margins of 10 per cent and 'soft' shoulders, could just get blown away.
- Concerned, like many others, that we are still underestimating the damage done to the world's trading system by exchange rate misalignments, which may

have taken longer to gather momentum than might have been expected, but which may also prove much harder to reverse than we yet realize.

History is usually quite messy. The recent steps to strengthen policy cooperation in the Group of Five go in the right direction, but the real test still lies ahead. There will quite likely be serious setbacks along the way. This is why I believe that attention should be primarily directed to managing the difficult adjustment process between the United States and Europe and Japan over the next year or two. But we should also continue to work hard on reconstructing the essential elements of a managed exchange-rate regime, strengthening the institutional and political framework, and aiming to introduce a formal regime linking the dollar, the yen and the ECU by the end of the decade.

NOTES

1. Financial Times, 15 April, 1985, p.14.
2. For a discussion of the changing attitudes to macroeconomic policy cooperation during the post-war period, see Marris (1984).
3. See the analysis of a hard landing scenario in Marris (1985), pp.161-75.
4. See Robert Solomon (1978), pp.192-211.
5. Deficits and the Dollar, Table 6.4, page 169.
6. See Marris (1984), Managing the World Economy, op.cit.
7. Marris (1985), pp.303-5.

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PERSPECTIVE

Lamberto Dini

I find myself in broad agreement with the main thrust of Steve Marris' paper, which I found, as usual, highly readable and elegantly provocative. I think his paper poses the right question, namely how to achieve a more balanced and stable pattern of exchange rates. He also points in the right direction when he advocates for the future 'a more ambitious approach to the mangement of the world economy organized, in part, around a system of target zones or adjustable pegs for the major currencies'.

One point that comes out quite clearly from Steve's paper is the concern that the major countries, while still reluctant to embark on a serious exercise of macroeconomic policy coordination, might find it expedient to stabilize exchange rates and therefore agree on some sort of exchange rate constraint (let's call it target zones). Marris is concerned that 'a target zone system with margins of ± 10 per cent and 'soft' shoulders could just get blown away'. He thus develops the case for a cautious pragmatic approach over the next year or two concentrating on managing the adjustment process rather than reforming the system.

I would like to comment on this point. I think that Marris' prediction is correct as regards what would happen to any prematurely-introduced target zone system, since present imbalances in the world economy are far too wide and the prospect of their eventual elimination still distant in the future. Having said that, I think that we should not be unduly concerned about such eventuality, as I do not see any broad consensus in favor of the introduction of target zones at an early stage.

Recent events affecting the working of the monetary

system, such as the coordinated intervention of European central banks, the Group of Five Plaza Agreement, the fall in the oil prices, have been carefully analyzed in recent meetings at the OECD and in the Group of Ten. The conclusion that appears to emerge is that all these factors do not justify any major change in the findings of the G-10 Report agreed upon last June. There are however important changes in the emphasis that is placed on certain conclusions and there is more clarity on what should be the broad lines of future action as regards international monetary arrangements.

Let me elaborate on these points. Exchange rate misalignments among the major currencies have generated sufficient domestic political pressure to induce the major countries to act jointly to correct the imbalances and reduce protectionist tensions. At the same time it is clear that the major countries still prefer a system that would allow enough flexibility to reconcile the objective of external and internal equilibrium. Quite frankly I do not believe that these countries are ready to shape domestic policies exclusively on the basis of an external constraint or an exchange rate objective. Moreover, as you will recall, the G-10 Report singled out some of the major problems raised by the proposal to establish target zones: it was noted that in the present circumstances of still large payment disequilibria the target zones would have to be too wide to serve as an anchor for expectations; that in any case the markets would test the zones adding to instability and it would be difficult to allocate the burden of policy adjustment among the countries involved. This last point needs to be stressed. There is a widespread concern that if target zones were in force, the burden of adjustment would fall too heavily on the smaller economies, pressuring them to adjust to the US policy stance, much in the same way as under the Bretton Woods system.

I think the recent events have not changed the motives underlying such reservations on target zones. With a dollar on a downward trend, which most would like to stabilize but that risks frequently to be accelerated by all sorts of 'news', good and bad, it would be inevitable for the dollar to reach very quickly the lower intervention limit of any target zone one can think of. Moreover, the recent decline in oil prices has provided a powerful reminder that flexibility in monetary arrangements is still very much needed.

At the same time all countries seem now to attach

greater importance to the exchange rate as an indicator of overall economic performance and there has been a more open attitude vis-à-vis the role and impact of central bank interventions with respect to the rather lukewarm position taken in the G-10 Report. While everybody agrees, and has always agreed, that intervention alone is not likely to produce any lasting results, there is now a consensus that intervention is a legitimate policy instrument that can have important effects, particularly if undertaken in a coordinated fashion.

More importantly, there appears to be now a noticeable shift of emphasis on what should be the primary objective of international cooperation. In the G-10 Report cooperation was mostly seen as a way of making sure that all the major countries would take similar positions on the need to combat inflation, to restore balance in public finances and to allow market forces to play a major role in the allocation of resources. The report also mentioned, but with less emphasis, the objective of policy coordination without spelling out how such objectives should be achieved. In recent discussions I have detected a consensus that the world economy needs to be managed and a much greater disposition to analyze the detailed implications of policy coordination. Indeed, I think most will agree with Marris that there is no alternative to try to strengthen collective efforts to manage world demand directly, rather than indirectly through control over international liquidity creation.

A clear sign of this disposition toward policy coordination is the willingness to examine in depth the problem of the compatibility of policies in and among the major countries. This means that the objective of international cooperation should be to ensure that (i) policies in the major countries are internally compatible, i.e. do not generate domestic imbalances; and (ii) that policies are internationally compatible, i.e. do not generate external imbalances and exchange rate misalignments. I think there is agreement on the fact that these objectives are not easily achievable and that they can be pursued only in a pragmatic and gradual manner. The emphasis is going to be placed on the need to develop new and comprehensive indicators, or to use again old ones, as suggested by Marris when he recalls the process of analysis and consultation on consistent balance of payments aims developed by the OECD and the IMF in the 1960s. Finally there seems to be a

genuine desire to give IMF surveillance, both country-specific and multilateral, a fair chance to operate on issues of systemic relevance, blending new techniques and indicators into the traditional consultation process and in the World Economic Outlook.

To sum up, I am not too pessimistic about the future of international cooperation. As I said, by now nearly everybody agrees that the system needs to be managed and that new ways of organizing international policy coordination should be found. I think it is fair to say that the 'hard work' advocated by Marris to reconstruct the essential elements of a managed exchange rate system and to strengthen its institutional and political framework has indeed begun.

PERSPECTIVE

Michele Fratianni

MAIN POINTS

The line of enquiry of Stephen Marris' provocative paper can be summarised as follows. (1) It would be unwise to burden the exchange rate with the task of completely redressing the US current-account imbalance. A cooperative solution is superior to a decentralized one: Germany and Japan ought to expand their budget deficits, while the United States is attempting to reduce theirs. Monetary policy ought to be more expansive as well, especially abroad. Without cooperation there is the risk of rekindling inflation in the United States, retard the pace of economic activity abroad and exacerbate the international debt crisis. The strategy recommended by Marris is for fiscal policies to adjust to private sector's saving and investment so as to achieve a desired (i.e. agreed upon) structure of current-account balances in the world, freeing monetary policy to pursue 'a reasonably steady growth of the money supply.'

My principal reaction to the paper was: why do we observe little cooperation, despite its proclaimed virtues? Several reasons come to mind. First, cooperation - like any other public good - is plagued by free riding. Clubs are the institutional answer to the challenge of free riding. By setting an entrance fee and through exclusion clauses, clubs can retain most of the benefits from cooperation. Small clubs are better than larger clubs in doing that because of the homogeneity of the membership. The benefits from cooperative economic policies, however, cannot be easily excluded, unless tariffs and quotas become part of the package. The alternative of getting more countries to

cooperate, on the other hand, faces high organizational costs arising from countries having widely divergent views. Indeed, cooperation must be limited to a few large countries.

Second, even within a restricted group of countries cooperation is not a foregone conclusion. For cooperation to take place all participants must gain, or at least not lose. These conditions are not easily satisfied. Third, the existence of roughly homogeneous preferences does not ensure cooperation. Independent policies will emerge if countries disagree about the way the world works (e.g disagreement about the short- and long-run consequences of higher government spending). Finally, decision makers can share similar preferences and a common framework of analysis; yet cooperation may yield marginal payoffs because of a small degree of interdependence.

To relate my comments as closely as possible to Marris' main thesis I discuss first the genesis of the US current-account imbalance and then the possible gains from a coordinated strategy.

GENESIS OF THE US CURRENT-ACCOUNT DEFICIT

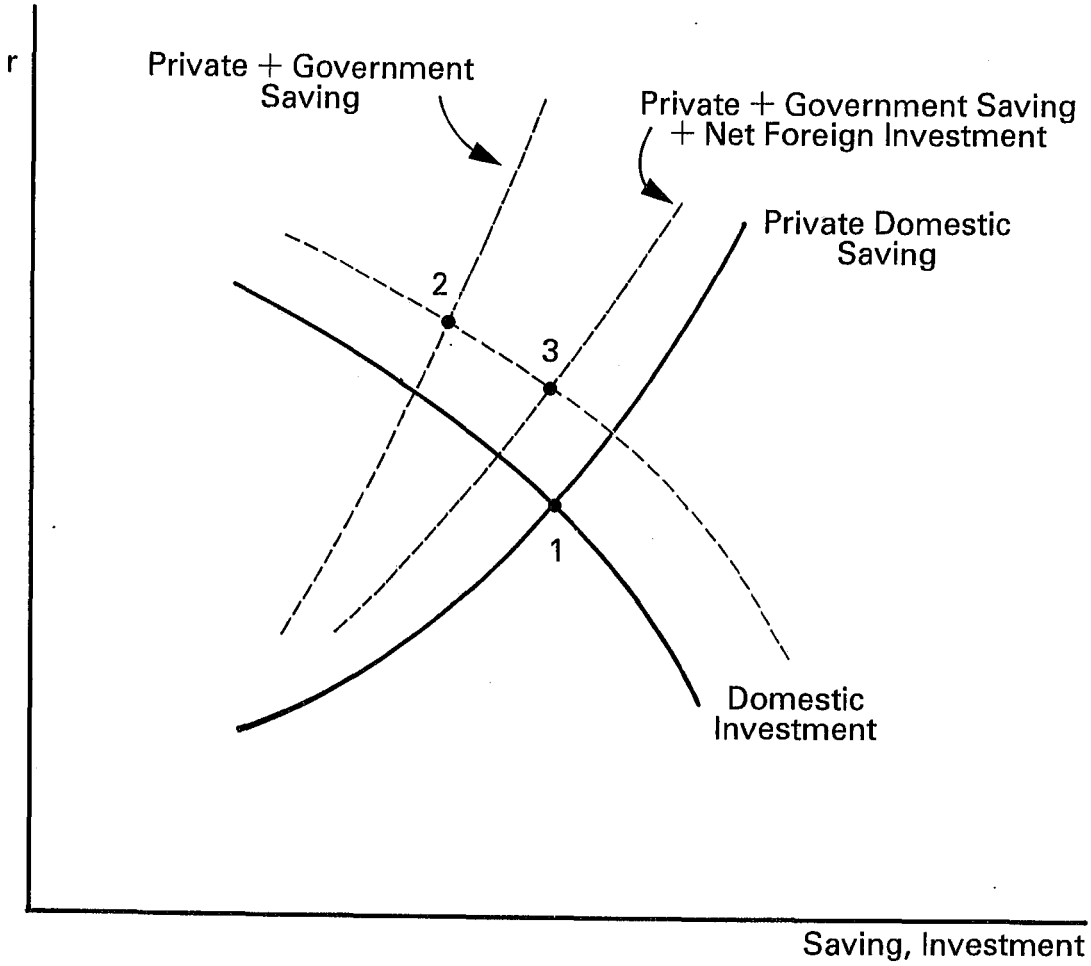
A great deal of Marris' analysis centers around the national income identity:

private saving + government saving = domestic investment + net foreign investment (1)

The US data underlying (1), even though well known, are worth restating. Government dissaving went from 1 per cent of GNP in 1980-81 to 3.5 per cent in 1985. Total saving, as a proportion of GNP, fell by approximately three percentage points over the same period. Domestic investment declined in 1982-83, as a reaction to the recession, but rebounded sharply in 1984 and 1985. The current account, the mirror image of net foreign investment, was in surplus in 1980-81, roughly in balance in 1982, and then progressively deteriorated. As a matter of arithmetic, the current-account deficits of 1984 and 1985 are quantitatively close to the size of the public-sector deficits.

These are ex-post outcomes which are consistent with a multitude of hypotheses. In an ex-ante sense we can state the reasons underlying the appreciation of the dollar with

Graph 1.



reference to Graph 1 where the demand for investment and the supply of saving are plotted against the domestic real rate of interest, r.

Equilibrium point 1 describes approximately the US economy before 1981: government saving and net foreign investment, measured as a proportion of GNP, were virtually zero. The Economic Recovery Act of 1981 raised after-tax rates of return on new investment projects, while at the same time reducing ex-ante domestic saving (Marris 1985, p.4). The economy moves to point 2. The higher r attracts net capital imports, enabling the United States to finance the higher desired investment at a lower level of real rates of interest that would have occurred otherwise; see point 3 in the graph.

With assets denominated in different currencies being imperfectly substitutable, the US real rate of interest is linked to the foreign real rate of interest, r*, via a risk premium, RP, and the expected real depreciation of the

dollar, $\bar{q}_{-1}$-q, where q denotes the log of the real exchange rate:

$$r - r^* - RP = \bar{q}_{-1} - q \qquad (2)$$

The risk premium depends on the current and prospective supplies of assets denominated in different monies. Given the sheer size of the US economy and the dominant position of the dollar in international financial markets, a higher r is not likely to be accompanied - at least initially - by a rising risk premium against the dollar. Assuming that q_{-1} represents the long-run equilibrium value of the real exchange rate, q must fall, or the dollar must appreciate today to depreciate later. This is essentially the disequilibrium view expressed in the Economic Report of the President 1984. (3) According to this view, the sustained nominal and real appreciation of the dollar from the end of 1980 to February 1985 can be explained by a series of budget deficit surprises.

The depreciation since February 1985 can be traced either to a sudden jump in the risk premium or to a reversal in the prospective stance of fiscal policy. Marris (1985, p.8 and p.10) refers to the damages that the risk premium could bring in his hard-landing scenario. At this moment, however, there is little empirical evidence of risk premia. (4)

An alternative - and more promising - way to explain the rapid depreciation of the dollar of the last fourteen months hinges on the anticipatory consequences of the Gramm-Rudman-Hollings Act, according to which budget deficits cannot exceed targets that are gradually reduced until the budget is balanced in 1991. Obviously, there are no quantitative estimates of what this is likely to entail for the exchange rate and the US current account. We have some estimates of the effects of the budget deficits of the 1980s. Peter Hooper (1984) has calculated, using the Multicountry Model of the Federal Reserve Board - which links the econometric models of Canada, Germany, Japan, the United Kingdom and the United States - that the sum of the fiscal measures taken in the United States from 1981 to 1984 explains a relatively small fraction of the appreciation of the dollar and of the US current-account deficit. The implication is that there are several other factors at work.

Regardless of the quantitative effects of US fiscal policy, the disequilibrium thesis is clear in attributing to it the appreciation of the dollar and the deficit in the current

account. A reversal in the current account will have to be preceded by a reversal in current or prospective budget deficits. This, in a nutshell, was the position of the Germans and the Japanese at the Tokyo Summit. (5)

COORDINATION OF FISCAL POLICIES

Marris disagrees with the policy prescription that a rectification of the US external imbalance requires exclusively the rectification of US fiscal policy plus the good fortune of falling oil prices. He downplays the beneficial effects of the latter and argues that an orchestrated redistribution of aggregate demand in the world is a superior strategy to decentralized policy making. The spending redistribution is to be achieved primarily through fiscal means: 'strong action to reduce the US budget deficit ... coupled with a substantial temporary fiscal stimulus in Europe and Japan' (Marris 1985, p.11).

The theoretical argument for cooperation is based on the notion that a country has more targets that instruments to achieve these targets. For example, assume that only monetary (M) and fiscal (F) policy can be employed to achieve target values of output growth (y), rate of inflation (π), and current-account balance (cab). The national authorities can pair M and F - assuming the existence of a reliable model that links targets to instruments - to obtain desired values of cab and π, cab and y, π and y. Which of these two pairs will be selected depends on the preferences of the authorities. The 'revealed' preference of the German and Japanese authorities is to aim at high cab and low π: the 'revealed' preference of the United States - at least until recently - is to be indifferent about cab and aim at high y and low π. The observed policy of fiscal contraction and monetary expansion in Germany and Japan has achieved high cab and low π, but at the expense of economic growth. The observed fiscal expansion and monetary contraction in the United States has served well this country in obtaining low π and high y, but at the expense of a deteriorating current account. Jointly these three countries could improve their position by coordinating their instruments. In this way Germany and Japan would not have to sacrifice economic growth and the United States would not have to put up with a large cab deficit. Since everyone is expected to benefit, cooperation should emerge. Yet, as we have mentioned

earlier, little cooperation is observed. In recent memory the Bonn Summit of 1978 and the Plaza Hotel agreement of September, 1985 are the only examples of economic policy coordination.

I have mentioned free riding and the difficulty to internalize benefits from cooperation by members of a club. (6) Another reason for not observing more cooperation is that national authorities attach different weights to the same targets, with weights shifting over time in reaction to changing economic conditions and changing public opinion. To illustrate this point, let us consider the policy multipliers generated by the Multicountry Model of the Federal Reserve Board, as reported by Oudiz and Sachs. (7) In their model under flexible exchange rates a contraction of fiscal in one country (US) has likely contractive consequences on Germany and Japan. (8)

To reduce the adverse consequences of this unilateral action, a cooperative strategy is set in place, consisting of a simultaneous fiscal expansion in Japan and Germany. The United States benefits from cooperation in that the reduction in y is more moderate and cab further improves without sustaining a higher rate of inflation. But the story is different for Japan and Germany: the improvement in y comes at the expense of π and cab. Is it a mere coincidence that at the Tokyo Summit the United States was an ardent advocate of this type of cooperation, whereas the German and the Japanese were reported as being very cool to the idea?

A third reason for not embarking on cooperation stems from the possibility that different countries have different frameworks of analysis, or evaluate the consequences of policy actions over different time horizons. Take Marris' prescription that fiscal expansion in Japan and Germany be temporary. The reality of budget politics is such that temporary expenditure increases have a way of becoming permanent, as the Reagan administration can well attest. Counter-cyclical considerations are less important than distributive ones in shaping the size of government expenditures and tax revenues. Hence the noted reluctance of the Japanese and the Germans of using the budget for short-run demand management.

COORDINATION OF MONETARY AND FISCAL POLICIES

While in the long run Marris wants a steady monetary policy, at present he favors a more expansive stance - especially outside the United States - to prevent too sharp a decline in the value of the dollar. The Economic Planning Agency of Japan has examined, with the aid of its World Economic Model, what gains could there be in a cooperative strategy involving a fiscal contraction in the United States, a fiscal expansion in Germany and Japan, and an overall easier monetary policy in the world. (9) The interesting aspect of the exercise is that the cooperative scenario includes many of the policy actions contemplated 'in isolation' by each of these countries.

In this exercise cooperation achieves a lower π in the United States and Japan, same π in Germany, higher y in Germany and Japan, same y in the United States; but lower cab throughout (negligible for the United States). One can argue that mercantilism cannot be so entrenched to leave Japan and Germany worse off. But, apart from this, the exercise suggest that the incentives for cooperation are marginal. (10)

Of course, there is much one can object to this type of exercise. The models examined do not incorporate the likely reaction of the US Congress to current-account deficits of $100 billion and more; nor do they envision the possibility of a large risk premium against US dollar assets; nor the long-run consequences of rising debt-to-income ratios; nor the consequences of financial crises arising from partial or complete repudiation of the external debt by some of the developing countries. The absence of these factors, as well as others, biases the case against cooperation. But having recognized all that, we still need to explain why national authorities adopt competitive solutions while preaching the virtues of cooperation.

NOTES

1. By the author's admission the paper is an outgrowth of his Deficits and the Dollar: the World Economy at Risk, Washington, DC, Institute for International Economics, December 1985. Unfortunately, at the time of writing only the summary chapter - policy analysis n. 14 of the IIE - was available to me. That I shall refer to as Marris

(1985).

2. Marris (1985, p.2) states that 'it is not particularly helpful to analyze the dollar's strength in terms of real interest rate differentials.' Consider, however, the US resident with local consumption patterns wishing to maximise the risk-adjusted rate of return expressed in terms of local goods. The US yields a rate of return, expressed in terms of local goods, equal to r. The German bond yields an expected rate of return, again expressed in terms of goods, equal to $r^* + q_{-1} - q$. Arbitrage - which need not be instantaneous - forces, in the absence of a risk premium, the equality between r and $r^* + q_{-1} - q$.

3. For small open economies r could not rise above r*. A budget deficit in these countries would generate the 'normal' spot depreciation of the home currency. Maurice Obstfeld (1985) cites the positive correlation between changes in stock prices in the United States, Japan and Germany as evidence against a dollar stock premium.

4. Cf. 'Floating Exchange Rates: Experience and Prospects,' Brookings Papers on Economic Activity, 1985, vol. 2.

5. Marris (1985, p.13).

6. On this point see Michele Fratianni and John Pattison (1982).

7. Oudiz and Sachs (1984), Table 5.

8. Theoretically, the outcome on output is ambiguous because of the opposing effects of changes in real rates of interest and real exchange rates. The latter, however, are believed to dominate.

9. Cf. 'Study of International Policy Coordination in 1986-87', November 1985.

10. Similar conclusions were reached by Oudiz and Sachs (1984). Larger incentives for cooperation are found by A.J. Hughes-Hallett (1985), 'How Much Could the International Coordination of Economic Policies Achieve? An Example from US-EEC Policy Making,' Discussion Paper n.77, Centre for Economic Policy Research, London, October 1985.

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