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America in
the World
Economy-the
Decade Ahead

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America

in the World Economy

-The Decade Ahead

ECONOMIC FORECASTING is a hazardous game, especially in the international economic field where one is faced with the problem of forecasting the behavior of not simply one national government but of an interacting group of national governments. A forecast for a decade ahead in this area can make no real claim to scientific support, but must instead be an exercise in "hunch" or "feel," derived from contemplation of contemporary trends. Anyone who undertakes to make such a forecast, however, has the consolation that by the time he has been proved wrong by events no one will have taken the trouble to notice it, so that he might as well be bold as timid. It is in that spirit that I approach the assignment of pronouncing on the subject of U.S. international economic relations a decade ahead-prospects and problems. I shall, in fact, put the emphasis on the prospects and problems, rather than the decade; for one can be surer of the general shape of the problems of the future than of the precise point of time at which they will become urgent. Specifically, I shall discuss four problem areas: The U.S. balance of payments, and balance of payments policy; the international monetary system; international trading arrangements; and problems of facilitating the economic development of the less developed countries.

This division of the topics, I should point out, is suggested by the economic aspect of the problems. If one were to place the main emphasis on the *international relations* aspect of the problems, which in some ways would constitute a more fundamental approach, one

would arrive at a much simpler classification. For in its international economic relations the United States confronts and is under pressure from two major groups of countries: The countries of the European Economic Community (the Common Market countries) and the less developed countries. Each of these groups has emerged on the international economic scene only in recent years—the Common Market in 1959, the developing countries group only since the 1964 United Nations Conference on Trade and Development. Each has its own ideas on how the international economic system should be organized, ideas which conflict with established U.S. policies and attitudes; and each has the power—both economic and political in the case of the Common Market, primarily political in the case of the developing countries—to compel some accommodation of U.S. policy to their views in the decade to come.

Trade with Communists

One important aspect of the differences of opinion between these groups and the United States relates to trade with the Communist bloc. Unlike the United States, the Europeans do not believe that imposing restrictions on normal commercial trade with the Communists yields the West significant military-political advantages in the Cold War, while they are extremely conscious of the loss of trade and profits that such restrictions entail. For their part, the developing countries are too desperate for trade (and aid) of any kind to discriminate among their trading partners on political grounds. Thus the United States is under the pressure of competition from the other two groups to moderate its policies with respect to trade with the Communists. The United States balance of payments deficit, moreover, in combination with mounting evidence that the Russians are not so bent on

world conquest as was formerly assumed, has made official opinion in the United States more receptive to the attractions of expanded trade with the Communist countries. One can, I think, safely predict a gradual weakening of barriers to trade with the Communists, and a consequent expansion of trade between the Communist bloc and the West, in the next decade. I mention this point here, because the remainder of this essay is concerned with problems in which the Communist bloc figures little if at all.

A political approach to the problems of the next decade, in terms of the tensions between the U.S. and the other two major blocs, would in some ways be more fundamental than the approach I adopted in what follows, which concentrates on economic problem areas. But the economic classification is more helpful to orderly thought, though it is always necessary to keep the political background in mind.

The U.S. Deficit

My first topic is the U.S. deficit, and U.S. balance of payments policy. The deficit as officially measured deteriorated sharply in the last quarter of 1964, and the deterioration evoked a new program to correct the situation, a program that concentrated on restricting private capital exports. Nevertheless, the deficit as calculated on a more reasonable definition than the one currently employed—the “official settlements” basis as contrasted with the “regular transactions” basis—showed an improvement last year, while the “basic deficit” as calculated by the Brookings group actually showed a surplus in the last quarter of 1964. My own judgment is that the underlying trend is in favor of the United States, and that sometime in the next decade the dollar deficit will give way to a European deficit problem. This judgment rests on the view that in the balance of payments field there is an underlying

long cycle of deficits and surpluses, a cycle whose length is associated with the reluctance of countries to take prompt action to restore equilibrium if this means either inflation or pronounced unemployment; and that, in consequence, the process of international adjustment is prolonged, and has a strong tendency to overshoot the mark.

What is important about the deficit that the U.S. has sustained over the past seven years, however, is not the conclusion that it will eventually disappear, but the effects that it has had on U.S. economic policy, effects which will persist into the future and will probably become more pronounced. Over the past five years, the U.S. has had to evolve policies appropriate to maintaining a regime of fixed exchange rates subject to very slow adjustment processes; and this has entailed radical departures from traditional policies. Let me list briefly some of the changes already under way that I believe will go still farther in future—indeed must go farther, in accordance with the logical requirements of balance-of-payments policy under the present regime of fixed exchange rates.

Shifting the Burden

First, and most important in terms of departure from previous policy, is the subordination of monetary policy to the requirements of balance of payments equilibrium, and the consequent necessity of relying on fiscal policy to stabilize the domestic economy. Under a fixed exchange rate regime, with the convertibility of currencies and mobility of capital, monetary policy must be used primarily to control international capital movements. Correspondingly, the job of maintaining high production and employment falls on fiscal policy. Traditionally, the U.S. has relied on monetary policy for domestic stabilization; except for very brief episodes since the Federal Reserve

was established, the country has never until the last few years had to cope with a deficit and a depressed economy simultaneously. Traditionally, also, the United States has not made deliberate use of the Federal Budget for economic stabilization, and indeed has cultivated a mythology of budget-balancing and of limitations on federal borrowing antithetical to the use of the budget as an instrument of stabilization. The tax cut of 1964 marks the first real attempt to use fiscal policy for domestic stabilization, an attempt stimulated by the balance-of-payments obstacle to expansionary monetary policy. There is, however, a long way to go to the adoption of the integrated use of monetary and fiscal policy for the simultaneous pursuit of domestic high activity and price stability, and international balance. The obstacles lie in part in traditional attitudes to the function of the Federal Budget, in part in the traditional insistence on the desirability of low interest rates. I would suggest that the next decade will see a process of refinement and streamlining of the use of the Federal Budget as the main instrument of counter-cyclical policy, and also a trend towards acceptance of the idea that high interest rates may not only be required to equilibrate the balance of payments, but may safely be resorted to, provided that fiscal policy is expansionary enough to offset the depressant effects of high interest rates on domestic economic activity.

Restrictions on Outflow

Reference to the political resistance to higher interest rates brings me to a second important change in policy, associated with that resistance: The growing resort to interferences with the international flow of private capital. The interest equalization tax, and the so-called "voluntary" restraint on bank foreign lending and direct foreign investment, consti-

tute devices for obtaining the effects of higher interest rates on international private capital movements without incurring the domestic effects of higher interest rates. In common with most economists and business men, I dislike these forms of intervention, on the grounds that they are arbitrary, discriminatory, and likely to be of diminishing effectiveness because the capital market will find ways around them. Nevertheless, I believe they are likely to become a permanent part of the machinery of U.S. international economic policy, both because of the reluctance to use interest rates already mentioned and because the European countries-whose attitudes must exercise an important influence on U.S. policy so long as the U.S. is in deficit-regard control of capital movements as a legitimate and desirable instrument of balance of payments policy. Moreover, this attitude is reinforced by latent hostility to U.S. direct investment in other countries, which is frequently believed to be a threat to national independence. Consequently, the logic of the situation leads one to expect that-as so often happens with regrettable temporary expedients-controls on capital exports will become a well-established feature of U.S. economic policy in the next decade.

Wage and Price Restraints

A third change, also derived from European ideas on the proper scope of balance of payments policy, is concerned with voluntary restraint on the upward movement of wages and prices, designed to keep the economy competitive in world markets. This type of policy is embodied in European thinking in the concept of "incomes policy"; in this country it has taken the form of setting wage "guide-posts," and using Presidential authority to press important industries-notably steel, which has been promoted by Harvard economists to chief

villain in the drama of inflation-not to raise prices. Incomes policy is the only alternative method of keeping prices internationally competitive that is open to a government that seeks to maintain full employment and is committed to a fixed exchange rate. There is no evidence that it will really work, especially in an economy as large and internally competitive as the United States, but the pressure to resort to it is virtually ineluctable. I therefore predict that more will be heard of it in future.

Finally, in this connection, the deficit has produced strong pressures on the government to intervene in international trade to restrict imports and promote exports. By the rules of American free enterprise, most of the interventions evolved so far are regarded as legitimate-such as aid-tying, and buy-American policies with respect to defense spending-since they concern government spending; for some mysterious reason, citizens who venture to travel outside the land of the free also are regarded as fair game for restrictive policies. What is more important for the future, in my judgment, is that the deficit has prompted the administration to look into such fiscal matters as the possibility of tax credits for exports, and the impact of the present tax system on the U.S. competitive position in world markets. I would expect that in the next decade there will be some revisions of the tax system-perhaps major ones, such as a shift from corporate income taxation towards excise taxation-in response to the desire to increase exports and reduce imports.

International Effects

The foregoing remarks pertain to U.S. international economic relations as they affect domestic U.S. economic policy. The remainder of the essay will be concerned with the major problems of international economic organiza-

tion with which U.S. policy will have to be concerned in the decade ahead. As already mentioned, there are three major policy problem areas: International monetary organization, international trading relationships, and assistance to developing countries.

In the international monetary sphere, it is apparent that the present system, in which the dollar has increasingly served as a reserve currency and a supplement to gold, has outlived its usefulness. The persistence of the U.S. deficit, and the obligation on the other major countries to finance it by holding ever-larger volumes of dollars, have led to increasing strain and resentment. On the European side, there has been increasing resentment of the inflationary pressure on the European economies created by the accumulation of dollars, and also of the fact that in accumulating these dollars the Europeans have in effect been financing American investment in Europe. In addition, the Europeans are conscious of the fact that in supporting the dollar they have to a large extent been supporting the economic and political dominance of the U.S. in the world economy. On the U.S. side, there has been increasing resentment of the ingratitude of the Europeans with respect to the willingness of the United States to finance Europe's immediate postwar deficits under the Marshall Plan, and of the European failure to appreciate the policy restraints on the U.S.'s capacity to deal with its deficit. Both sides are now agreed on the necessity of devising a new form of international reserve, alternative to both gold and dollars, and by implication are agreed on a diminution of the role of the dollar in international payments and finance. A dwindling of the role of the dollar may therefore safely be predicted.

Burden of Adjustment

There is, however, sharp disagreement over

the nature of the new international reserve and the terms on which it will be provided. At the heart of this disagreement is the issue of adjustment of international disequilibria. The issue specifically is whether the main burden of adjustment should be borne by the surplus country (through inflation) or the deficit country (through deflation), and the distribution of the burden will depend on the liberality with which the new form of international reserve is provided. Present indications are that the new reserve will be a multiple-currency-reserve unit, provided outside the IMF, with the Europeans having a major voice in the quantity to be provided. This, in turn, would imply greater rather than less pressure on the U.S. to get its deficit under control. That implication, moreover, derives its force from the range of policies that the Europeans include in the notion of adjustment. As already mentioned, these include incomes policy and controls on capital movements; they also include government intervention designed to improve the efficiency, or to reduce the level of activity, in specific sections of the economy. Thus likely developments in the international monetary field reinforce my previous prediction of a trend towards more governmental intervention in the economy in future.

The foregoing remarks relate to the likely course of development. I cannot forebear to point out that the crux of the difficulty in the international monetary field is the problem of adjustment. Given governmental commitments on the one hand to rigidly fixed exchange rates, on the other hand to domestic policies of maintaining full employment and resisting inflation, adjustment of relative prices and costs as required to restore international equilibrium is bound to be a slow process, since it depends precisely on governments failing to achieve their domestic objectives. There are two possible rational solu-

tions: one would be to arrange for long-term inter-governmental financing of deficits, instead of relying on short-term financing through central banks as at present; there has been some development in this direction, and it may well go further, though it raises all the problems of political rivalry and government co-operation. The other solution, which would be simple and more consistent with competitive principles, would be to arrange for more flexibility of exchange rates. Exchange rate changes are a far less painful way of adjusting relative prices and costs than the present method of relying on natural forces and inter-governmental squabbling; but the major countries are definitely heading in the opposite direction, towards more rigidly fixed exchange rates. So long as they continue in this direction, we must expect international adjustment to be increasingly handled by governmental interventions in international commerce and finance.

Trading Relationships

I turn now to the field of international trading relationships. U.S. policy in the postwar period was based initially on the overriding desirability of achieving economic integration in Europe as a means of strengthening that region as an ally against the Communists. The formation of the Common Market, however, created an economic and political force which in important areas of policy conflicts with U.S. foreign policy objectives. Specifically, from the economic point of view the establishment of the Common Market threatened to divide the free world into rival trading blocs. Recognition of this danger prompted the design and passage of the Trade Expansion Act of 1962, which was intended to contain this divisive threat by enabling the U.S. to negotiate with the Common Market a massive reciprocal re-

duction of tariffs, which would result in the kind of liberal international trading system that has been the objective of U.S. tariff bargaining policy since the 1930's. This was the purpose of the "Kennedy Round" of tariff negotiations under the General Agreement on Tariffs and Trade (G.A.T.T.). It has become evident in the past two and a half years, however, that the Common Market, under the domination of France, is the reverse of enthusiastic about the objective of a general liberalization of trade; and that while it is prepared to negotiate tariff reductions, it is not prepared to sacrifice the protective intentions of the Common Market, especially in the agricultural field. Experts now seem agreed that the Kennedy Round is likely at best to produce a 25% average tariff cut, and even this may not come off. The objectives of the Trade Expansion Act will therefore not be achieved.

The outcome that faces U.S. foreign economic policy is therefore that of a world divided into rival trading blocs, contrary to the grand objective of U.S. postwar foreign economic policy. Such an outcome poses the problem of what direction U.S. trade policy should take next. One possibility, of course, would be for the U.S. to drop the whole notion of striving for trade liberalization, and to retreat towards (relative) isolationism; this choice might result from disgust with the obstructive behavior of France, combined with the tendency of the present Administration to concentrate its attention on domestic issues and the improvement of American society. The alternative would be to abandon the U.S.'s long adherence to the principle of non-discrimination-which forces it to bargain through G.A.T.T. and enables the French to block the achievement of trade liberalization-and instead to base policy on the principle that freer trade is more desirable than non-

discriminatory protectionism. The U.S. has already made a start in this direction with the signing of the agreement for free trade with Canada in automotive parts; and there has been some expression of expert opinion to the effect that if (as seems certain) the Kennedy Round proves disappointing, the next logical move would be the formation of a preferential trading group comprising the U.S., Canada, Japan, and the European Free Trade Association. I would expect the whole question of preferential trading relationships to be reconsidered in the years ahead, not only for this reason but because pressure for preferences has been mounting from the developing countries, to whose problems I now turn.

Aid Versus Exports

U.S. policy towards the developing countries has in the past been based on the principle that the U.S. contribution of assistance should primarily consist of loans or gifts of development aid; and a substantial part of that aid has been a convenient means of disposing of farm surpluses. However, experience of the attempt to initiate economic development, and the increase in the numbers and elevation of the growth aspirations of the developing countries, has produced a fundamental change in the views of the developing countries on what their needs are, a change embodied in the *Final Act* of the United Nations Conference on Trade and Development. In place of aid, the developing countries now place heavy emphasis on their needs for increased export earnings to finance their development; and they are seeking to use all the political pressure they can muster in the United Nations and elsewhere to force the advanced countries individually and collectively to change their policies so as to provide the increased export earnings they require. Specifically, they are demanding two types of action that go against

the grain of the principles on which past U.S. commercial policy has been based. First, they want international commodity agreements to support the prices of their primary products at "fair" levels: explicitly, they are demanding that they receive the same treatment as farmers in the advanced countries. Second, they want preferential entry of their manufactures into the markets of the advanced countries; this amounts to demanding the same protection in advanced country markets from producers in other advanced countries as the domestic producers in each advanced country now enjoy.

These demands were advanced in full force at the United Nations Conference on Trade and Development, and just as forcefully rejected by the U.S. delegation. But they will be reiterated more vehemently in future; and they are not as repugnant to the Common Market countries, which accord privileges of this kind to the former colonies now associated with the Common Market, or to Britain, which has an established system of Imperial Preference and some existing commodity price support schemes, as they are to the United States. It is therefore extremely likely that in the next few years the United States will be more receptive to international commodity agreements than it has been in the past, and that it will begin to experiment with preferential schemes for the industrial products of the developing countries (as indeed it has already done with Puerto Rico). It would be natural also to expect that such schemes would be extended largely to Latin American countries, and so reinforce the tendency towards regionalism in international trading arrangements that is likely to follow the (at least partial) failure of the Kennedy Round.