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SUSTAINING THE INTERNATIONAL ECONOMIC SYSTEM: ISSUES FOR U.S. POLICY

MARINA v. N. WHITMAN

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

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Sustaining the International Economic System: Issues for U.S. Policy

Introduction: General Themes

In discussing the viability of the international economic system and the role of the United States in that system, it is tempting to organize the analysis into traditional categories: international trade, investment, the monetary system, relations with developing countries, and so forth. But this would risk ignoring or underemphasizing the strong interconnections among these categories and major issues and challenges that appear to concern all of them. And today, with virtually all aspects of the system in transition, under serious challenge, or embryonic, there is the rare opportunity—as well as the need—to build, expand, or rebuild components taking account of their interconnections and of the need for consistency and mutual support among them. To start, therefore, it is essential to recognize major themes that run like leitmotifs through issues ranging over virtually all aspects of the international economic system. And when the discussion moves on to take up the traditional policy categories, particular issues and problems will be discussed selectively, not comprehensively, in order to show how the central themes relate to and are reflected in detailed policy problems and choices.

In the sphere of macroeconomics—issues relating to the general level of prices and real economic activity and to overall economic stabilization—the dominant theme is the tension between the increase in international economic interdependence and the demand for domestic economic autonomy on the part of nation-states, and the search for means to minimize this tension. Few would deny the fact of increasing interdependence brought about by advances in technology, improvements in transportation and communication, and the deliberate reduction of barriers at national borders over the past thirty years. What needs emphasis today is the change in the way that this fact is assessed. For the first two decades after World War II, developments producing increased interdependence were viewed in classical economic terms, as factors enhancing specialization, efficiency, and competition, thus raising output, income, and standards of

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living in the participating countries. Recently, by contrast, another aspect has been more heavily emphasized. Increasing interdependence heightens the sensitivity of national economies to events and policies originating outside their borders and therefore beyond their control.

Tension between international market integration in the sphere of private transactions and the desire for national autonomy in the sphere of public policy was the theme of Richard Cooper's now classic book on *The Economics of Interdependence* nearly a decade ago: "The central problem of international economic cooperation—and of this book—is *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*" (1968, p. 5). Most nations, moreover, have been seriously concerned with this tension for some time. But, as we shall see, a number of developments have served to exacerbate it in recent years. And it has come to prominence in the United States, later than elsewhere, partly because a number of dramatic shocks to the domestic economy in the past few years have served to heighten our perception of the "dark side" of interdependence and to stimulate our recognition that such interdependence is, increasingly, symmetrical.

The reduction in national economic autonomy that accompanies increasing openness has several aspects. The most obvious is the increased sensitivity or vulnerability of the domestic economy to influences originating abroad. The larger the export sector relative to GNP, the more important, generally, are shifts in foreign demand as causes of domestic economic fluctuations; a similar relationship exists between the size of the import sector and shifts in foreign supply. And aggregates are not all that matter here; the more a country depends on imported oil, as we have been forcibly reminded, the more will domestic prosperity be affected by foreign decisions regarding its supply or price. Such vulnerability is not absolute; it "is a matter of degree and varies with the costs and time involved in developing alternatives. This implies hard policy choices about acceptable degrees of dependence and how willing we are to sacrifice the economic benefits of cheaper foreign supplies" (Nye, 1976, p. 134). Nations have some choice between the gains from international specialization and the reduced vulnerability that accompanies greater self-sufficiency.

No government, it is safe to say, has ever regarded a loss of autonomy with equanimity, but the problem is exacerbated today by the fact that, in the years since World War II, the governments of industrial nations have taken upon themselves (or had thrust on them by their electorates) responsibility for an ambitious list of domestic macroeconomic goals—for achieving and maintaining high levels of employment, an acceptably rapid and stable rate of economic growth, a reasonable degree of price stability, and socially determined standards of equity in the distribution of income. Their ability to discharge these responsibilities is critical to an assessment of the benefits and costs of increased economic interdependence. As Cooper (1974, pp. 58-59, and 1976) has noted, the efficiency gains from market integration are maximized by ignoring the boundaries of the nation-state; for private transactions in goods and factors of production, the optimum size of the integrated area is the world. By implication, the economic justification for the nation-state must lie in the existence of public or collective goods—including stabilization targets, the distribution of income, and the regulatory climate—and of differences in national consumption preferences for such goods (see Whitman, 1972).

An increase in economic openness not only widens the exposure of an economy to external disturbances, it also attenuates (at least under pegged exchange rates) the effectiveness of the domestic policy instruments used to achieve the collective macroeconomic goals just described. For example, an increase in the marginal propensity to import that generally accompanies the integration of commodity markets reduces the domestic impact of fiscal policy by increasing the proportion of that impact that leaks out into imports. Similarly, the integration of capital markets attenuates the impact of monetary policy on domestic economic activity, as flows of interest-sensitive capital across national boundaries offset desired changes in domestic interest rates or credit-market conditions.

The heightened tension between international market integration and the desire for national economic self-determination has encouraged what has been termed "defensive economic nationalism"—a nationalism based not on the desire to extend the nation's power beyond its own borders but rather on the desire to retain or regain control over economic developments within those borders. Historically, barriers to insulate an economy from foreign disturbances have taken the form primarily of restrictions on imports. Recently, nations have employed a wider variety of devices. Thus, American plans for reduced dependence on imported energy—to the extent that they are translated from words into action—represent attempts at insulation on the supply side. Furthermore, with the acceleration of worldwide inflation and concern about "stagflation," several countries, including the United States, have sought to avoid importing inflation (perhaps even to export it) by erecting barriers to exports, just as they have long sought to ward off (or export) unemployment by restricting imports. Today, with many countries still in recession, some observers see troublesome indications of a resurgence of conventional beggar-my-neighbor protectionism (see, for example, Bergsten, 1976). On the whole, however, it seems to me that the cup should be regarded as half full rather than half empty. Given the severity and breadth of the most recent recession, I am impressed by the extent to which nations have so far avoided resort to protection and other distortions of international transactions.

This self-restraint may reflect in part recognition of the fragility of the international economic system and recollection of the havoc wrought by self-defeating beggar-my-neighbor commercial policies in the 1930s. It is also undoubtedly due to the change in the exchange-rate system that took place in the early 1970s. The movement from pegged rates to managed flexibility was itself a shift away from integration and the thrust toward "world money." It created a buffer between national monies and therefore between national economies and economic policies. But this form of insulation is far less disruptive of market integration than the alternative of pegged rates and piecemeal restrictions on trade, capital flows, or both. There can be little doubt that the avoidance of a wholesale retreat into competitive protectionism in the face of accelerating and divergent rates of inflation, the oil crisis, and the subsequent widespread recession was made possible by the shift from pegged rates to managed floating. The insulation provided by managed floating is only partial, however, and has indeed turned out to be more limited than had been generally anticipated. The reasons will be discussed later.

The minimization of tension between interdependence and autonomy can be approached from another direction. The integration of national markets can be accompanied by the coordination of national economic policies. The institutional framework constructed for this purpose since World War II has been directed primarily at what might be termed negative coordination; it has aimed at the avoidance of beggar-my-neighbor policies and the reduction of explicit barriers restricting or distorting international trade and investment. The very success of this effort, however, has helped to create the tension just described, and its alleviation will require something quite different and more ambitious: the positive coordination of domestic economic policies by sovereign states, a process with which there has been much less experience and for which an adequate institutional framework does not yet exist. What I mean by positive coordination, what it will require, and the implications of experience so far with limited efforts to introduce it will be explored further later in this essay.

If the key issue on the macroeconomic side is the tension between international interdependence and national autonomy, the leitmotif on the microeconomic side—in the sphere of international trade and investment relationships—can be characterized, equally elliptically, as the unresolved tension between market orientation and planning orientation, between those who focus on reductions of government barriers to private transactions and those who emphasize the collective management of international economic transactions.

Over most of the postwar period, the primary focus in economic relations among the industrialized countries was on *liberalization*: the elimination, on a reciprocal and nondiscriminatory basis, of measures that explicitly restricted transactions across national boundaries. Reflecting at least in part the laissez-faire orientation and strong leadership of the United States, these ongoing exercises were marked by such milestones as the formal restoration of currency convertibility by European nations in 1958, the subsequent reduction by these same nations in the number and severity of remaining exchange-control restrictions, the substantial reduction in tariff levels achieved by successive rounds of tariff negotiations under the aegis of the General Agreement on Tariffs and Trade (GATT), and, more recently, the significant loosening of trade and investment restrictions by the newest of the major industrial powers, Japan. These developments were major stimuli to the rapid growth of international trade and investment and thus to the advance of economic integration.

Today, however, the focus on the nondiscriminatory reduction of barriers is meeting increasing resistance. There are several reasons. First, there has existed for some time an underlying friction between the relatively laissez-faire globalism of the United States and the more interventionist attitudes of European nations, with their stress on regional relationships and the use of collective management by governments of international economic relationships.[1] And as the hegemonial position of the United States has declined, for both political and economic reasons, the dominance of the U.S. approach has also diminished. Second, the international trading system has broadened beyond the initial nucleus of North America and Western Europe, and most of the newer participants (Japan and the developing countries), as well as potential participants (the Communist-bloc nations), bring with them traditions of strong gov-

[1] For an interesting account of these differences in outlook, see Shonfield (1976). One must be careful, of course, not to exaggerate the homogeneity of European views. The position just described as "European" most accurately describes the French outlook; the German position has tended to be closer to that characterized as American. Whatever the internal difficulties involved in compromise, however, the EEC countries have succeeded in "speaking with one voice" in a number of important areas, particularly on trade issues, and their common positions have tended to reflect heavily the general outlook described above.

ernment intervention in the domestic economy. Third, the proliferation of economic responsibilities shouldered by the governments of the Western democracies, already described, has almost certainly enhanced the pressures for intervention within the original core of trading nations.

In addition, and perhaps most important, barrier reduction has fallen victim to its own success. Although industrial tariffs still exist and are in fact the first order of business in the current round of GATT negotiations in Geneva, previous rounds of reductions have brought them to levels at which they are no longer the principal distortions. Tariff negotiations have been difficult, but tariffs have had the advantage of being distinct and separable from domestic economic policies and of being amenable to some measurement of reciprocity, however rough and analytically assailable. Today, the major barriers to trade fall into two broad groups: nontariff barriers and agricultural restrictions. The nontariff barriers include a broad range of measures, and many are inextricably intertwined with domestic microeconomic policies. Furthermore, it is rarely possible to define reciprocity in the reduction of nontariff barriers and even more difficult to devise a means of measuring it. Finally, attempts to liberalize agricultural trade by the conventional approach of reducing governmentally imposed barriers are brought up short by the fact that virtually every nation, including the United States, has a long-standing and deeply ingrained tradition of government intervention in the domestic agricultural sector (see Warley, 1976, for an historical survey). It is therefore futile to try to negotiate reductions in restrictions "at the border" in isolation from broader domestic policies. Just as in the macroeconomic sphere, the dynamics of interdependence appear to require a shift from negative to positive coordination in crucial microeconomic areas, taking into account the involvement of national governments in these areas but aiming to minimize the extent to which that involvement thwarts or distorts transactions across national boundaries.

Finally, there are broad systemic questions relating to the international economic system as a whole. One has to do with the organizing principle that will characterize the system. Analytically, one can conceive of at least four "pure" principles. One is automaticity: a system such as universal free trade with a pure gold standard or freely flexible exchange rates, one that is subject to an absolute, self-regulating discipline of the marketplace. A second is hegemony: general acceptance of dominance by a single country or group of countries that in turn takes on a special responsibility for the operation of the system. A third is supranationality: collective adherence to the decisions of one or more supranational institutions that would utilize a mixture of rules and discretion to operate the system effectively, much as national governments do today domestically. The final mechanism is negotiation or pluralism: the system would be enabled to function by hammering out repeatedly compromises among the divergent interests of sovereign participants.

Obviously, no international system has actually functioned according to one of these pure principles. The international economic system that prevailed roughly from the end of World War II until the beginning of the 1970s, for example, was characterized by the unprecedented prominence of international economic institutions: the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), the World Bank, and the Organisation for Economic Cooperation and Development (OECD), to name only the most prominent. But these institutions have been effective less in formulating rules or promulgating binding administrative decisions than in providing an agreed set of procedures by which national disagreements could be discussed, negotiated, and minimized. "The institutions were seen, in other words, as an adjunct to the ordinary processes of diplomacy, not as a substitute for them" (Shonfield, 1976, p. 126). Completing the mixture was a strong dose of hegemonial leadership by the United States, which not only placed its unmistakable stamp on each of the institutions listed above but also enjoyed substantial (although by means unlimited) leadership in the management of economic relationships within the framework provided by the institutions. The hegemonial position of the United States, which was based partly on overwhelming economic dominance throughout most of the period and partly on the security guarantees it gave its allies against Communist aggression, had two aspects. For its part, the United States took special responsibility for maintaining the international economic system; it was frequently willing to subordinate its short-term economic interests, narrowly conceived, to the long-term political and economic advantages of strong economies in other free-world nations and of a viable trading and monetary system. Other countries, in turn, were willing to accord the United States certain special privileges (primarily that of printing international money) as a concomitant of its special responsibilities for the military security and economic stability of the non-Communist world (see Whitman, 1975b).

Clearly, the new international economic system will also be based on a combination of these organizing principles, but it will not be the same mixture as before. The main reason is the attenuation of the hegemonial status of the United States. As cold war concerns have diffused and domestic economic problems have become more urgent, the United States and its allies have each, for somewhat different reasons, grown impatient with the special U.S. position in the international economic system, particularly in the monetary sphere. European and other countries have increasingly urged a system in which the United States behaves and is treated "just like everyone else." The United States, disillusioned with being world "policeman" and increasingly reluctant to sacrifice immediate economic interests at home for the sake of global economic stability, has given some disturbing indications that it might be only too glad to comply.

The decline in the economic hegemony of the United States has been spurred by détente but began with the gradual decline in its global economic importance. Although the United States remains the world's largest economy, with a GNP accounting for nearly half that of all the OECD countries together, its share of world GNP fell from 39 per cent in 1950 to 25 per cent in 1975.[2] At the same time, the openness of the U.S. economy, and therefore its sensitivity to influences from abroad, has increased. The ratios of exports and imports to GNP have doubled, and the share of foreign earnings in the profits of U.S. corporations has tripled. The openness of other industrialized nations has increased substantially too, and the United States remains the least open economy in the non-Communist world, but the increasing participation of the United States in interdependence has been striking and must be taken into account if the international economic system is to be reconstructed to achieve maximum viability and effectiveness.

If the system of the future is to be based far less on hegemony than was its predecessor, which of the other organizing principles will take up the slack? Academic analysts and political participants alike seem to agree that international institutions will have to play an enhanced role. But this apparent agreement conceals an important divergence of views. One approach, which might be characterized as "the American position," holds that, in the absence of a generally accepted hegemony, the reconciliation of divergent interests and thus the viability of the system can be ensured only by the discipline of universal rules: by some combination of the self-enforcing disciplines of the marketplace and of general rules applied by international institutions, accompanied by the development of effective sanctions against states that try to evade the disciplines or break the rules. Europeans, skeptical of American legalism and doubtful that sanctions can be applied effectively to sovereign states without

[2] The same pattern of relative decline is reflected in alternative measures of economic importance. There are exceptions to this general pattern in three areas in which the position of the United States has held or increased: international investment, agricultural exports, and the financial role of the dollar (see Whitman, 1976, esp. pp. 187-189).

endangering the survival of the system itself, stress the need to develop and expand international institutions to support more effectively the negotiation of divergent economic interests, to develop modes for cooperative management of domestic and regional policies, and to avoid retaliatory escalation during particular disputes.

Finally, the most fundamental leitmotif of all is the preservation of a liberal international economic system. Until relatively recently, it was taken for granted that the nations participating in the international economic system agreed that the ultimate goal of the system was to maximize world efficiency and international harmony by minimizing the distortions and uncertainties created by the existence of national boundaries. The system was laissez-faire in orientation and neutral in intent. This characterization must not be pushed too far; each participant in the system practiced interventionist policies, in varying degrees, within its own economy, and the system proved relatively flexible in accommodating the international ramifications of these policies. But the liberal thrust of the system was nonetheless clear and generally accepted.

Today, however, these fundamental principles face serious challenge. One reason is that, over the postwar period, domestic economic goals have broadened from a primary focus on efficiency and growth to an intensified concern with economic and social stability and distributional equity. The political importance of these concerns, together with the increased vulnerability that is one face of interdependence, generates hostility to a laissez-faire international framework directed toward promoting market integration. The other major challenge comes from the increasing prominence and activism of the new participants in the international economic system: the developing countries. Despite their heterogeneity, most of these nations share the belief that the "neutrality" of the postwar international economic system has operated to their disadvantage. They are firm in their insistence on the construction of a "new international ecomic order" that will adopt the international redistribution of income as an explicit and primary goal. Is it possible to fashion an international economic system that can incorporate these emergent participants and reconcile their goals with traditional aims? This is the greatest challenge of all.

Macroeconomic Issues

Moving now from general themes to the more familiar functional categories, two topics confront us in the realm of macroeconomics: the international monetary system and the international transmission of economic