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6 The Consequences of Interdependence:
A Policy Point of View

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Summary

The common supposition that the US economy is becoming increasingly interdependent with the rest of the world is clearly borne out by statistical investigations preliminary to this paper. Indeed, not only has the degree of interdependence risen substantially; the extensiveness of it is now considerable as, for example, more American plants are located abroad, more American banks do business abroad and so forth.

This raises questions concerning the extent and nature of implications for the execution of domestic policy and for our international political and security relations. As we move more intensively and extensively into interdependence, the distinction between policy action uniquely of domestic concern and action with international implications becomes blurred. Thus, the domestic policies we adopt and the means of pursuing them can increasingly be reinforced or countervailed by the international connections they carry.

To reduce inequities -- real and apparent, for it is the visible effect that is more relevant -- and hence international friction and distrust, governments will increasingly find it necessary to agree on international rules, codes and the like that limit freedom of action by each of them in wide areas of what are here called micro-policies heretofore considered domestic. This will almost certainly require surveillance and in some cases arbitration within international institutions.

More difficult to achieve, even to conceive intellectually, yet fundamental to these adjustments, is the need for substantially more effective international coordination of macro-economic policies and conditions -- the domestic fiscal and monetary policies that determine levels of aggregate income, employment and prices. The economic turbulence that has plagued the world in the past several years attests to this.

And few things can give cause to stronger strains politically than the belief that the economy of another country is aggravating your own unemployment problems.

There are two general factors that apply with special importance to any such tasks. Fortunately, substantially improved coordination of macro-economic policies and conditions -- and, if we choose the tactic, closer international involvement with domestic micro-policies -- need only concern little more than a handful of major, advanced countries, namely, the US, the European Community, Japan and Canada. Unfortunately, on the other hand, the task of governments in exercising control over such things as the international flow of money, the location of plants and regulatory and tax policies is growing much more complex.

Our international political, security and economic relationships are closely interwoven. Each segment affects and is affected by the others. Rising interdependence can make positive contributions to our political and security relations, for example, by its contribution to economic prosperity and a basis for political stability. On the other hand, the larger the volume and relative importance of international transactions the more frequent will be the potential for international friction and declining mutual confidence; it is reduction of this friction and an increase in mutual confidence that surely must underlie efforts to improve our international political and security relations, notably among our major allies.

We are, at least arguably, at a stage of interdependence with these major trading countries where serious and sustained friction and damage to mutual confidence are inhibited by the very size of the stakes that have thus far evolved. If we are to continue the trend toward great interdependence, it will be crucial that we carefully cultivate such inhibitions. This is almost certain to entail established procedures and a more effective international institutional framework.

To the extent that our institutional approach can include intimate and comprehensive consultations in a small group comprising such major actors as the US, the EC, Japan and Canada, we shall find such efforts more likely to succeed. The effective coordination of domestic macro-economic policies and conditions actually makes this a prerequisite, but such consultations could also go far in reducing friction and distrust over trade and other issues.

One might sum up the major, key costs and benefits of increasing interdependence among major allies along the following lines:

- Benefits: -- Increasing good international business, possibly adding inhibitions to unacceptable practices;
- Contribution to economic prosperity;
- Forming a base for political stability;
- Contributing to the means for participation in mutual security.
- Costs: -- Potential for more international friction and distrust;
- Encroachments on the choice and execution of domestic policies.

If this is accepted, one might agree that the following constitutes the line of action necessary if increasing interdependence is to be accommodated constructively:

- A careful buildup of the inhibitions to factious behavior by cultivating political wills, by more effective international procedures and by stronger international institutions;
- Improved use of domestic policies and a wiser choice of them;
- More effective international coordination of domestic macro-economic policies and conditions.

This is a formidable line of action, and different readers will judge its feasibility or desirability differently. In doing so, it is important not to exaggerate what the needed action implies.

It is not the perfect system that would be required.

There will always be some international friction, even among major allies, and how it is resolved may be, within limits, more important or certainly more feasible than its complete elimination. We shall never see flawless execution of domestic policies nor a perfect international coordination of them. But a continuation of rising interdependence will require a far less imperfect and a more progressive international system, along with more intelligent and effective domestic policies, than we now have.

When looking at the impact of international aspects on domestic policy choice, it is important to keep in mind that the most aggressive competition to a given domestic policy usually arises from alternative domestic policies. We often choose a domestic policy in conflict with interdependence because it is easier in terms of domestic politics, not because it is necessarily in the best interest of the US, even from a domestic point of view. A typical product is uneconomic protection from foreign competition, leading to more international friction. For example, our government procurement practices may increase operations for a domestic firm, but they go against our domestic objective of minimizing government expenditures. It is not only interdependence that argues against such protection.

And while the strongest indictment against growing interdependence is perhaps the important inhibitions it places on the free execution of domestic monetary policy, we do not always acknowledge that we have tried in the past to rely unduly on monetary policy in the management of the US economy. We have done this because it is so difficult to persuade Congress and the public on the need for more timely fiscal action. But, with or without growing interdependence, we surely now see that our execution of domestic fiscal policy must be substantially improved.

What are the broad policy alternatives available to us as regards growing interdependence? There are at least the following, plus a number of variations and combinations

of them:

- could
- We/continue to drift into increasing interdependence, acting here and there to increase it, while generally supporting moderate improvements in the international institutional framework;
- We could execute a measured and deliberate reduction in the pace of interdependence otherwise prevailing, for example by exercising controls over certain international transactions, while supporting maximum freedom for exchange rates to seek their own levels with no international surveillance; an important variation in this case would permit an individual country to impose special restrictions against transactions with other countries for its own balance of payments purposes with the consent of other members of the community;
- We could press on, with deliberate support for and accommodation to the interdependence trend.

In considering these (and other) options one must exercise care in being consistent to the extent that the effectiveness of our international institutions must keep up -- roughly -- with policy choices.

A deliberate reduction in the rate of increased interdependence raises this question starkly. It could happen through growing divisiveness, through negative actions such as those that gravely threatened the present system in the early days of the current energy problem. This, surely, would be the worst of possible worlds.

In fact, to reduce the rate of interdependence constructively, especially if some countries were to be able to have restrictions while others did not (the variation on alternative two above), would require the type, if not the degree, of international institutional success and inter-governmental empathy that is requisite to accommodation of further interdependence. Any sensible and constructive resolution of the problem, indeed, is going to require just this.

If in the face of growing interdependence we are to increase the inhibitions and mutual confidence referred to

earlier, we shall need a shift in the responsibilities of our international institutional framework from international cooperation to codes, and rules backed by international surveillance and arbitration and, more important, international coordination of domestic macro-economic policies. And, of course, the execution of domestic policies will have to be improved in any case -- substantially improved.

Where one comes down -- whether one believes that accommodation of further interdependence is practical or desirable -- to a large extent depends on whether one believes that a political will for this kind of shift can be developed domestically and internationally and on how one views the alternatives.

Preface: The Semantics of "Interdependence"

Webster defines interdependence as being mutually or reciprocally dependent. This is tidy enough, but it begs the question of what dependent means. At best, dependent is a relative state of affairs, meaning different things to different people and at different times.

The US and the USSR are mutually dependent that neither will take a casual attitude toward nuclear destruction. In the diplomacy of power, and in other ways, we have a mutual stake with, say, Japan as to whether that country continues to ally itself with us or chooses to become overridingly oriented toward, say, China. Each of the parties involved stands to lose or gain by the actions taken or necessitated by another.

We may attach great importancesome day to cleaner waters in the Atlantic Ocean. We and numerous other countries are responsible for fouling these waters; cleaning them could not be done by the action of any one, but it could be done if all or most concerned shared the responsibility. We are mutually dependent on a responsible approach by all, and the importance of this mutual dependence depends in this instance on the importance we attach to less foul Atlantic waters.

Economically, there are certain products which the US, for example, can only get from other countries. We may depend on these products to meet important needs, and the extent of this importance will be associated with the significance we attach to a mutually responsible association with the producers and the producer nations.

But economic interdependence has a far broader base than plugging the shortfalls of any hypothetical attempt at autarky. The US automotive industry could exist without its markets in, say, California and Texas, but it has come to depend on the sale of a rising volume of autos in those states; conversely, California and Texas could exist without the US automobile industry, but they have come to depend on it (along with the Japanese, Germany, etc. automobile industries) for an important means of transportation at a

given comparative cost. And so has been increasingly the case in our view of foreign markets and the view of foreigners of the US market. We have become mutually dependent.

Similarly, US financiers and industrialists could always find profitable places for their money and for their direct investments, but they have come to depend on the possibly greater profit of some placements abroad, and foreigners reciprocate this kind of dependence both as recipients at home and as investors in the US.

Thus we have come to measure -- roughly -- the extent of economic interdependence by the rise in international transactions of the US, for example, relative to the rise in domestic transactions and by other, highly sophisticated means.

But it is in the aggregate that these many specific forms of economic interdependence combine to make the greatest general impact through the increasing sensitivity of the US economy to the movements up and down of general economic activity of the rest of the world or of particularly important parts of the world, that is, we are mutually dependent, at the margin, as concerns changes in our aggregate levels of income, prices, employment, etc. Thus, to paraphrase, when the German economy sneezes loudly and for some while, Europe catches pneumonia and the US comes down with the grippe. Inflation can be traced across international borders in much the same way. Indeed, as pointed out in Chapter III of this paper, the current inflationary virus is very much the result of a series of international events and is thus sharply distinguished from the inflationary swell in the US some six to eight years earlier.

Interdependence, then, exists and its existence can be substantiated to any reasonable person. But there is no reason to expect that all will agree on the importance of a specific aspect of it or on the degree of importance

attached to interdependence generally. This paper, indeed, is designed to help readers clarify their views on just such matters.

The Consequences of Interdependence:
A Policy Point of View

Introduction

Among the handful of fundamental underlying trends affecting international relations over the past three decades two are directly related to the purposes of this paper. They are, first, the increasing role of government in the national economy, from commitment to high employment and preservation of the environment to safety standards and an occasional freeze on prices and wages, and, second, growing interdependence among national economies.

The emphasis of most economic studies dealing with general and substantive aspects of the interplay of these phenomena has been on the interference of the first with the second. The literature on nontariff trade barriers (NTBs) falls in this category. The focus tends to be on measures that sacrifice potential gains in world income. Although attention to the factious impact of NTBs internationally is sometimes generous, the trade-off is more often than not seen as domestic protection against higher income. And quite usefully so.

This paper looks at these two fundamental trends the other way round -- at the impact of growing interdependence on the execution of national policy. As such, it will examine the same coin. But the view differs. It will look, for example, at how we come on to some of these problems from the beginning, and the problems, of course, are much broader than those represented by NTBs. From this view, the trade-off might be said to be independence of action domestically at the expense of others doing likewise.

This, in turn, raises questions of the extent and

nature of implications of interdependence for domestic policy execution. It also raises the question of whether the current pace of interdependence is compatible with judicious and broad pursuit of our domestic objectives and the kind of international political and security relations we seek.

Interdependence is not a new phenomenon. It has been with us for centuries. The case can be made that the world, as we knew it, was more interdependent than now under the Roman Empire and, a less persuasive case, under the gold standard. What distinguishes the present system more than anything else is the large extent to which it is both man-made and voluntary, the extent to which it reflects the common reaction of the countries involved to what makes sense in prevailing circumstances from the view of the interests of the individual countries.

And this is very much a matter of degree. The community of advanced nations -- primarily the US, the European Community (EC), Japan and Canada -- among which interdependence is most intense, are a long way from economic integration as a unit. For convenience, let us say that they are at a point of high interdependence, and the degree of interdependence of these advanced nations with other parts of the world varies substantially.

We are, in this process, on a trend, not at a cross road. Indeed, it is an assumption of this paper that, setbacks (however severe) notwithstanding, we shall be on that trend for many years to come. But this is a trend along which we shall need to bend, delay, ride with the tide, even accelerate, depending on prevailing circumstances. We need to know where we are along this trend, where we seem to be heading and what are the consequences of these questions for our welfare as a nation.

It is the aim of this paper to help in the formulation of answers to such questions. It will try here to sharpen and there to broaden our perceptions of what

interdependence constitutes from the policy point of view. The particular focus of the paper will be on the principal fields in which interdependence has an impact on US national objectives -- and on how these objectives are pursued -- notably in what fields and circumstances interdependence acts as an inhibition, a prohibition or, on the contrary, a reinforcement in pursuit of our objectives.

The paper begins with a brief description of selected statistical measures of the degree and extensiveness of US interdependence. This is followed, in Chapters II and III, by an examination of illustrative national policies affected, broken for presentational purposes into those called micro-policies (involving some part of broader policy such as a sector or a program) and those called macro-economic policies, which entail the management of the economy as a whole. The paper will then look at how interdependence fits into our objectives relating to international political relations and international security and how multilateral consultations fit into the pursuit of our objectives. At the end, there will be an attempt to assess the varied features of interdependence treated in the paper, designed to assist the reader in reaching conclusions on the relative role of interdependence in the execution of policies to achieve national objectives.

The hurried reader will wish to confine attention in Chapter I to the statistical table and in Chapter II to its introduction.

A word of explanation seems justified here for the special geographic focus in much of the paper, a focus on the interdependence of the US, the EC, Canada and Japan or, more generally, on interdependence among the advanced industrial countries whose trade and finance are so closely interwoven.

Interdependence is, of course, global. There are,

indeed, times when we may be forgiven for thinking US interdependence is most important with, say, the Middle East. On the long and broad view, however, US interdependence -- economic, political and security -- is most intense and important with the industrial countries here highlighted. This is where the volume of transactions is greatest; this is where the capacity of the US to seek and carry out policy objectives is most affected.

Collectively, these countries set the pace for the rest of the world, for example, in work toward economic growth with reasonable monetary stability. This is where the international momentum and influence lie, for example, toward a freer world. When these countries pull together, most things are possible; when they are beset with divisiveness, little can be accomplished. It is perhaps particularly in the challenging field of synchronization or coordination of macro-economic policies and conditions -- a field given much attention in this paper -- that these countries represent the key to solutions that may be pursued.

A paper that attempts a comprehensive view of such a complex and varied phenomenon as interdependence perhaps inevitably finds a necessity here to skimp on the depth of treatment and there to skip examination of facets not without importance. This paper is no exception. A special geographic focus in much of the paper has just been mentioned; it in no way contradicts the significance of US interdependence elsewhere, notably perhaps with the so-called Third World. There are other omissions.

The treatment of national exchange rate policies and, collectively, nontariff trade barriers, for example in Chapter V, is not as extensive as in papers on individual aspects of interdependence. There has been no attempt to slant the contents of the paper topically. Thus, the

problems of energy and of the multi-national corporation (MNC) are not given special focus. They, like other fresh problem areas that will arise, fall in the scheme of this paper into broader issues here considered more fundamental.

An important area not treated separately in the paper is the impact of interdependence on national tax and regulatory policies, and the MNCs are especially involved in them. No doubt interdependence does impact on the effectiveness of these national policies. It is the position of this paper that this impact can be lessened or not, depending on national wills, in much the same way as most issues here treated.

I. Some Measurements of Interdependence

Most observers have long accepted the proposition that the US economy has over the past decades grown increasingly interdependent with other economies. We have been told in countless speeches and not a few books and articles that foreign trade has grown more rapidly than GNP. But the growth of the US involvement in the international economy has been much broader than this common comparison tells us. For example, in the past two decades:

- US merchandise exports have increased sixfold;
- The book value of US foreign direct investments has risen fivefold and is over \$100 billion;
- As a consequence, US firms are now participating in the production and/or distribution process of 152 foreign countries and territories;
- Net income on such investments plus fees and royalties has risen from \$1.6 to about \$13 billion annually.
- And some 107 US banks now operate a total of 627 foreign branches throughout the world, holding assets of over \$75 billion.

For a more specific idea of the extensiveness and pace of interdependence, a time series has been run for four selected equations comparing indicative international transactions with their domestic counterparts. These data are summarized in the statistical table below.

Statistical Comparisons of US Data:
Annual Average 1957-59 to Most Recent Year

(In millions of dollars)

	Annual Avg. 1957-59	1972	1973	% Change
Goods				
a) Merchandise exports	17,478		70,252	301.9
b) Goods GNP	238,200		622,700	161.4
Ratio of foreign to domestic	(0.073)		(0.113)	54.8
II. Investments in Mfg. Plant & Equip.				
a) Direct investment abroad	1,265		8,915	604.7
b) Domestic expenditures ^{1/}	10,780		32,560	202.0
Ratio of foreign to domestic	(0.117)		(0.274)	134.2
III. Sales of Mfrs.				
a) Affiliates abroad	19,715	110,404	n.a.	460.0
b) Domestic sales ^{1/}	300,651	725,910		141.4
Ratio of foreign to domestic	(0.065)	(0.152)		133.8
V. Private claims				
a) Private liquid claims abroad	13,295		65,651	393.8
b) Private domestic claims	600,582		1,716,178	185.8
Ratio of foreign to domestic	(0.022)		(0.038)	72.7

a. Not available

Preliminary

Excluding petroleum

Sources: See footnote to this chapter

The base period for these series is the annual average for 1957-59. The status of these relationships has been run through 1973, except in the equation involving sales of manufactures by US affiliates abroad, data for which are only available through 1972.

The first equation is the familiar one of the ratio of US merchandise exports to US GNP goods output (GNP minus expenditures on services and structures). The trend toward growing interdependence is unquestionable, the ratio rising from the base period to 1973 by 54.8 percent. While this is the ratio most commonly considered, it is noteworthy that it has risen least of the four here considered as, collectively, an indicator of the pace and extensiveness of the interdependence trend.

The ratio of US direct investment abroad in manufacturing plant and equipment to domestic expenditures on manufacturing plant and equipment rose 134.2 percent over the same period.

The ratio of sales of manufactures by US affiliates abroad to US domestic sales of manufactures rose by 133.8 percent. This particular series is designed to take this brief investigation beyond a look at what has been happening to the establishment of investments (above) and shed some light on the degree of activity or intensity of the involvement abroad.

Finally, and as a crude catch-all for the innumerable and varied monetary transactions other than trade, services, direct investment and government accounts, the ratio of US private liquid claims abroad to comparable US domestic claims was considered. Here the rise was by 72.7 percent.

The trend of these four ratios is clear and consistent. Economic interdependence has been proceeding at a very substantial pace and it has been more comprehensive than commonly judged.

Like any other years that might have been chosen for the comparisons used above, 1957-59 and 1973 were affected by unusual conditions. The base period was chosen because it straddles the achievement of convertibility for European currencies, dramatizing the end of European reconstruction. The choice of 1973, the most recent year for which data are available, raises serious questions. US merchandise exports rose sharply to new heights that year. On the other hand, to have chosen a less recent year would have been to measure exports under the handicap of an unrealistic exchange rate. In any event, the choice of 1973 seems justified: if 1972 were used, the ratio of exports to GNP goods output would remain substantially higher than in the base period; exports in 1974 rose to higher levels than 1973 and the higher plateau established in 1973 does not appear to be evanescent.

Chapter I: Footnotes (Sources)

US Merchandise Exports:

1957-61: Survey of Current Business (SCB) (US Dept. of Commerce), 6/70, Table 1, p. 34
1962-73: SCB, 6/74, Table 1, p. 30

Goods GNP:

Annual Report of the Council of Economic Adversers
1975,
Table C-6, p. 256

Estimates of Property, Plant and Equipment Expenditures
on Manufacturing by Majority-Owned Foreign Affiliates of
US Companies:

1957-62: Balance of Payments Statistical Supplement (Rev'd) to SCB 1962, Table 62, p. 220
1966-73: SCB, 9/74, Table 2, p. 25-32

Estimates of New Plant and Equipment Expenditures for
Manufacturers in the US:

1957-69: SCB, 1/70, Table 1, p. 29
1972-73: SCB, 6/74, Table 5, p. 20
(Petroleum excluded)

Sales of Manufactures by Majority-Owned Foreign Affiliates of US Companies:

1957/59/60: Balance of Payments Statistical Supplement (Rev'd) to SCB, 1962, Table 65, p. 22
1966-72: SCB, 8/74, Pt. II, Table 3, p. 28

Corporate Sales by US Manufacturing Industry:

1957-63: National Income Supplement to SCB, 8/66, Table 6.19, p. 145
1964-69: Supplement to SCB, 7/73, Table 6.19, pp. 28.69
1970-73: SCB, 6/74, Table 6.19, p. 41
(Petroleum excluded)

US Private Liquid Claims Abroad:

1957: SCB, 8/59, Table 1, p. 29
1959: SCB, 8/61, Table 7, p. 26
1961: SCB, 8/63, Table 9, p. 22
1963: SCB, 9/65, Table 15, p. 32
1965: SCB, 10/70, Table 2, p. 23
1966: SCB, 10/68, Table 1, p. 20
1967: SCB, 10/69, Table 2, p. 24
1969: SCB, 10/71, Table 3, p. 21
1960 and 1971-73: SCB, 8/74, Pt. II, Table 3, p. 5

Definition: For example, in last cited source, line 2 minus lines 4, 9 and 21.

US Private Domestic Holdings of Funds:

1959-64: Flow of Funds Accounts 1945-72 (Federal Reserve Board) 8/73, line 12, p. 81

1965-73: Flow of Funds Accounts 1965-1973 (Federal Reserve Board) 9/74, p. 28, line 12

II. Implications of Interdependence for Domestic Micro-Policies

Introduction

As we move into more extensive and intensive interdependence, the distinction between specific policy actions uniquely of domestic concern and those with international implications becomes increasingly blurred. This is a natural consequence. The more foreign trade, investment and finance among countries grow the higher are the stakes and the exposure to damage, advertent or inadvertent. The consequences among policies discussed in this chapter more often than not appear to the foreigner as forms of nontariff trade barriers (NTBs).

If we decide in the national domestic interest to increase government appropriations to support research and development in machinery for the manufacture of shoes, for example, exporters of shoes to the US would certainly protest that we were on the international side of the blurred line.

Suppose that as part of our efforts to increase jobs and raise incomes in Appalachia, manufacturers of shoes, among others, are offered large loans at rates and terms subsidized by the federal or state government (or both) and as a consequence domestic manufacturing processes for shoes sold in the US are measurably more efficient and imports of shoes fall. Our objective may seem domestic to us, but foreign exporters would see such action as an international measure.

What, though, if as a part of our federally-sponsored manpower programs, we helped train workers on shoe machinery and as a result made their output more competitive or arguably more competitive? Or can we find ourselves unquestionably on the domestic side of the blurred

line when government merely brings about a determined rise in the quality of public education in a district dominated economically by the manufacture of shoes?

All rather far fetched, one might say, but in each case we are underwriting higher productivity in our shoe industry. Each such type of activity -- and more -- has been cited in at least one brief filed by US importers with the US Commissioner of Customs.^{1/}

Once again, the authorization of public funds to build a dam with hydroelectric facilities may seem at first glance entirely a domestic matter. But we know from publicity surrounding the Greer's Ferry case, for example, that foreigners do not see it that way. Indeed, that matter was raised at levels as high as between President Eisenhower and Prime Minister Macmillan, resulting in a ringing defense of interdependence.^{2/}

Surely, the case has been made. The instances of interplay between domestic and international interests are beyond counting or even meaningful category. The points of interest here are how the interplay comes about, has it on the whole been significantly harmful in terms of US national welfare and how have we tended to cope?

Generally, our policy responses to international inhibitions or prohibitions in these areas have fallen into three categories: (a) to circumvent the inhibitions and take the sometimes costly consequences, (b) to accept the inhibition or prohibition and conform domestic policies to them, or (c) by careful and patient debate to persuade others that our objectives are valid and that the inhibitions are misplaced.

The sometimes heated debates within government have tended to center on adoption of (a) or (b) above -- and compromises of course occur many times. More recently, option (c) has been followed with a certain quiet frequency. This tends to be in areas lately brought into

conflict or question by increased interdependence and more extensive government intervention domestically, for example, air pollution control, but this does not mean, for a moment, that options (a) and (b) have ceased or will cease to be active.

It is worth noting that the international connection is by no means the only interference encountered in the pursuit of a particular domestic policy objective and in deciding how it should be pursued. Alternative domestic objectives and means of pursuing them are commonly the more aggressive competitors. These two facets of policy selection and pursuit often overlap, sometimes to the nation's favor, sometimes to its disfavor. For example, we often avoid a conflict of domestic objectives -- or resolve one -- by imposing a nontariff trade barrier.

On the other hand, we sometimes gain support for a laudable objective precisely because a popular, seemingly easier alternative would be in violation of our international obligations or contrary to our national interests because it would invite costly retaliation or otherwise risk damage to profitable operations internationally.

In the remainder of this chapter illustrative cases will be examined in an effort to provide more specific insight into how the interplay has come about and how we have responded. In selecting these illustrations variety has been an objective to make the overall picture reasonably representative.

Agriculture

This constitutes the most obvious illustration of the interplay of international forces and domestic policy execution. A key domestic policy objective in the US (and elsewhere) has been to support farm income. This is a valid option open to any country. But the means by which it is to be pursued are critical, not just in terms of workability and domestic cost, but also in terms of

whether the international interplay will work to support or hamper achievement of what is sought.

The US (and many others) chose from the start -- that is, beginning in the 1930's with intensification through the 1950's -- to achieve its domestic objective by manipulating domestic supply, for example, through acreage control, and supporting domestic demand at artificially high prices, for example, through stockpiling.

There were domestic problems from the start. Domestic supply was never susceptible to absolute control, in part because US farmers are adept at exploiting technological advances. Domestic production of many major crops exceeded domestic demand, and at high domestic support prices imports of certain products were significantly encouraged. But in the short run the international interplay seemed to provide a convenient prop in execution of these policies. Subsidized and other concessional exports helped in bolstering demand for some domestic products; import quotas were used to contain the problem of supply in certain other products while maintaining high domestic prices.

In the end, early US agricultural policies proved in significant cases to be unsustainable for domestic reasons relating to inequities that evolved and to their financial and economic costs. They have been undergoing substantial change since the 1960s. In the interim, we found it necessary to support critically weakened provisions of the GATT applicable to subsidized exports of agriculture and we maintained import quotas under GATT waiver. ^{2/} That one of our more bitter controversies with the EC has been over agricultural policy cannot be entirely disassociated from the earlier neglect of the US and others of the international implications for the means by which domestic policy objectives were pursued.

The past two years have seen a dramatic shift from

problems of domestic agricultural surpluses to world food shortages of serious proportions. This occurred at a time when the US and most of the world faced a most serious inflationary threat. The quandary for the US in these circumstances became, on the one hand, a strong urge to embargo or otherwise artificially curtail exports of certain products to reduce price pressures domestically and, on the other hand, to meet our commercial and legal commitments to foreign purchasers and generally to preserve an international posture in trade policy.

Briefly and with great selectivity we resorted to embargo and export controls when this situation was at its worst. It seems fair to say that at some degree of a lower level of interdependence we almost certainly would have gone the embargo route more generally, less briefly and, arguably, at greater long-term cost.

The brief fling with embargo and export restraints in 1973 points to possibilities that controversies between domestic and international interests in agriculture may become more acute in a world of shortages as compared with the familiar problem of surpluses.

The fact that serious and practical experts in trade policy and agricultural policies are now advocating international negotiations on domestic agricultural policies and how they are pursued ^{4/} and are voicing increasing concern that international negotiations attempt also to stabilize supplies of agriculture ^{2/} says much for the degree of interplay in this area, of past failures and of current realities.

Government Procurement

Narrowly defined, this type of government program does not belong in this discussion. The stated objective -- again, narrowly defined -- is to restrict procurement from foreign suppliers. Implementation of the program is in the form roughly analogous to a supplementary

tariff. Fear of any foreign retaliation in kind is diluted by entrenched practices elsewhere. Formal international obligations are not in danger of being violated because malpractice in this field is thus far generally omitted from them.

On the other hand, if one takes the broader view, the objective of the Buy American Act is to combat unemployment in the US. The early history of the act is clear on this, as is brought out in Stanley Metzger's Lowering Nontariff Barriers.⁶ Make-work projects were not to be squandered on foreign employment. The act dates from 1933, when this kind of thinking was prevalent. But the employment objective of the act has been restated on occasions through 1955 and the Defense Department invoked the balance of payments argument in 1962 and later.

Of course, pork-barrel politics have entered into compromises that shape this and other programs. And it would be foolish to assume that had we chosen more sensible means of achieving our objectives, others would never have engaged in procurement policies that discriminate against foreigners.

The facts as they pertain to the US interest would seem to go about like this: we entered into certain make-work projects and saw that the international connection would come into play; we isolated ourselves from this by such as the Buy American Act; long after we have learned that there are less costly and more efficient ways of pursuing high employment and balance of payments objectives we have continued to use discriminatory procurement under the guise of logic and efficiency but at a high cost to the American taxpayer and consumer and to the efficiency of the American producer; in the US the practice has proliferated seriously into acts of states and municipalities, and since we find ourselves particularly ill-placed to stem this trend, given our

system of government, the cost and inefficiency are extended, despite attempts in the courts to halt such practices.

Increasing interdependence has not caused the US to rescind this practice; nor has it led to violation of international obligations. In the end, it may help the opposition to uneconomic practices to overcome Buy American and similar acts. In the interim, it has, at least arguably, contained those who would like to see such practices extended. In this connection, a review of the Greer's Ferry case is rewarding.^{2/}

Aids to Distressed Areas and Industries

This is an area in which the subtle breach of international obligations and perhaps economic good sense is often apparent. All advanced industrial countries resort to various forms of activity under these programs that result in subsidized exports, import substitution and the artificial attraction of foreign investment. Normally, the policy objectives and means of achieving them are devised with little regard to international implications.

Generally, the aim of regional development is to attract capital and industry into areas where inadequate employment opportunities and depressed income levels prevail. In the US this is done by a combination of federal, state and local activities. The most common incentives are concessional interest rates and tax concessions. The social merits of such programs are not in question. The relevant point here is that many corporate recipients of such artificial concessions are to one degree or another engaged in international activities, and the benefits they so receive are reflected in their international position.

The US also extends substantial aid to selective industries, sometimes indirectly, sometimes in the form of

direct aid. The major vehicle for this support has been government-financed research and development (R & D). Government direct expenditure on R & D in the US is larger by far than in any country for which data are available. Much of this, of course, is space or defense oriented, and benefits to corporations likely to be involved internationally are more often indirect. But the US has also led, among OECD countries at least, in providing government funds as a percent of total expenditures for R & D in the business sector. 8/

To these expenditures on R & D may be added a long list of types of federal aid to industry, including investment tax credits of considerable variation (e.g., aid to the textile industry versus aid aimed at raising capital investments generally), transportation subsidies and others. One step removed from such aids are government expenditures on manpower training, education, export promotion (including activities of the Export-Import Bank) and so on.

While action in these fields (regional and industrial assistance) constitutes a clear example of the interplay of domestic measures and international implications, there is no evidence that the international factor has exercised a serious influence on domestic policies of this sort. It must be concluded that only the widescale prevalence of such programs -- and, perhaps, their social role -- has kept them generally from the arena of international controversy. The question arises of whether this will always be the case or whether we should want it to be.

A recent case of international controversy so arising is the US countervailing action against X-radial steel belted tires from Canada (The Michelin tire case). Clearly, Michelin had located in a depressed area of Canada with a view to supplying the entire American market, and thus primarily the US, and it had been attracted

to its location by concessions of the type mentioned above. Yet, as pointed out in a most informative brief filed by the American Importers Association with the US Commissioner of Customs, ^{2/} practices of a similar type are frequent in the US and, it should be added, elsewhere.

A much more portentous case lies in the objective of a common industrial policy within the EC. Such a policy would aim at coordinating on a community-wide basis the various aids to distressed regions and industries -- again, a seemingly logical choice of policy objective, seen in isolation. Much would depend on the policy objectives and the means of pursuing them, but disadvantages to the trade and investments of non-member countries could be sufficient to give dramatic attention to -- possibly leading to action in -- this area of the interplay of domestic policy and international repercussions.

Hazardous Materials^{10/}

It is a common act of governments to regulate the packaging, shipping, labeling and handling of these materials. Since such materials are actively traded internationally, however, their regulation, contrary to the superficial glance, cannot be a matter purely domestic. Safe and equitable treatment are the key words, and equity, too, extends beyond national borders.

A number of genuine problems arise. Packing and labeling requirements, for example, can be more easily met by domestic than the foreign supplier. More important, testing can raise serious barriers to the foreign supplier through the cost of distances involved. It is not surprising, therefore, that we find here instances where equity has been achieved with no loss to safety, but also cases where regulations have been used to inhibit or prohibit foreign competition. And in these latter cases there are domestic costs and international friction.

The US has tried to ensure that the international connection in this area is met even-handedly, combining safety with equity at maximized benefit economically. It has participated actively in work of the UN in operating under an international system. Such an international system has not impinged on our capacity, when we see fit, to enforce more stringent regulations within the US than elsewhere and to require importers to meet these requirements. The process of notification seems to work well.

To be sure, there are exceptions to the rule. The situation is one that inevitably opens such possibilities. A major exception is reflected in the treatment of compressed gas cylinders. This is a case in which we require that each cylinder must pass inspection only within the US with no practical procedure for testing, even of prototypes, abroad. The requirement is such that no shipment can be made with any assurance that all parts of it will indeed be accepted. The result, based on spot checks of potential exports of this product to the US is to preclude sale in the US of foreign compressed gas cylinders, some of which are in fact safer as well as less costly than those made in the US. And this circumstance has prevailed even when the availability of these cylinders is in short supply domestically, prompting complaints from domestic users.

The UK is seeking redress; Canada has notified us that it intends to retaliate in kind. That this is a case of seizing on a domestic requirement in order to find protection is at least indirectly agreed to by the domestic producers who have publicly argued in favor of the present practice on grounds that it protects US industry from the products of cheap (not unsafe) labor.

It seems fair to expect that within the near future interdependence will force a prohibition of this particular practice.

Highway Safety^{11/}

Sparked by growing concern and debate over the lack of control over the safety of automobiles, the US Congress delegated authority to the Department of Transportation (DOT) to write safety standards to be met by all vehicles sold in the US. The changes that resulted were a decided innovation, and changes continue. Since imports of motor vehicles had become substantial, concern and suspicion prevailed abroad. There was concern that the testing and other requirements would be such as to disadvantage foreign exporters significantly and suspicion that this would indeed be exploited, especially at a time when concern over the US balance of payments was grave.

The procedures followed, while perhaps imperfect, nevertheless constitute something of a model in coping with an international reaction to what was in fact a genuine domestic determination to improve safety.

The purpose and nature of each regulation were carefully written and widely distributed. Officials of DOT and other informed administrators of the new regulations went overseas and met with foreign officials and with businessmen to explain and justify the regulations. They continue to do so, although the need for a major educational exchange has passed. Other governments were encouraged, in some cases with success, to impose some of the same safety requirements as the US. The issue of testing was essentially resolved by approval (or not) of prototypes, sometimes in the US, sometimes abroad.

The contacts of US officials with their foreign counterparts formed over the past years have permitted on a number of occasions the discussion of coming regulations while in their planning or speculative stage. In any event, proposed new regulations are published in the Federal Register with time for foreign industry and

government comments. In this process, it would appear that the sincerity of the US in pursuing safety without inequity has been apparent also by the consideration given to comments received from foreigners.

Pollution^{12/}

Like auto safety, the need for the government to regulate and reduce pollution was perceived late and quickly gathered momentum. The validity of the need was not in question. The fact that the problems in the US were particularly serious and early in perception relative to elsewhere added to the general tendency to consider them as purely domestic in nature. US legislation authorizing regulation followed that tendency. One of the principles adopted was that the polluter should pay for the cost of eliminating or reducing pollution.

But of course measures to reduce pollution inevitably have an international connection. At one extreme, they may actually decide the location of an industry, for example, the refining of certain minerals and metals. Clearly, checking and reducing such factors as water pollution require at least bilateral cooperation when waters are shared with one or more countries. It is in foreign trade, however, that the connection is most prevalent. This is most obvious in the case of motor vehicles, notably in emission control. But trade in devices that aid in control of emission in industry as well as motor vehicles also developed.

There was early concern in the US that if we followed the principle that the polluter should pay and major foreign competitors did not our competitive position would suffer. We did not wish to resolve this by abandoning our chosen principle in favor of government subsidies. We turned to international organizations -- an array of them -- first to show our good faith and the

soundness of the principle we had adopted and then to try to persuade others to do likewise.

By and large, and as the result of extended effort, this approach was successful. In the process of these negotiations it was accepted that Japan would have to subsidize anti-pollution efforts to some degree owing to the extent of pollution prevailing there. Limits to this exception were agreed on. It seems to be generally accepted that such competitive advantage as this may give, if any, is not significant.

International negotiations first centered on US requirements for auto emission. Major problems at these negotiations were, first, to understand the complex US regulations, adapt to a two-track production line where exports to the US justified it, and work out equitable testing programs. A compromise on testing procedures removed much suspicion. Prototypes of emission systems are tested before assembly lines are in place, while individual vehicles remain subject to inspection upon arrival in this country.

On the other hand, the US did not hesitate to deny an appeal that imports of small cars should be generally removed from the need to comply with emission controls, an appeal based on the claim that such cars do not contribute significantly to pollution.

In the process of adjusting to the international factor procedures of consultation permitted a profitable exchange between national officials engaged in anti-pollution efforts. The US had much to offer. It also profited from some of the programs developed abroad.

Solid Waste

Advanced countries are in early stages of developing procedures and regulations to contain and reduce problems caused by solid waste. This has not prevented them from initiating international consultations. Since the problems

involved are generally individual, these consultations have been largely educational through the exchange of ideas and approaches under consideration.

One development in this broad field may be of special interest within the context of this paper. While it points to no issues involving high economic cost to the public or to serious international friction, in a quiet way it helps illustrate the extent to which growing interdependence interjects the international factor into issues seemingly of a uniquely domestic nature.

The issue is the so-called bottle bill (S. 613) designed to reduce litter (and to save energy) by prohibiting the introduction into interstate commerce of non-returnable beverage containers. Such a law would put an end to "fliptop" cans and provide a strong incentive for consumers to return empty containers to retailers, who in turn would have such an incentive to return them to distributors for reuse. It is modeled on Oregon's "bottle bill" and was introduced by Senator Hatfield.

The objectives of the Hatfield bill would seem unexceptionable. Controversy has centered on disruption to industry, chiefly canning, but also to the bottle industry. Lobbyists against the bill, first in Oregon and now on the Hill and in D.C. and many counties that have similar proposals, have been active. (See footnote 13.)

Where's the international connection? German and Danish beers have become increasingly popular in this country. They are usually sold in distinctive containers prominently proclaiming their foreign origin. While foreigner brewers have gone about it in a remarkably discreet (and probably realistic) manner, they have not failed to let it be known that it would not be practical for them to return bottles to their breweries located overseas

and that they would be unduly, even if inadvertently, disadvantaged. Of course, they would have the option of establishing regional breweries within the US, and they have some now. But a certain distinctiveness, which they currently enjoy and advertise, would be lost.

The European point is made plainly enough in another context in a publication of the Environmental Protection Agency where on the basis of studies it is concluded that brewers within the states of Oregon and Washington have been positively affected by the Oregon bill, but that shipping brewers have not been able to ship refillable bottles to and from Oregon economically. EPA goes on to cite the example of National Brewing Company of Phoenix, Arizona, where shipping costs into Oregon increased by 38 percent due to the weight and breakage associated with refillable container distribution.^{14/}

To say that German and Danish brewers have not been in the forefront of US national efforts to head off extension of Oregon's bill would be too much of an understatement. It is understood, however, that they have made their point to STR and elsewhere.

Provisions of the bill currently under consideration on the Hill would draw one distinction in recognition of the brewers using distinctive containers: while the mandatory deposit would be two cents on containers that could be used interchangeably by various beverage manufacturers and bottlers, a five cent deposit would be involved for all other beverage containers.^{12/}

It is known that the German and Danish commercial attaches in Washington are reporting regularly on the progress of the bill, but neither they nor the brewers involved are likely to be surprised if their containers are not exempted. To do so, assuming the bill passes, would be to dilute a national domestic objective out of undue concern for the international connection. It is

interesting, however, that the point should even arise.

Extra-territoriality: Business Practices and Trading with the Enemy

These two illustrations of domestic legislation that encounters unintended repercussions internationally will be treated with special brevity. We may just note that the more interdependent we become the more this kind of action rankles foreign governments and disadvantages US commercial interests. In the extreme, international discrepancies in such regulations can dictate the location of an industry or plants and so affect employment.

While the objectives of anti-trust legislation and practice in the US have been generally seen as logical and necessary, the system that has emerged is highly complex and diverse; it has developed piecemeal over many years. Application of such a system, in principle or in practice, extra-territorially has been a matter of increasing friction with foreign governments, most notably with Canada. It, like trading with the enemy regulations applied similarly, starkly raises questions of where lie the loyalty, responsiveness and legal responsibility of US-controlled firms operating abroad.

Domestic objectives behind regulations against trading with countries on the US list of enemies are open to debate, at least in their extensiveness. This is a domestic political issue bedeviled, as Ed Fried has pointed out in a more general context, by exaggerated views of all the factors involved.^{15/} Irrespective of its merits when applied to domestic firms, when it results in legally forbidding a US-controlled firm operating in a foreign country to act in a manner that that country considers in its general welfare, it can weaken US objectives in other fields, for example, toward a more liberal attitude concerning inward foreign investment.

Domestic Adjustment Assistance

These programs are included in this list of illustrations with a view to the future and on the assumption that interdependence will continue to grow, as is also the case with the illustration to follow. As such, it is a bell-weather, but it is not one that requires great foresight, being well in view on the horizon.

Briefly, what is in mind here are those domestic programs designed to ease the process of adjustment by specific industries that are disrupted by increasing liberalization of trade barriers. As a coherent concept, they are relatively new, but the objective is clear and valid enough. As protection against imports is lowered, first tariff and now, presumably, nontariff barriers, and as the propensity to engage in foreign trade expands, there is a need for such assistance as an integral part of any trade liberalization program.

While the society as a whole may clearly benefit from such liberalization, individual sectors of it can be disrupted in a relatively short period. These are consequences that have in the past constituted the soundest argument against liberalization. From the view of economic cost to the society, it is sounder to provide assistance in such cases, but under programs that ensure a healthy and lasting adjustment through shifts in the factors of production so disadvantaged to other, more efficient activities. The point is that the phase-out of aid to the damaged industry -- notably where such aid includes tariffs, import quotas and the like -- should be complete and that protection should therefore be visibly temporary.

Again, we have here a seemingly simple issue to be resolved on the basis of the best use of domestic resources. But even a casual examination reveals possibilities of competitive domestic adjustment assistance

policies. How is the exporting country to be reasonably assured that the adjustment program in the importing country is not one that results in protection that is not just temporary and progressively lessened but more or less permanent?

While the answer, fortunately, will not be uniform programs in all or even all leading countries, it would appear that such domestic programs will have to meet certain internationally-agreed criteria and probably be subjected to international scrutiny and possibly an international system of appeals. What we permit ourselves to do domestically will affect and be affected by the extent of interdependence.^{16/}

Safety and Other Standards

A few major illustrations that might otherwise be included under this heading have been treated separately above. The setting and observation of standards, however, is an extensive practice that has a long history. This is a particularly complex field in the US because of the separation of responsibilities for devising standards and testing among federal, state and county governments and a large number of private groups. For the purposes of this paper it may be taken that the basic purpose of such standards is valid, that they are designed to assure the consumer that the product meets minimum standards of safety and performance. With the growth of interdependence, the interplay between domestic objectives and means of pursuing them on the one hand and the international implications on the other has come increasingly into play.

It is apparent that the interplay of domestic and international forces can invite varying responses. Two specific illustrations will be given.^{12/}

In 1970 the Food and Drug Administration published new and more stringent safety standards for eyeglasses and sunglasses sold in the US. Replies were requested

within 30 days and it was implied that the standards would be enforced promptly. This seems valid enough -- particularly since domestic manufacturers had been consulted in advance of publication of the new standards -- until notice is taken that about one half of fashion sunglasses sold in the US were imported from Western Europe. Importers and foreign exporters protested over lack of adequate notice in which to reply to the FDA and to retool assembly lines in the overseas plants. In the end, the FDA extended the time given for replies to its notice and the period for compliance with the new standards; it also restricted the standards to the manufacture (rather than the sale) of such glasses. This last permitted inventories of imported glasses to be liquidated. Achievement of the domestic objective of safer glasses was delayed, but it was made equitably and apparently to the longterm advantage of the domestic consumer.

Procedures in the certification of boilers and pressure vessels, established many years ago, present a case in which protectionist interests were pervasive. Standards and procedures were established and administered by a private group whose mark of approval became firmly embedded and, in many states, compulsory. The code symbol was systematically denied, however, to products manufactured outside of North America. These protectionist practices were stopped through court action initiated by the Department of Justice.

The list of known cases where domestic standards have conflicted with international interests could be quite long and has, in fact, been the subject of much examination. The relevant point in the context of this paper is that with growing interdependence we shall certainly see considerably more attention forced to the international connection, leading conceivably in some sectors to international codes and agreed criteria. We shall also almost certainly see the metric system of

Measurement introduced into the US.

Chapter II Footnotes

- 1/ Statement Re Countervailing Duty Proceedings on Certain Electronic Products from Japan, X-Radial Steel Belted Tires from Canada (American Importers Association) July 1972
- 2/ Lowering Nontariff Barriers (The Brookings Institution, 1974) p. 41
- 3/ Agricultural Trade - A look Ahead - Policy Recommendations (The United States International Economic Policy in an Interdependent World, Report to the President, 1971) Vo. I, p. 884
- 4/ The United States International Economic Policy in an Interdependent World (Report to the President, 1971) pp. 791-910
- 5/ Toward the Integration of World Agriculture (The Brookings Institution, 1973) p. 22
- 6/ Lowering Nontariff Barriers (The Brookings Institution, 1974) pp. 30-31
- 7/ Ibid. pp. 39-41
- 8/ Gaps in Technology (Organization for Economic Cooperation and Development, 1968) pp. 129 and 133
- 9/ Statement Re Countervailing Duty Proceedings on Certain Electronic Products from Japan, X-Radial Steel Belted Tires from Canada (American Importers Association, July 72)
- 10/ This illustration draws on oral conversations with officials in the Hazardous Materials Office of DOT
- 11/ Based largely on conversations with officials in the Highway Traffic Safety Administration
- 12/ Based largely on conversations within the International Division, EPA
- 13/ Congressional Record Vol. 120, 93rd Congress in Second Session, No. 148
- 14/ Oregon's Bottle Bill: The First Six Months (US Environmental Protection Agency, 1975) p. 12

- 15/ The Next Phase in Foreign Policy (The Brookings Institution, 1973) p. 197
- 16/ For a more complete examination of issues on this subject see World Trade and Domestic Adjustment (The Brookings Institution, 1973) and Report by the High Level Group on Trade and Related Problems (OECD, 1972)
- 17/ Lowering Nontariff Barriers (The Brookings Institution, 1974) pp. 209-212

III. Implications for Macro-economic Policies

Introduction

Trade wars, scrambles for scarce resources, disparate approaches as to who pays for pollution, use of domestic adjustment assistance programs as protective devices, all of these and many other potential hazards of building a constructive, even viable community among nations pose delicate and conceivably disastrous risks. The fact that these risks are susceptible to some control by internationally agreed rules or codes of behaviour does not eliminate this potentiality.

It seems valid, however, to consider the problems of coordinating macro-economic policies and conditions as fundamental -- and hence critical -- at least in the sense that if the international community is beset with an underlying economic situation that is periodically unacceptable in terms of aggregate income, employment and prices it will be more likely to fall into counter-productive behavior in more specific areas, internationally agreed rules, codes, etc. notwithstanding.

There is a point to be made here concerning a difference of degree. We must do better in the macro field just to ensure an international setting that is coherent and constructive. Irrespective of one's attitude towards rising interdependence, it is assumed that we would all want to pursue that kind of objective. So fundamental and difficult are the achievement of marked progress in effective coordination of macro-economic policies and conditions that we are here discussing a question at the core of whether the international community is capable of accommodating a continued increase in interdependence and at what cost in terms of national policy options.

As postulated in the Introduction to this paper, the coordination that is so critical is essentially among the US, the EC, Japan and Canada or, more generally,

among countries that comprise membership in the Organization for Economic Cooperation and Development (OECD).

In the discussion that follows some attention will be given to the very great difficulties of managing aggregate demand through macro-economic policies even on a domestic level, how growing interdependence makes this task more difficult, the need for more effective coordination internationally, especially among advanced countries, and two illustrations of how the community of leading nations has attempted to cope with these difficulties. Special attention will be given to economic conditions and policies in the US over recent years and to how they have been affected by rising interdependence.

The US in Isolation

It will be useful if, first, some experiences of the US are looked at as though there were no interplay of its macro-economic policies and conditions with the rest of the world, that is, in the classical tradition, consider a one country (the US), one world approach. When the world is subsequently more realistically considered, the interaction should be apparent.

The goals of US macro-economic policy are set forth primarily in the Employment Act of 1946 which declared the federal government's continuing responsibility to promote "maximum employment, production and purchasing power," relying mainly on fiscal and monetary devices. ^{1/}

Since 1946 we have learned that governments acting through macro-economic policies can, indeed, prevent high unemployment for any but very brief periods, but that in doing so an inflationary bias is likely to creep into the picture. We have learned much about the shortcomings of stop and go, suddenly reversed changes in macro-economic policies. The goal now, by popular acceptance and presidential statements, includes stabilization with growth of the economy at rates as consistently as the science permits at high levels of employment. We have

learned at some cost that the best way to avoid high unemployment and inflation is to avoid excessive movements in any direction.^{2/} Smoother growth -- which should not be confused with government inaction, since it might indeed require more frequent intervention -- is not only more sustainable; over time it means greater growth with reduced inflationary pressures.

The requisites for achieving this are awesome, but they do not justify hopeless pessimism. The sciences involved have far to go, but they have come a long way in a very short period of history and on the whole improvement has been progressive.

To set standards by which the international interplay may later be judged, three major problem areas in execution of macro-economic policies are briefly commented on below. They are the areas of forecasting the economy, the policy decisions that flow from such forecasts and putting the chosen policies into effect.

To influence the economy in the right direction, one must first know where the economy is, where one wishes to see it go and one needs an assessment of policy choices in promoting the movements desired. Economic forecasting is at the heart of answers to these questions. As in most things, good judgment is critical to economic forecasting, above all on how the interrelation of the economic variables can be expected to work in given circumstances. An increasing knowledge is demanded of how the economy functions in changing circumstances.

In all logic, the amount of details that the forecaster must know and understand ought to be finite. The forecaster may be forgiven if from time to time he questions this logic, for he is dealing with human response against a background that never seems exactly the same as before. Forecasting will never be perfect. A reasonable aim would be that it should invariably point in the right direction promptly enough, that the forecasters remain at all times open to adjustments when

the evidence calls for it and that the art of forecasting is improved progressively, even though learning by error.

Fiscal and monetary policies remain the two major macro-economic policy instruments in guiding the economy toward achievement of national objectives. Thus, when it is decided that policies should aim at a change in direction, an intensification of a direction, or maintenance of an actual direction, one needs to take into account by which of these two policies this should be pursued, to what extent, and by what mix of the two major policy instruments.

In an ideal world the difficulties of policy managers -- that is, of those who decide these questions -- would not be nearly so great as that of the forecasters. There are peculiarities to fiscal policy and to monetary policy, whether applied as restraints or stimulants on and to the economy. There are known advantages and disadvantages in each case, depending on the circumstances. The impact of fiscal policy can be very broad, as when tax rates are raised or reduced or expenditures changed in a manner yielding a substantial shift in the full-employment budget deficit or surplus.

But fiscal policy requires legislative action and, thus, is far from flexible or even predictable in its timing. The separation of powers and the loose system of party loyalty in Congressional voting strongly reinforce any natural stickiness in fiscal action.

Monetary policy, on the other hand, is administered institutionally, at least theoretically, in an apolitical manner. It can be shifted in either direction promptly, although with a time lag between policy action and actual impact on the economy.

It serves in the US, therefore, not just as a supplement to fiscal policy, which it should, but also as a substitute. It is effective both as a restraining and a

stimulative influence on the economy so long as it does not get too far removed from the direction taken by fiscal policy. Thus at one extreme, or so one school has it, if fiscal policy is highly and persistently contractive, monetary policy (stimulative in this case) finds it is being asked to push a string. At the other extreme, when monetary policy must carry an undue part of the burden of restraint, certain sectors of the economy are singled out for harsh punishment, for example, housing, business investment, and other sectors that depend on credit. Carried to its extreme long enough institutions become threatened.

To meet most demands for macro-economic policy direction over any length of time, fiscal and monetary policy must work together and must share the burden in ways most effectively designed to accomplish the purpose. The problem in assuring this is not an analytical one, but one of institutions and political affairs; in brief, how to get the Congress (and thus the American people) to support the needed change in fiscal policy at the right time.

The third major problem area, therefore, is the one of selling the change in policy needed. This, and some of the other points raised above, can best be brought out by a look at some recent experiences.

During the years more or less immediately preceding the 1960's, a number of innovative forecasting tools were developed, for example, the full-employment budget-surplus concept and the potential GNP. When President Kennedy's new team of economic advisers assumed office, they were determined to use them and to ensure that the economy profited from them. The need for fiscal stimulation was widely seen among economists. As Herb Stein wrote, "if (President Kennedy) had chosen six American economists at random the odds were high that he would obtain five with the ideas on fiscal policy

which his advisers actually had, because those ideas were shared by almost all economists in 1960."^{3/}

The idea was to stimulate the economy, largely by a broad tax cut, to achieve growth rates above normal long enough to bring the growth path to or within hailing distance of the economy's potential, make a soft landing on the potential growth curve and maintain growth rates at potential. This was a largely unchallenged objective among economists. Nevertheless, it was not until June of 1962 that the President began to call for the needed tax cut, which in the event was not enacted until February 1964."^{4/}

The economy was not in recession in the intervening period and prices were stable. Despite a high volume of unemployed persons and other resources, Congress was reluctant to act. The timing of the Administration's fiscal efforts was, in this sense, not optimal. In the interim, the Administration took such piecemeal fiscal action as it could and monetary policy was eased within the limits of a prudent attitude towards the US balance of payments.

With the tax cut finally in effect, the budget plan envisaged a shift into neutral during 1965 and toward moderate restraint in the first half of 1966, all of this assuming of course that budgetary expenditures, including especially defense expenditures, would follow planned trends. Favorable results were exceptionally prompt. As Arthur Okun put it, "The nation had finally unleashed the private economy."^{5/} And the price-cost record remained reassuring. But the soft landing turned out to be elusive. Practically at the very moment when his economists were preparing for this most difficult point of the entire exercise, the soft landing, President Johnson, in July 1965, requested additional funds for Viet Nam and announced that a further supplemental appropriation would be required in January. As Okun

reports it, "We entered a world of rapidly growing defense spending at a time when we were approaching full utilization of resources. For the next three years, the upward movement of the defense budget exerted a key influence on fiscal policy and on economic activity."^{6/}

Optimizing its institutional flexibility, the Federal Reserve did not hesitate. In December of 1965 it raised the rediscount rate, signalling a shift in monetary policy toward restraint. It is worth noting that while, briefly, some Administration economists questioned the timing of the Federal Reserve action on economic grounds, the question more commonly posed was whether in so doing the Federal Reserve had weakened the Administration's task of convincing Congress (and the public) of the need for fiscal restraint.

That task, however, was to require two and one-half years. This period is not a reassuring one on the use of fiscal policy as a significant and favorable influence on the US economy. Arguably, at least, it was not so much a breakdown in communications as between needs.

The economists urging fiscal restraint were looking ahead at the dangerous excess demand accumulating for the next years; the Congress felt it could not act until there was a clear and present danger. These are divergencies that can easily spell disaster and had it not been for the independent action in tightening money further disaster is what we could have seen. But the heavy reliance on monetary policy, itself, had its predictable distortions and inequities. It was not until passage of the Revenue and Expenditure Control Act of 1968 (late June) that the threat of disaster was removed.

The US in the World Economy

Had the reader not been alerted to the unrealistic but perhaps enlightening approach of first treating the above events as though we lived in a one country (US)

world, very little difference might have been noticed between the sketch of events given here and those often found in recitals of what went wrong. In the real world a great deal was going on outside the US and much of it was relevant. This should not be surprising.

For the sake of orderliness, this section will focus on the following major factors that affect the interplay of macro-economic action between the US and its principal trading partners in a world of growing interdependence: the rate and the level of economic activity in the US relative to elsewhere.

This omits corporate flows into foreign investment, tourist expenditures and many other accounts. It also leaves out the direct impact of exchange rate changes and movements in US domestic costs and prices relative to elsewhere. All of these other factors are important, but those selected for examination are fundamental or more direct or both.

First, a word on the difference between the rate of growth and the level of domestic economic activity as factors in the international interplay. During 1962-65, for example, the US economy was expanding in volume terms at more than an average annual rate of 5.5 percent, significantly above a long-term sustainable average, that is, significantly above its potential rate. Our major trading partners were experiencing growth at rates much closer to their norms. Yet, the US cost-price performance in this period was decidedly superior. Moreover, the US balance of payments on trade and on current accounts was exceptionally strong. We were not sucking in imports massively to sustain any limited supply to meet such rapidly rising demand and our exports were not being crowded out by excess domestic demand.

The key to this apparently happy -- but in fact expertly managed -- combination lies in the fact that the level of US domestic economic activity was well below the capacity of the economy to produce. The gap between our

actual output and our potential output (the output the economy was capable of at full employment) was substantial as a result of recent recessions and unsustained recoveries from them. Hence, as domestic and foreign demand for US output grew rapidly, the domestic capacity was there to meet it.

By 1966, however, the US had more than taken up the slack in its economy; demand had begun to exceed the economy's potential to produce. The average annual growth rate during 1967-69 was slowed to about 3.3 percent, below our norm. Yet, our trade balance dwindled and our current account fell into deficit. The lessons seem clear enough and sufficiently consistent with logic as to make further exposition unnecessary. The rate of growth and the level of domestic activity are major factors in international interplay and the most important single direct vehicle in this interplay is foreign trade. Changes in the level of exports, for example, are affected by and affect the domestic economy.

We have become accustomed to think of changes in the volume of exports as having a relatively insignificant effect on demand for the total volume of goods produced in the US. ^{2/} In more ways than one, foreign demand is traditionally the residual of our calculations and analyses. We understand that the emphasis may be different, for example, in the case of the Netherlands. For that country, exports account for a major share of total demand; not so in the US. There are at least two reasons why we need to become more aware of foreign demand for US output in forecasting and in the formulation of domestic macro-economic policies. First, the level of exports is gaining significantly relative to total demand for US output. Second, it is the change in this larger volume of foreign demand, rather than its absolute level, that impacts on the changing status of aggregate demand and supply within the US. These two factors reinforce each other and become a major implication of

growing interdependence.

For example, in 1957, the first year treated in the presentation of measurements discussed earlier, the volume of merchandise exports accounted for only 7.6 percent of goods produced in the US. Yet, those exports made the difference -- with considerable room to spare -- between what would have been in the aggregate a negative growth rate and the positive one recorded.

In 1968 and 1969, the years of most serious excess demand arising from the fiscal rigidity discussed above, the rise in merchandise exports accounted for almost 14 percent, in volume terms, of the rise in aggregate demand for goods produced, even though the total of such exports represented only about 8 percent of the level of aggregate demand.

In 1970, when US policies had finally eliminated excess demand to an extent causing a sharper fall in output than called for in the game plan, the contraction in goods output, volume terms, would have been about 60 percent greater in the absence of a rise in the volume of merchandise exports.

Finally, although the level of merchandise exports accounted for only 10 percent of total output in goods in volume terms, the growth of real export demand between the second half of 1972 and the first half of 1973 accounted for almost one-third of the rise in the volume of US goods output.

Of course, US forecasters have for years taken the foreign sector into account, and the OECD regularly hosts a gathering of member-country forecasters where views of what each country expects in the way of export demand from others can be exchanged and examined for inconsistencies. But the trend toward higher levels and continued swings in exports indicates, as Helen Junz has pointed out, ^{8/} that even large countries like the US will have to incorporate changing economic trends abroad

more explicitly in policy formulation and that an appreciation of how foreign demand for US goods and US demand for foreign goods might be affected by changing business conditions needs to form an integral part of such a process.

The foreign trade account is indeed a major one, but it is only one of many types of foreign transactions that affect the US economy and the capacity of the US to execute macro-economic policies effectively. A decidedly major international factor within this context is the flow of money. When the US domestic monetary situation becomes easy relative to that in other major countries, capital flows out of the US in large -- at times, enormous -- volume, and when monetary situations are the reverse, massive flows come into this country. Herein lies a major constraint on the use of monetary policy as an instrument of macro-economic influence.

When fiscal policy is temporarily rigid, as it was in 1966 to mid-1968, and monetary stringency must carry the full burden of restraint, the domestic monetary situation becomes tense. As noted above, domestic housing suffers inordinately (and irrespective of social needs), business capital spending becomes abnormally expensive if not impossible, along with all types of credit financing. Neither businessmen nor bankers react with indifference. Large sums of money come from abroad to take advantage of the relative high demand for money in the US. Domestic banks with branches abroad usually can recall vast sums, notably in the form of Euro-dollars, on short notice and with great efficiency.

There are inequities in this kind of situation. Banks with the most Euro-dollars in branches overseas tend to be the larger ones, and the scarce funds so received tend to go to prime borrowers.

When the shoe is on the other foot, and we find it necessary to ease the domestic monetary situation unduly,

because the economic situation requires stimulation and fiscal policy is inhibited, the results are only somewhat less dramatic. Assuming more normal monetary conditions in other major countries, funds flow massively from the US to abroad where they seek more profitable returns. We should notice, first, that these funds were intended by US monetary policy to augment spending in the US. Not all of them are doing so. Second, the arrival of these funds abroad in such large quantities often counteracts the intentions of monetary policy in other countries, frustrating attempts they may be making to disinflate by a stringent monetary situation. Third, they distort the balance of payments.

Some supporters of an international monetary system incorporating freely floating exchange rates believed that such a system of rates would free the US of undue external constraints in the execution of macro-economic policies. This has yet to be proved. It is true that if we pursue easy monetary policies to meet domestic objectives the consequences for our balance of payments no longer fall necessarily or entirely on our net reserve position. They are absorbed in large measure by shifts in the dollar exchange rate. But each further depreciation of the dollar with respect to currencies of our major trading partners is inflationary and it may happen that this is more undesirable than a change in net reserves or that one consequence exercises a less dramatic reminder of the need for prompt fiscal action than the other.

In this kind of situation, the US finds itself particularly disadvantaged by its process of changing fiscal policy, that is, all changes of substance must be made by Congress, but we have a system that permits an opposition majority in the Congress and Congressional votes are not subject to party discipline. We are thus twice hanged; the Administration cannot command support for a fiscal policy change from its own members in Congress, and its own members often enough do not constitute a

majority. In these circumstances, serious questions have to be asked as to how much we have freed domestic macro-economic policies from the discipline of the balance of payments.

Other advanced countries are commonly well situated institutionally to avoid rigidities in executing fiscal policy. They, nevertheless, face familiar domestic political pressures against tax rate increases and substantial reduction of government expenditures. Domestic political instability -- for example, government by loose coalition -- has more often than not led these other countries to over-reliance on monetary policy. When their domestic political situation is reasonable, they are able to use fiscal policy in timely fashion, and more recently they have been tending to do so.

At the same time, they have retained their preference (usually political) for monetary policy as the most active partner in macro-economic implementation. They have been able to do this in part by learning to cope with their own monetary squeezes, for example, by the large amount of housing financed through the public budget, general use of variable mortgage rates, and by raising funds for private business investment through the budget or by government-guaranteed loans at relatively low interest rates. Their chief difficulty, as they see it, is with getting caught in the swirl of our own excesses in monetary policy.

For a country the size of the US, a sudden and major flow of money is on the order of a nuisance. If we are in a situation of monetary ease relative to elsewhere, large sums of money will flow out of the country; our aim is partly frustrated, since we had eased money to induce a rise in domestic demand, but the sums involved are small relative to total domestic money, and we seem able to adjust. If we are in a state of monetary squeeze relative to others, the massive funds pulled into the US

will in part frustrate our aim, but again our size is such that we can in time absorb it.

Other countries, particularly the smaller ones, complain bitterly, however, that such massive swings of funds into and out of the US seriously frustrate their attempts to administer macro-economic policies in accordance with domestic objectives as they see them. Lawrence Krause has shown that on occasion private short-term capital flows have represented eight to ten percent of domestic money supply in, for example, Germany, Italy and Canada. ^{2/}

This kind of circumstance is by no means unrelated to the cries of pain from abroad that the US has exported inflation. Although in many cases foreign authorities might do a better job of effectively reducing the impact of these flows if they had better instruments and procedures with which to work, the point is that they feel they cannot, and resentment against US economic policies becomes considerable. ^{10/}

With this background of international interplay, let us now take an episodic look at some other problems in administering US macro-economic policies over recent years.

It has already been noted that the economists with the Kennedy Administration came into office seeing green lights all along the way (as did most other economists). It will be recalled that substantial fiscal stimulus was long in coming and that, among other things, an easier monetary situation was encouraged through monetary policy. Progressively easy monetary conditions conceivably could have gone far enough to have "spared" the economy the tax cut of early 1964, except for concern over the effect of the US balance of payments through flows too massive to support in reasonable calm.

Milton Friedman has argued that "So far as I know, there has been no empirical demonstration that (the 1964) tax cut had any effect on the total flow of income in the U.S. There has been no demonstration that if monetary

policies had been maintained unchanged . . . the tax cut would have been really expansionary on nominal income. What Okum did (in an analysis of the tax cut) was to assume away the whole problem because he looked only at the effect of fiscal policy without asking what role monetary policy played during that period." ^{11/}

Okum has replied that "As a political judgment, I am confident that the route would not have been traveled (easier and easier monetary policy), given the constraints of the balance of payments on lowering interest rates as they were viewed -- rightly or wrongly -- by the administration and the Federal Reserve." ^{12/} Few who were even remotely engaged in the execution of US monetary and US balance of payments policies at the time would fail to agree with Okum.

The Federal Reserve's concern that the US balance of payments not suffer unduly as a result of easier money here than in other major countries is repeatedly reflected in the Federal Reserve Board's Annual Report Covering Operations for the Year 1963. The report cites a continuing concern over the persistence of high unemployment and less-than-optimum utilization of a steadily expanding industrial capacity. It notes that "Expansion of bank credit during the year reflected a generally stimulative monetary policy, but one that became somewhat less so during the first 9 months of the year. In July the discount rate was raised . . . in an effort to help reduce the large deficit in the U.S. balance of payments." It reports progress in reducing the balance of payments deficit and notes that "much of the improvement in the second half (1963) was traceable to the return flow of short-term liquid funds and, even more, to the reduced outflow of long-term capital."

In subsequent years and at the other extreme of employed resources, the end of excessive demand in the US was signalled by belated passage of the surcharge on income and corporate taxes (mid-1968), but lags between the

policy action and its full impact on the economy, intensified by a premature easing of tight money, carried the boom and, especially, the inflationary pressures into 1969. Monetary policy was tightened somewhat in late 1968. Under the new Administration extreme monetary restraint was built up and maintained throughout 1969. Interest rates reached record highs and there were questions of whether some of our financial institutions might be shaken. One result was a more recessionary period beginning in 1970 than desired.

Massive international monetary swings came into the picture early. For the first time in many years, the net flow of private funds was into the US, by almost \$5 billion in 1968 and by about \$8 billion in 1969, compared with, for example, an outflow approaching \$2 billion in 1967. To be sure, this very substantial swing was influenced by a complex of events, including currency uncertainties touched off by a sterling devaluation in November 1967 and the May-June 1968 civil disturbances in France. An overriding stimulant, however, was the extreme shortage and high return of money in the US relative to other countries. About \$7 billion of the 1969 inflow took the form of an increase in liabilities of US banks to their foreign branches, representing principally funds obtained in the Euro-dollar markets. ^{13/}

One result of all this was that the US balance of payments as measured on the official settlements basis swung from a very large deficit in 1967 to a surplus of \$1.6 billion in 1968 and a surplus of almost \$3 billion in 1969. ^{14/} To those who wished to, this provided an occasion to see an end to the long history of US deficits. Those who looked more closely, however, noticed, for example, that the balance of goods and services dropped precipitately and forebodingly during 1968-69.

Other results included the usual partial frustration of the intent of US monetary policy, the inequities of

which banks and which borrowers partially evaded that intent, a susceptibility to rapid and massive reversal of the international funds that had come in so fast, and disruption in the Euro-dollar market and of the monetary policies of other countries. The temporary achievement of balance of payments surplus, far from stilling the plea from abroad, intensified urging that the US get its house in order.

By the end of 1970, the US economy was once again off on a growth path and once again government economists were aiming for that soft landing near and more or less parallel to the potential growth path, which by now was rather high on the chart, given the amount of slack that the economy had generated. When sags in the growth rate appeared in mid-1971, the President responded with the initiatives of August 1971.

These initiatives were literally heard round the world. For mixed with certain moderate stimulants to the domestic economy, in which discrimination against other countries was involved, and along with a temporary wage-price freeze was, most dramatically, devaluation of the dollar with respect to other major currencies. In the turmoil that followed, the US decided on the tactic of at least temporarily vacating its role of leadership in initiatives on the international scene. How the major nations were to pick up the pieces, restore monetary order and begin to intensify coordination of domestic policies was left for others to decide. Fortunately, this dark age was shortlived.

The response of the US domestic economy, however, was positive. We had our boom in 1972, pushing into the early months of 1973. Once again, however, the soft landing eluded us. Like its predecessor, it was a boom stopped by government action to halt a dangerous rise in inflationary pressures. On this occasion, it was stopped before excess demand set in, but not before the inflation was very real, even dangerous.

It would seem fair to ask why the economic recovery of late 1971-early 1973, starting as it did with substantial slack in the economy, was so shortlived, compared with the record of 1962-1969. The answer is that, while the inflation that led the government to shift to policies of restraint was and is by no means divorced from errors in the domestic management of macro-economic policies, it is fundamentally an international inflation. A brief examination of its origins and components is relevant.

In a real sense the present inflation started with the global slowdown in the growth of output roughly during the period 1970-71. For the US, the slowdown followed by recession began in late 1969. The years 1970-71 were marked by economic slowdown in practically all industrial countries, bringing in turn a slowdown in production of raw materials and producers goods from other parts of the world. This was the kind of situation in which forecasts for individual countries almost inevitably underestimated the dormant strength of world demand once it revived.

The general upturn came in 1972 and was, in consequence of the above, exceptionally broad geographically and unexpectedly sharp within individual countries. Even so, in its early stages supply capabilities were elastic, given the general slack that had accumulated. But the boom was too broad and too sharp. Supply bottlenecks developed at an early stage and price pressures intensified. The volume of world trade rose 13 percent in 1973, compared to a more normal 8-9 percent over previous years. This was a phase marked by a sharp rise in prices for most primary commodities, notably in the industrial materials sector where starting inventory levels were generally inadequate. A scramble for supplies ensued and world prices for industrial materials, according to the London Economist's index, almost tripled between the end of 1971 and April 1974 (oil prices excluded);

the index of metal prices was up by well over three times. ^{15/}

But the highly abnormal global economic cycle was not given even a fair opportunity to be sorted out before the world food situation took an extremely adverse turn, from poor grain harvests in much of the world to disappearance of the anchovies from Peruvian coastal waters. Beef production, for which demand has been undergoing a structural shift upward, fell. By late 1974, spot prices for raw foods (expressed in dollar terms) were over three and one-half times their late 1971 levels.

The industrial countries had begun in 1973 implementing macro-economic policies of restraint, leading many of them practically to the point of stagnation by the last half of 1973. This was having some impact on prices. By October 1973, the Economist's index of spot prices of industrial materials had shown no trend increase for about three months, and the food index had dropped about 10 percent from its August peak.

Then came the October 1973 war in the Middle East, which brought uncertainty followed by stoppages, shortages and the substantial increase in oil prices. A considerable impact on general prices was immediate and both direct and indirect. Given the uncertainties that had prevailed and continued to prevail, and given the basic nature of oil to the world economy and considering the continued low level of stocks of many commodities, expectations of inflation were set off and a sharp speculative boom in commodity prices began.

The OECD Secretariat has suggested that "Throughout these first two phases (the scramble for commodities followed by the food shortage and the oil affair) much of the inflation appeared, to any given country, to be essentially exogenous. While the first phase . . . was caused primarily by an excess of demand for commodities relative to their supply, it was an excess of world demand

that was the problem, rather than excess demand in any one country considered on its own. The increase in the relative price of oil was a truly exogenous phenomenon as far as Member countries were concerned and the final speculative commodity price boom also was a worldwide phenomenon which individual countries, in the short run at least, simply had to accept."

It is difficult to imagine a more effective -- albeit costly -- scenario than that just described in making the points that (a) we live in a world of economic interdependence, and (b) such interdependence can at times bear very hard on the capacity to achieve domestic macro-economic aims. The hazards of grain crops and the oligopolistic capacities of Middle East oil producer states should not conceal the fact that a major contributory factor was ineffective coordination of domestic macro-economic policies among the giants of the world economy, the US, the EC, Japan and Canada. It is surely cause for sober thought on the part of any who believed that economic conditions abroad are of little importance to a domestic economy the size of the US.

Moral Suasion

As in most economic matters, it is not only events and developments within the system that can influence the course of macro-economic policies. Two illustrations of a less market-oriented influence will be given below. They each fall within what may be called moral suasion.

First, because it can be treated so briefly, one might take into account foreign urging on the US during the 1960's to eliminate its persistent balance of payments deficit and to do so by an exemplary performance of price stability, such as in the period of the early 1960s. When the need for significant fiscal restraint in the US became generally apparent in 1966, vocal urging at international economic conferences became increasingly strong. Watching the highly successful record of growth

with stability in the US face mounting threats was not at all to the liking of the governments of our leading trading partners. Seeing their efforts at international conferences fail, some called directly on members of the US Congress, including on the Chairman of the House Ways and Means Committee, to urge prompt fiscal restraint.

How much effect this may have had on a US Congress is impossible to say, but in the view of one of the leaders in the US government's efforts to achieve Congressional action (Arthur Okum, then Chairman of the President's Council of Economic Advisers) international economic events had an important impact in finally breaking the dam that so long delayed the fiscal restraint required.

Okum has written that "The threat of an international financial crisis may well have been the single most decisive factor in getting Congress to move on fiscal restraint. . . The pleas and threats, the cajolery and rebukes of central bankers around the world had a major impact on our political process. . . Without the world bankers, I seriously doubt that we would have enacted the fiscal program that was so urgently needed for our own good." 16/

Thus interdependence hampered US efforts to curb inflationary demand in the US solely through application of tighter and tighter domestic monetary policy, but it was a major contributor to a much sounder domestic solution.

A second illustration of international moral suasion involves the economic situation and policy intent of Germany during the 1965-68 period. While the US is the single country with the major commercial and financial influence internationally, the German economy exercises a remarkable influence in Europe and, through it, the world. Germany constitutes the dominant export market for many West European countries to such an extent that,

paraphrasing, one may say that as the German economy goes so goes that of Europe, and the rest of the world is not unaffected by how Europe goes. The German balance of payments has for many years been exceptionally strong. The direction and mix of German macro-economic policies are therefore always of interest generally and of intense interest in much of Europe.

These interests are reflected in policy recommendations of the OECD to Germany. The recommendations here described are those published in OECD's Annual Economic Survey of Germany. They are no less interesting because the OECD, with German concurrence and consistent with its normal practice, was able to publish them. The period covered is one in which Germany, first, restrained an economic boom, largely by stringent monetary policies, went through a sharp recession in 1966-67 and, after initial reluctance, emerged with a strong enough growth path in 1968 and 1969 substantially to reduce, if not remove, the slack in its economy.

In December of 1965 the OECD urged strong efforts to change Germany's policy mix, with a relaxation of monetary restraints. The recommendations particularly urged smoothness in application of macro-economic policies and avoidance of large surpluses in the capital as well as current account in Germany's international payments position. ^{17/}

By March of 1967, when another annual survey on Germany was published, Germany was in its recession. The OECD's policy recommendations noted that the adjustment from boom to cooling off had by then gone too far; the immediate object of economic policy must be to get the economy on a normal growth trend, both for internal and external reasons. Externally, the recommendations noted that "it is essential that monetary ease should be generated by relaxation of domestic restraints on liquidity to support a revival of the capital market and stimulate an outflow of long- and short-term capital on a scale

sufficient to provide a significant offset to the current account surplus . . . For such an outflow to be achieved, interest rates in Germany would have to fall below the rates prevailing in other major financial markets. . . in existing conditions of low rates of (domestic) capacity utilization there may also be need for additional fiscal measures to stimulate demand." ^{18/}

These recommendations go on to attack a myth then prevailing in Germany: "There is a wide-spread impression in Germany that a budget deficit will lead swiftly to inflation. . . But this is not the situation in Germany at present. . . the broad test of budget policy should not be so much whether the budget (however defined) is in balance, but rather whether it contributes to a reasonable balance in the economy as a whole." ^{19/}

Prior to publication of the next OECD Economic Survey on Germany, in April 1968, the German Minister of Economics had taken a strong and widely publicized position that Germany should emerge from its recession on a growth path built on an annual rate of 4 percent in volume terms. Since the capacity for output by the German economy was growing and had been growing at a rate somewhat above this, the 4 percent growth curve, starting from such a low level of activity, would have meant locking in or increasing the underutilization of the German domestic economy; as German industrialists sought increasingly to sell their output, they would look more to exports and further rapid growth in Germany's foreign trade surplus would ensue. An indication of the considerable slack that had accumulated in the economy is given by the estimated six percent gap between actual and potential output in mid-1967. ^{20/}

OECD's survey pointed out that "real GNP would need to expand at a rate of close to 5 percent and domestic demand at close to 6 percent a year in the period 1969-71 if the balance of payments target (of Germany's own

medium-term plan) were to be realized."^{21/} It recommended that a main concern of the authorities must be to make certain that the recovery of the economy continued strong; the government should have standby action a hand and move with it promptly at signs that growth might be faltering; any expansionary action would best rely on fiscal changes, since these were more likely to produce sufficient stimulus to demand, but it was clearly desirable that monetary conditions should be kept as easy as possible.

On the well-publicized 4 percent growth rate, OECD reported that "It is also important to consider how far, in present circumstances, the official growth target of 4 percent in 1968 represents an adequate first step towards the Government's 'optimum combination of economic aims'. A cautious estimate of the present slack in the economy suggests that a 5 to 5.5 percent growth rate of GNP might constitute a reasonable interim target for the next couple of years."^{22/} Much effort went into explaining the case that such a growth rate would be in Germany's own best interest, as well as that of her neighboring countries, for example, the rise in productivity through achieving optimum capacity utilization would mitigate wage rises.

Of course, there were economists in Germany working toward the same policy ends. To say the least, they were in a minority; they needed help from outside. The OECD recommendations, forged out of Secretariat drafting and long debate among representatives of member countries with German experts from Bonn and Frankfurt, carried their weight, too.

In the event, the recommendations made through OECD were acted on with surprising thoroughness and reasonable promptness. The Bundesbank began progressive easing of monetary policy in 1967 and succeeded in creating a situation of considerable liquidity which led to the recommended capital out-flow. The discount rate was reduced from five to three percent in four steps and reserve

ratios of the banking system were reduced in several stages; the effective average ratio fell from 8.0 to 5.3 percent, or about a third, by September 1967. ^{23/}

German banks responded to the release of minimum reserve balances by increasing their short-term foreign assets, as interest rates were by then lower in Germany than in other major countries and German domestic demand was weak. The impact on the German balance of payments was dramatic and favorable to international monetary stability. Long-term capital, which had been a net inflow into Germany in 1965 and 1966 (and most postwar years) began to flow out of Germany in 1967, reaching a net outflow of almost \$3 billion in 1968 and almost \$6 billion in 1969. ^{24/}

As for economic growth at a higher than 4 percent annual rate, primarily through fiscal ease, Germany experienced its first planned budgetary deficit of the postwar period; the annual rate of economic growth, in volume terms, shifted out of the minus 0.2 percent of 1967 to a positive 7.1 and 8.2 percent, respectively, in 1968 and 1969. ^{25/}

Most member countries of OECD have had numerous experiences similar to that of Germany described above. Few, if any, have never felt the strong impact of international moral suasion. The German experience makes a convenient example because in earlier years economic thinking generally in Germany was uniquely conservative and, given the importance of German international trade and finance, special efforts were marshalled to ensure that international implications were fully taken into account in execution of German domestic policy -- that international and domestic aims were reconciled.

It is, as such, a good illustration of what all of the advanced countries may increasingly expect to see as, through growing international interdependence, what is done in pursuit of domestic aims matters too much to permit any such country to fail adequately to reconcile

how it pursues its own objectives with the international requirements of the time and to do so with reasonable promptness and, therefore, smoothness.

Chapter III Footnotes

- 1/ 60 Stat. 23
- 2/ Economic Report of the President (February 1970) p. 10
- 3/ The Fiscal Revolution in America (University of Chicago Press, 1959) p. 380
- 4/ The Political Economy of Prosperity (W. W. Norton, 1970) pp. 45 and 46
- 5/ Ibid.
- 6/ Ibid.
- 7/ As in Chapter I on measurements, throughout this paper "goods GNP," "output of goods" and such terms mean GNP minus services and structures, i.e., the middle column of Table 6 in the statistical tables accompanying the CEA's Annual Report, January 1975
- 8/ Proceedings of American Statistical Association, 1973
- 9/ Transnational Relations and World Politics (Harvard University Press, 1972) Table 1, p. 182
- 10/ For a serious attempt at placing these complaints in perspective, see Economic Outlook (OECD, July 1973) especially pages 88-90
- 11/ Monetary vs. Fiscal Policy (W. W. Norton, 1969) p. 55
- 12/ The Political Economy of Prosperity (W. W. Norton, 1970) p. 58
- 13/ Annual Report (Board of Governors of the Federal Reserve System, 1969) pp. 49-51
- 14/ Ibid. Table 8, p. 48
- 15/ This discussion of international inflation draws on a paper prepared by Helen Junz (Joint Economic Committee Print, Spring 1975) and analysis in Economic Outlook (OECD, July 1974) pp. 25-37
- 16/ The Political Economy of Prosperity (W. W. Norton, 1970) pp. 88-89
- 17/ Economic Survey of Germany (OECD 1965) p. 30
- 18/ Economic Survey of Germany (OECD 1967) p. 30
- 19/ Ibid.
- 20/ Monetary Policy in Germany (OECD 1973) Chart I, p. 11
- 21/ Economic Survey of Germany (OECD 1968), p. 29
- 22/ Ibid. p. 30
- 23/ Monetary Policy in Germany (OECD 1973) p. 55
- 24/ Ibid. Table 2, pp. 14-15
- 25/ National Accounts of OECD Countries: 1960-71 (OECD 1973) p. 440

IV. Implications for International Security and Political Relations

Introduction

Broadly and generally, governments pursue foreign relations with a view to protecting and fostering the security and prosperity of their citizens. Among the advanced industrial countries which are the special focus of this paper this includes the pursuit of a common security, at least so long as there is a common threat.

Unfortunately, the logical counterpart, common prosperity, is too rarely perceived, much less promoted. Even though there exists a discernible common threat -- that these countries would return to something like the degree of self destruction prevailing in the 1930s -- we do not seem to find it credible. Individual members of this economic alliance continue attempts to export their problems to one another and otherwise to achieve individual gain at the expense or threat of common loss. Hence the adverse interplay between economic issues and international political and, to a lesser extent, security relations.

There is, of course, a favorable interplay between these forces and this, too, will be examined in the paragraphs that follow.

International Security Relations

Collective security is related to economic interdependence in very much the same way that national security is related to the state of the national economy. Reasonable economic prosperity does not guarantee a national will to support large, growing and persistent military expenditures, but in a democratic society it does constitute a prerequisite.

Like political relations, collective security can be affected positively or negatively by economic interdependence. Interdependence is likely to support efforts towards

progressive prosperity at the national level; the question is whether the international economic issues arising out of interdependence can be contained so as to preserve and possibly foster a necessary mutual confidence and so as not to arouse a degree of friction insupportable in international relations.

German Chancellor Helmut Schmidt seems to perceive the interrelationship clearly. He is quoted as stating at the May NATO summit meeting that the Atlantic alliance was threatened "more by the economic situation than in any particular geographical area" and to have called for more coordination in economic policies. He is said in this to have received the concurrence of President Ford and Prime Minister Wilson. And the Chancellor was apparently not speaking of trade wars or friction over what have here been called micro-issues. He is reported to have linked the strategic effort and capacity with such macro-economic issues as competitive long-term interest rates, increased industrial capacity and long-term economic growth with stability to combat social tension and political instability. ^{1/}

Whether interdependence can ultimately be seen as a means toward a common prosperity is, it seems clear, a central question in security, political and economic relationships. It is a question that will be examined under the heading that follows.

International Political Relations

Do international economic interests, objectives and the consequences of their pursuit constitute the tail to the body of international political relations, or is it the other way round? Do they constitute the whipping boy of or do they exercise a discipline on international political relationships? Curiously, the answer is not always clear.

Economic interdependence between the US and pre-Castro Cuba was substantial. For political reasons the US took

deliberate measures that eliminated that interdependence, despite obvious economic costs and strong protests from segments of the US business community.

The US has at times blocked much trade of its nationals with the USSR, Eastern Europe, Mainland China and North Korea, for example, in the name of security. In all of these cases, trade relations have been made subject to political relations, which in turn are affected by security considerations.

But supposing no involvement of national security, would the US for any conceivable reason initiate and maintain a politically hostile -- and not just cool -- relationship with Canada or Germany, for example, given the magnitude of our economic stakes in Canada and the EC? Possibly so, but the proposition boggles the imagination.

The US launched the Kennedy Tariff Round, one of its numerous initiatives to increase interdependence, in part out of political motivations -- an instance of complementarity of trade policy and political purposes. It is true that the concept of a US-EC partnership, which carried considerable weight in US circles at the inception of this effort, fell into disuse. But there has remained a concern to ensure, whether it be called partnership or not, continued close political and security relations with Europe, and closer trade ties are seen, among other things, as a means of reversing Europe's pre-occupation with itself and the threat of a shift by it toward economic isolation. This is an interesting role, in the context of this chapter, for closer trade ties.

The case can be made that the current round of trade negotiations is, for much the same reasons, in part politically motivated. Among other things, the most sensible way to remove friction caused by trade discrimination -- or, for that matter, discrimination itself -- is to eliminate or substantially reduce the instruments of discrimination.

Do our political and security objectives sometimes lead

us to accept inequitable treatment on economic issues that we otherwise would not accept? Many seem to think that they clearly do; but the evidence does not bear them out. We have avoided a type of confrontation threatening a widescale trade war with the EC over its proliferation of discriminatory trading arrangements, for example, because the economic results would be out of all proportion to the gain.

Does the economic gain from interdependence sometimes lead us to override our political or security objectives? They may, as concerns political objectives, depending on how important we consider them to be, but they could not do so as concerns serious national security objectives.

The point is that at least among these allied, closely associated countries our economic, political and security objectives converge. Political and security relationships are underpinned by economic prosperity which is fostered by interdependence, but interdependence can lead to friction that can adversely affect the total relationship. It is our total interest that would be served by avoiding such friction.

But any query into our capacity to cope with rising interdependence must acknowledge that such friction does not arise exclusively through differences over trade policies and actions. Increasingly, divergent macro-economic situations and policies are doing so, as the chapter immediately above attempted, among other things, to bring out. We are likely in future to see more friction over such things as what is conceived as unnecessarily harsh balance of payments discipline on the domestic economy and exported unemployment and inflation.

There are two extremes along the road toward increased economic interdependence, with a wide area between them. At the one extreme, precisely because the volume of transactions between countries is large and growing, interdependence increases the number of occasions for political friction and, given a lack of will and procedures to ensure equity

in such transactions, this friction festers. At the other extreme, interdependence has progressed sufficiently to become inhibitive to serious and prolonged friction. That is, the volume and value of economic transactions are seen to be such that highly interdependent economies demand the political will and procedures to avoid serious, hampering friction.

The road to inhibitive interdependence is long and rough. We are not yet within sight of such interdependence, but there are signs that in our most tightly knit relationships we are approaching it. This, in itself, is remarkable. Human nature and domestic politics being what they are, domestic rhetoric is, from the start, against a smooth ride.

The definition of inhibitive interdependence does not lend itself to precise judgments, but it is at least arguable that it exists in modest form today within the EC, the setbacks (not always temporary) and missed opportunities of the EC notwithstanding. The EC may be a long way from some of its dramatic and important goals, for example, monetary integration and majority voting. But for a fair reading, one must consider where relations stood between its member countries two decades ago. And one must ask whether one member country today would defy the full membership on an issue of such importance as to offer the alternative of dissolution. Has this inhibition not fostered compromise over confrontation? More important, have the habit and form of compromise not come to reduce friction itself? And is this not attributable in part to a gradual concept of common prosperity and a strong legal framework within which to seek it?

The US-Canadian relationship offers another example of intense interdependence, forming what Ed Fried has called in many respects a de facto economic union.^{2/} In trade, each country is the other's major market, and the closeness of the financial relationship is remarkable. Partly due to the great difference in size of the two economies and the

stages of their industrial development, problems have been many and at times hotly debated.

Few countries, if any, are as exposed to ramifications from US domestic policies and actions as Canada. As William Diebold has pointed out, the result "involves the Canadian and the American governments in something more than 'foreign economic policy.' The problems are at once foreign and domestic, being in fact a facet of the complex task of operating, on one land mass, two highly interdependent economies through a combination of private activity and the working of two separate sovereignties . . . (with) common and divergent interests." ^{2/}

In this relationship, interdependence has multiplied the number of problems, the incidences of friction. But it is such as to inhibit either government at least from action to the serious detriment of the other, for example, special treatment for Canada as concerned the US interest equalization tax, the US-Canadian agreement pertaining (at least at times) to the level of Canada's international reserves, and apparent resolution of the Michelin tire case less heatedly and dramatically than many supposed possible.

Special efforts to contain friction and avoid confrontation have resulted in what one Canadian historian has called "an elaborate and complex machinery of commissions, committees, boards and other joint bodies . . . (and a) regularly constituted procedure or apparatus for the conduct of almost every conceivable kind of Canadian-American business . . . The level of cooperation is so efficient and so constant that the general public is scarcely aware of its existence." ^{4/}

But this last goes too far. There are, indeed, untold bilateral committees and expert groups, public and private, that meet in attempts to resolve the many problems that arise. Their lack of success leaves much to be desired.

Can we learn anything or discover any portends for the future by this very brief examination of progress, if any, toward an inhibitive type of interdependence, that is,

within the EC and in the US-Canadian relationship?

This paper takes the view that economic and consequent political friction among countries can best be contained when there are firmly agreed and mutually respected rules and scheduled and effective procedures for close and frequent consultations on many levels, including the ministerial level, and that such rules and consultations are most likely, if at all, among countries that are highly (inhibitively, if you like) interdependent. The political will to yield to the fostering of mutual confidence and a concept of mutual prosperity must be there.

Thus, if interdependence is to continue to intensify and we wish, among other things, to avoid increasing friction, we must accept almost as commonplace the sentiments expressed by President Eisenhower at the conclusion of a summit meeting with Prime Minister Macmillan (over awards of public contracts) as far back as 1959. Here the President stated their belief in "the principle of interdependence. We believe that you cannot keep a coalition of free countries . . . unless we adopt cooperative measures that do promote the interest of all . . . the greatest need is to look at the long-term benefits of the whole group, because with that group, our own fortunes are tied up." 5/

Chapter IV Footnotes

- 1/ New York Times, May 31, 1975, p. 10
- 2/ The Next Phase in Foreign Policy (Brookings Institution, 1973) p. 172
- 3/ The United States and the Industrial World (Praeger Publishers for the Council on Foreign Relations, 1972) p. 112
- 4/ The United States and Canada (Harvard University Press, 1968) pp. 314-15
- 5/ New York Times, March 26, 1959, p. 12

V. International Consultations

Introduction

Earlier in this paper we looked into some of the ways that growing interdependence has encroached -- and is likely further to encroach -- on a wide variety of domestic policy issues here called micro-policies. In the chapter that followed we explored how macro-economic conditions can be significantly affected through interdependence and how the choice of domestic macro-economic instruments may be narrowed and their impact thus delayed. The preceding chapter attempted to show the link between international security, political and economic relationships, how economic interdependence helps to underpin the other relationships and how it can, on the other hand, lead to friction and declining mutual confidence and so undermine efforts to strengthen our international political and security relationships.

In this chapter we shall examine in summary fashion what is being done about these effects through international consultations and what more might have to be done on the assumption of a continued increase in interdependence.

When the postwar network of international organizations was first designed, essentially in the 1940s, the major building block was a set of prior commitments constituting articles of agreement. That is, trade was to be non-discriminatory, currency devaluations had to meet established criteria -- that sort of thing.

This was never seen as all that would be required. Exceptions would have to be made and were, indeed, provided for in the articles of agreement, most widely spread in matters concerning trade. Existing barriers to trade and to the free convertibility of currencies were seen as targets to be progressively reduced or removed. In this and other ways, international consultations based essentially on articles of agreement were made a part of the system.

Even so, as the complexities of interdependence grew, the need for a different type of international consultations

became evident. It is a type of consultations which might for convenience be called issues-oriented. It flourished, first, in the OEEC, then in its successor, the OECD, and has assumed an increasing role within the IMF.

These two types of consultations, not always readily distinguishable, supplement rather than replace each other. To meet current and foreseeable problems of interdependence, each approach would need to become considerably more effective. It will be difficult and not without some cost in terms of domestic policy options to effect improvements of this sort.

But we must not exaggerate. It is not the perfect system that is needed; just a system that works with decidedly more visible equity and effectiveness on a wider range of issues than before. In a sense, it is a trade-off that is involved. The more effectively equitable the system, the greater the cost in terms of freedom to choose domestic policy, but also the more we reduce friction and distrust, especially among countries with whom we have closest economic links. To the extent that we prefer to let the friction and distrust and their consequences fall where they may, we can limp along with a system of international consultations that is mediocre in effectiveness. But there are limits as to how mediocre the system could be if it is to accommodate rising interdependence, and the more mediocre the system, the more vulnerable it will be to successive strains.

What would substantially improved effectiveness involve? That is, what kinds of payment in terms on complete freedom of domestic action would have to be made to accommodate further increases in interdependence with progressively less -- but never zero -- friction and distrust? The discussion that follows will put forward some of the more reasonable conjectures as indicative and representative.

Trade

The GATT has been a prime target of criticism among major international economic institutions, but it has also been generally recognized that the faults in operation of the GATT lie not so much in the General Agreement -- even though it has here and there been overtaken by events -- as in the manner in which the contracting parties have failed to respect the Agreement.

It would be hard to improve on the following: "What is required is not so much the application of poultices or even radical surgery to GATT itself, but the undertaking of concerted action by those member countries capable of doing so to apply its rules in improved form with greater vigor, to adopt additional rules suited to modern needs, and to supply more effective means of international enforcement." ^{1/} Indeed, the analysis and conclusions of the proposed reform of the international trade system put forward by the Special Advisory Panel to the Trade Committee of the Atlantic Council ^{2/} are generally endorsed by this paper.

In brief, to accommodate increased interdependence we need a tighter, stricter, more modern system of international trade surveillance, rather than an overhauled GATT. What would be involved?

Exceptional treatment under agreed rules would need to be held to an absolute minimum; such exceptions constitute seeds of future discord. There could be no place for endruns such as voluntary export controls to avoid import restrictions. And the import restrictions themselves, notably when applied for protective reasons, would be abolished. Subsidies linked directly to exports would be outlawed. Claims to preferential trade treatment in less developed countries would be given up. Genuine cases of barriers that arise in agricultural trade would be negotiated on the basis of domestic programs that collectively ensured a fair sharing of their burdens and a further promotion of trade. The export of the domestic

cost of such programs would in principle be outlawed.

Escape clause actions under Article XIX of the GATT are in special need of tightening. Probably, they should require procedures to lessen their frequency and to ensure that they are temporary. There would, in all likelihood, be need for international surveillance and discipline involving domestic adjustment assistance to ensure that the restrictions involved were progressively removed.

Finally, as concerns trade, there would presumably be a need for agreement on how to cope with food, raw material and other shortages and export embargoes. This could include prior notification, international consultations and commitments to fair sharing among importing and exporting countries.

What this all comes to is stricter compliance with agreed and modernized rules with a meaningful system of international surveillance.

Nontariff Trade Barriers

This vast area has been the subject of intense and varied research, internationally, nationally and privately. The industrial world is groping here with enough energy to make it likely that some discipline here and there will gradually emerge.

One effort earmarked for the current trade negotiations has been to attempt to compile and agree on international rules on product standards. These rules would focus particularly on national standards that are mandatory and on an internationally agreed system of certification. They could result in changes in US practices, changes that flushed out protection where it was here disguised, but changes also in what is mutually agreed upon to meet safety requirements. In domestic debate, the two would frequently be confused.

Generally, the problems in negotiating liberalization in this broad area are that the practices are not only ingrained; methods and procedures vary greatly from country

to country, quite unlike tariffs or most quotas. An overriding problem is that of reciprocity: who gives what for what, how can one be sure of rough equality in the giving and the taking and how can one be sure that what has been given in negotiations will actually materialize as planned?

Practices in government procurement constitute a good example of these complexities. In the US the discrimination against foreign bidders is clear. It is in legislation and, unless and until overridden, in the powers given to the individual states. In most other countries it lies by long practice in the manner of soliciting -- or not soliciting -- bids, that is, questions arise as to advance public notice, if any, how much notice, as well as treatment of bids received. Yet, an increasing volume of business is involved.

No one approach is likely to provide the magic response to liberalization of NTBs. It may be that a promising route is represented by the OECD's agreement on "Procedure for Notification and Consultation on Measures for Control of Substances Affecting Man or His Environment," established in May 1971. This calls for governments to report measures "likely to affect adversely and to a substantial extent the economic interest of other Member countries or international trade." ^{11/}

As William Diebold has pointed out, "If used more actively than some other complaints procedures, this one could in time provide the rudiments of a code of behavior (if not precise rules) that was accepted in practice (if not in law) and that began to establish common standards (at least among member countries)." ^{12/}

In other words, it seems likely that most issues concerning NTBs are susceptible to resolution, if at all, among a group of like-minded countries who are prepared to start by a fair system of notification and end by agreement on what can and what cannot be done. This seems specifically applicable to areas as broad and potentially

contentious as regional or industrial policies. Issues concerned with customs valuation methods and procedures, on the other hand, like import quotas, seem closer to tariffs in intent and effect, though they may be more inhibitive to trade. They are more likely to lend themselves to traditional negotiations. They, surely, constitute an area where changes in national procedures are a prerequisite to reduced international friction and distrust.

With all of the analysis already available in how to proceed in this area, it remains in this paper merely to point out that NTBs are costly in economic terms; they often cause friction and increase distrust among countries with much common interest at stake; as interdependence grows, these consequences are likely to intensify, and in the process of reducing them the US, like others involved, will have to yield on some of its practices on a well-known list of action.

Exchange Rates

At least among technicians, this is an area that has been as thoroughly explored as NTBs. At the moment, world economic conditions are sufficiently turbulent that floating rates are accepted and the points at which national authorities intervene in the exchanges -- and to what extent -- are left to discrete discussions among central bankers and, from time to time, finance ministers. Differences of view as to the appropriateness of a rate only occasionally make the headlines, but they are then sometimes harsh.

There are only a few things that need to be said about exchange rates in this paper. They are a matter of great importance, directly affecting the relative international competitiveness of an economy. They can affect a country's domestic economy significantly. Sooner or later there will need to be international agreement, -- tacit or explicit -- on what type of exchange rate system

should be expected when world economic and financial order, or something like it, is restored.

There are individual points in this debate that are important and that will only be resolved with effort and time. It would require a separate paper to deal with them fairly.

What seems clear on the exchange rate system of the future -- and which is chiefly relevant to this paper -- is this: whether the new system in principle requires fixed but promptly adjustable rates with wider bands or whether in practice it is characterized more by a system of floating rather than fixed rates, there will be stronger international surveillance over the actual rates that prevail or much bitterness will characterize a system in which individual countries act unilaterally but often counterproductively.

The comments in the introduction to this chapter about a tradeoff involved in less freedom of choice domestically and reduced friction and distrust internationally are applicable here.

Macro-economic Policies and Conditions

Conceptionally, the broad lines are drawn with reasonable clarity as to what at least major countries are likely to be called on to do concerning micro-issues and exchange rates if they are to reduce friction and maintain confidence in each other in face of growing interdependence. There are different ways of going about it and varying degrees of accommodation are possible, indeed, likely. Domestic freedom to act would be curtailed as agreements were reached and effectively enforced. We cannot know how extensive or effective such action will be. Different people will have different ideas as to how far one should try to go. But the concept of what to attempt and ways in which it might be attempted is there.

This is not so clear as concerns issues in the macro-economic area. As the macro-economic chapter attempted

to make clear, we do not yet know as much as we need to know about how to achieve our domestic aims in this area even if we lived in a one-country world. The science of forecasting the domestic economy is far from perfect; we remain unenlightened as a nation on macro-economic issues, on what is needed (and when) in order to achieve what we nationally aspire to; and our domestic institutional arrangements are too often inflexible.

These problems are multiplied many times when we consider the need to improve management of the international economy in a way that is satisfactory or deemed reasonable to all countries. Differences of great weight can arise, therefore, because a major country has misjudged its situation and thus pursued the wrong policies, because it tries to pursue the proper corrective policies but is caught up in its own institutional rigidities or because it successfully pursues policies not judged in the mutual benefit.

And since we are here dealing with impacts on employment, income and prices, for example, on a national basis caused or apparently caused, or susceptible to being so labled, by action of another country, we are dealing with matters of great potential divisiveness.

Since they are relevant and not popularly known, it might be useful to summarize how these problems are now dealt with through the OECD mechanism.

The major OECD effort to coordinate international conditions for the mutual benefit is made through the process leading to and including meetings of OECD's Economic Policy Committee (EPC), which normally meets twice annually but is often called for special meetings as occasions demand. Whether improvement in future is sought by making these particular procedures more effective or by concentrating on other procedures, possibly in other institutions, the problems will be the same.

Months before each meeting of EPC, the international secretariat of OECD begins its short-term forecast of

economic conditions, world-wide, for the OECD area in general, and for each major member country in particular. "Short-term" is the coming twelve to eighteen months. These independent forecasts are circulated to national authorities of member countries, and forecasting experts from national member capitals meet to discuss them. It is here, for example, that the forecaster that has assumed that foreign demand for the exports of his country will be strong is sometimes faced with an array of experts -- with or without secretariat concurrence -- that are convinced that demand in their countries, including demand for all imports, will, on the contrary, be weak. It is here that it may be learned that one member country is assuming -- and following policies to make it so -- that a corrective recession will be under way nationally. It is here that a collective view of the outlook for the world economy is formed.

With the benefit of these exchanges, the international secretariat then circulates to member countries a document setting forth its independent view of the international outlook and the major issues it raises in terms of policies to be followed by individual countries, notably the major member countries. These issues form the agenda for EPC discussion, generally a two day discussion attended by policy-making officials from national capitals. The US delegation, usually the strongest, has typically been headed by the Chairman of the President's Council of Economic Advisers and has included an Under Secretary of the Treasury and a Governor of the Federal Reserve Board.

It is through discussions at meetings of this sort and, of course, in the corridors and over business lunches and dinners that a common appreciation of what is likely to come and what will be done about it is reached. A conviction of specifically what should be done by all parties and a mutually consistent determination to do just that is rare. The more common result is that each member country will in the exercise of its policy options take

into account what others will be doing, toward what ends and why. These are not small accomplishments; they are not insignificant rewards.

There are, in addition, supplemental arenas. In the EPC's Working Party Three international financial aspects of the same and other issues are debated; in its Working Party Two inflationary and growth aspects are given special attention; and each country is given a full day's attention at the annual economic reviews, such as those of Germany mentioned in the chapter on macro-economic implications. All of these efforts are made against the broad analysis of the world and OECD-wide economic outlook as presented to the EPC, suitably brought up-to-date for the occasion.

Ultimate success in influencing German policy and its timing during 1965-68, as described in the chapter on macro-economic implications, might be taken as a favorable measure of how this system has worked.

In that case, the German economy did go through a costly recession. And the timing of OECD forecasting was off, so that its recommendations came late, though not as late as the published review would indicate since considerable time, no doubt, was used between arrival at the recommendations and German agreement with them and hence their publication. There is also represented here the problem of differences in priorities which countries attach, for example, between price stability, high employment and what they consider to be a healthy balance of payments.

It is safe to speculate that at the time the OECD recommendations were published and subsequently acted upon, a number of German officials saw this action as part of the cost of growing interdependence or increased international cooperation.

On the plus side of this experience with Germany, it should be noted that the German recession was surely less severe or prolonged than it otherwise would have been and

German officials took special measures, as urged through OECD, to limit the extent to which the cost of Germany's strong disinflationary program was exported to its major trading partners. While Germany's balance of payments on trade and current accounts became much stronger, with corresponding weakening elsewhere, its capital account was, as noted earlier, such that others did not have to retrench drastically their domestic economies to meet the German domestic situation. In brief, a compromise was struck.

As noted in the earlier section, there are many other examples of this kind of thing, of a degree of harmonization of economic situations to the common good, that could be given. Indeed, and again as noted earlier, international action through the OECD and elsewhere affected the timing of the US tax measures of 1968.

But this progress is decidedly insufficient even for the present extent of interdependence. What more would need to be done in this area to accommodate growing interdependence?

There would have to be substantial improvement in the coordination of policies, their thrust, their mix and their timing. The experience since 1970 is a reflection of this need. As recounted in the earlier chapter on this subject, this was a period just following an exceptional adjustment of currencies, when all major countries experienced boom conditions simultaneously, world shortages developed, exogenous factors (oil and food) were extreme, all major countries adopted disinflationary policies with the result of a broad and, in some cases, including the US, deep recession that was accompanied by price rises of exceptional magnitude.

There are two general factors in this area of what more might be needed. First, the closer coordination of policies and conditions need not be on anything like a global scale. In fact, only a handful of major countries is directly involved, essentially the US, Germany,

France, Japan, the UK and possibly Italy and Canada. Fortunately or unfortunately, the world is little affected by the monetary policy of, say, Guatemala.

The second general factor, however, is that the international economy is growing more complex and even more difficult to make responsive to government action alone. Lawrence Krause, among others, has pointed out the importance and significance in this respect of the widening of horizons of private business. He points out that, in their pursuit of domestic stabilization objectives, governments are especially bothered by international short-term capital movements, to which they are forced to react in an ex post facto manner.^{6/}

Somehow, despite these increasing complexities, governments of major countries must learn to guide their economies toward smoother growth, to limit the excesses of overheating and deep or prolonged recession so that the corrective measures need not be so strong as to court overshooting. This is an objective of each of these governments whether interdependence existed or not. But with rising interdependence, it becomes a prerequisite and, at the same time, a more difficult task.

There is little doubt but that economic forecasting will have to improve. Again, this would be a domestic requisite with or without interdependence. But, again, the very real difficulties are intensified when they are internationalized. As interdependence intensified, the outlook for the rest of the world would have to be taken more seriously into account and pooled efforts to foresee worldwide shortages, for example, would need to be increasingly effective. This would require international discussion among many countries and separate discussions among fewer and fewer countries that impact most heavily and are best informed on the world economy.

Especially among the major countries, rising interdependence would make it necessary, first, to clarify

individual goals and priorities and, then, to reconcile and, as necessary, modify them to serve compatibility. All of this would require the participation of technicians and of policy makers and the attention even of heads of governments.

The need would be greater among major countries to clarify and attempt to agree on the relative roles of fiscal and monetary policies in the international context, including the timing and conditions of their application. The use of other policies, such as those treating with domestic incomes, prices and supply, might be clarified and endorsed -- quite possibly urged -- internationally in what would be termed appropriate circumstances. All of this, of course, would have the aim of attempting to narrow the accepted limits among these countries as to how far an individual economy could supportably be allowed to get out of line (and by which policies) to an extent that threatened to spill over into the international economy.

As for the US, there can be little doubt but that fiscal policy must become a more flexible instrument, a laudable objective in any event, but one that would receive a special discipline under increasing interdependence. A more enlightened public is a prerequisite to this. As the author of this paper has noted elsewhere, there is no discernible reason why an adequate enlightenment of the public should be improbable if economists would make a determined effort in this direction. ^{2/}

An interim step toward fiscal flexibility would be for the US Congress to cede authority to the President to alter tax rates by up to ten percent as a demand management tool, with the right retained by Congress eventually to work out more permanent or less impermanent responses. This is a recommendation that is well known, similar to a procedure adopted in the UK. Its timing at the moment runs counter to trends, but it is so near to being essential that an arrangement along its lines -- or

with similar effect -- will come sooner or later.

As we moved further and further into interdependence toward an integrated economy, occasions might arise when, under pressure from others, the US (and others) would find it necessary to shift the direction of its macro-economic policies earlier than its own priorities would normally dictate, to move a bit before price or employment objectives, say, had quite been guaranteed or seen to be at hand. This would, in effect, constitute a narrowing of acceptable limits to which governments were otherwise prepared to see an economy go in striving for particular objectives. The portend of this kind of thing, as noted earlier, was the case of Germany in 1965-68.

From all of this, the major countries might gradually develop a code or codes concerning, for example, the role of fiscal, monetary and other macro-economic policies, individual priorities to be served by such policies, etc. Preliminary work in some of these areas has been done among the working parties of the OECD's Economic Policy Committee. More ambitiously, there has been some progress along these lines, very gradual and begrudging, within the EC. But the kind of code or codes required by the more loosely integrated economies here discussed would not have to be as formal or exacting as those of the EC.

Taken as a whole, these demands for reconcilable and internationally tolerable macro-economic and social objectives constitute a tall order. Considerable effort could usefully be invested in finding means to assuring that they did not impose an unjustified burden. Supporting any such efforts would be the fortunate circumstance that the major countries given special attention in this paper generally share the same such objectives, with deviations very much a matter of degree, at the margin. And one should not overlook the role that could be played by a flexible

approach to exchange rates, whether under a regime of floating or adjustable rates, a flexibility not present in Germany, for example, during the 1960 experiences noted in this paper.

Finally, there is need to say a word about rhetoric. If nations are to continue to become increasingly interdependent without crippling friction and distrust, national leaders and ministers are going to have to give up the habit of publicly alledging that other countries -- notably major economic allies - take advantage, act more shortsightedly and, in a word, continually make problems directly and try to export the costs of their own problems. It would not be peaceful coexistence we would be seeking, but common prosperity.

No doubt there are mischievous and even sinister governments around at any given time. They need to be put right and firmly so, but at least first efforts should be without public rhetoric. In the course of such more private efforts it will be found that misunderstanding, too, often prevails. An international system that ensured reasonable and visible equity through consultations would have a healthy role to play here.

It would be reassuring to think that a lowering of the rhetoric would be an objective irrespective of trends in interdependence. But if interdependence is to continue to intensify and if we are to have helpful relations with other countries, domestic public enlightenment is going to be strained. It should not have to bear the extra burden of being told that the other fellow is a thief.

Chapter V Footnotes

- 1/ Interim Report on Reform of the International Trade System (Special Advisory Panel to the Trade Committee of the Atlantic Council) p. 5
- 2/ GATT Plus - A Proposal for Trade Reform (The Atlantic Council of the United States, 1975)
- 3/ World Trade and Domestic Adjustment (The Brookings Institution, 1973) pp. 17-18
- 4/ OECD Notification Procedure for Environmental Control Measures (OECD Press Release/A (71) 10, Annex.)
- 5/ The United States and the Industrial World Praeger for the Council on Foreign Relations, 1972) p. 353
- 6/ Transnational Relations and World Politics (Harvard University Press, 1972) pp. 175 and 181
- 7/ Trends in the Application of Economic Policy (National Planning Association's Looking Ahead, September 1970)

VI. Assessment

Introduction

It was stated at the outset that the purpose of this paper is to help individual readers form clearer views as to whether growing interdependence is in the national interest, with emphasis on the policy making implications that have now been explored. The paper assumes that, given equity, goodwill and reasonable international management, foreign trade, foreign investment, international banking, etc. are good. The questions raised are the costs of more and more of them in relation to national economic activity. In the process, it is hoped that the paper has contributed a clearer understanding of the consequences of interdependence from the policy point of view.

In a way, interdependence is as Mark Twain said of the weather, that everybody talks about it but nobody does anything about it. But this is not entirely so, in either case. Deliberate international initiatives, for example, the opening of the current round of trade negotiations, are taken from time to time that can greatly affect interdependence. But do we take these initiatives with the fullness of this result in mind?

A certain degree - a rather considerable degree -- of interdependence is going to be with us irrespective of official policies and initiatives. But there are alternative responses that can affect how much interdependence will prevail. It may be useful to examine some of them.

For starters, let us set aside as not practical two extremes: a rapid move to full economic integration or a deliberate return to the restraints and economic warfare of the 1930s. The former is easier to dismiss than the latter. During the early weeks of the 1973 oil embargo not many astute bookmakers would have given better than 50-50 odds that the existing degree of international

order would withstand the pressures. The industrial world was as close to breaking ranks and engaging in cut-throat action as at any time since World War II. It is possible to believe that, in avoiding this, good statesmanship was aided by the favorable results that working together in the past had shown. There are no guarantees but that greater strains may appear and that the present system will suffer a severe setback, but not to the world of the 1930s, not if we continue to make determined efforts to avoid it. Too much is at stake. Too much has been accomplished.

Three Broad Policy Alternatives

What, then, are the most logical alternative broad policy approaches to interdependence within the bounds of what we might seek?

First, our policies could be such that we continued to drift into increasing interdependence, largely through private initiatives. We could here and there act to increase interdependence, for example, through modest trade negotiations, while championing non-discriminatory treatment as between foreign and national direct investments, opposing attempts to control short-term capital movements and taking a relaxed view of the absence of a coherent supervision of multinational corporations. We could pursue monetary reform routinely, while generally supporting progressive but slow and moderate improvements in the international institutional framework with no special initiatives or programs for changing it significantly.

A second possibility would constitute a measured and deliberate cutback in the degree of interdependence prevailing. This would best be accomplished by carefully executed international diplomacy to explain the objective and rationale. Possibilities include attempts to get some control over movements of short-term capital (for a minimum example, reinstatement of the US interest equalization tax), internationally-agreed supervision over

multinational corporations and a halt to further efforts to negotiate reduced barriers to trade with a less dedicated approach to unimpeded foreign investment; we could champion maximum freedom for exchange rates to seek their own levels, with any initiatives toward improvements in the international institutional framework tailored to the policy objective.

A variation on this second possibility would be to work toward maximum freedom in international transactions but to provide for orderly deviations by individual countries in the form of restrictions when the need for balance of payments adjustment made it imperative. This would be what Richard Cooper (see below) calls a system of controlled restraints on international transactions. The key word here is "orderly."

A third broad possibility would be to press on, with deliberate support for and accommodation to the underlying trend toward increased interdependence. Here we would work toward free trade with the minimum of NTBs, while actively supporting stronger international institutions with powers of surveillance and, gradually, arbitration. It has been a central point of this paper that interdependence is growing, not just in depth, but in breadth, touching many facets of our international economic and, through them, other relations. Such an effort of institutional support would, therefore, have to be pretty much across the board, that is, marked improvement in institutions dealing with trade, finance and domestic macro-economic policies and situations.

Of course, there are any number of combinations among these broad choices, but one must exercise care in being consistent to the extent that the effectiveness of international institutions must keep up -- roughly -- with policy choices.

One combination that commends itself is the treatment of trade proposed by the Special Advisory Panel to the Trade Committee of the Atlantic Council. Here barriers

to trade would be reduced as much as possible; the benefits would be extended more or less globally; but there would be an institutional change in which those countries prepared to do so -- presumably, at least at the outset, the advanced countries that have formed the special focus of this paper -- would accept the extent of institutional discipline necessary to give reasonable assurance of an improved and fairer system, referred to in the preceding chapter.

Encroachment on Domestic Policies

Perhaps the strongest and surely the most coherent case for caution, at the least in the need to construct prerequisites to facilitation of more interdependence, is put forward by Richard N. Cooper, first in his article in the Yale Law Journal (1967) and, then, in his book, The Economics of Interdependence: Economic Policy in the Atlantic Community (McGraw Hill, 1968).

There is no question but that the state of interdependence has outpaced our national wills to cope with it constructively and that, consequently, international friction and distrust have their moments. There is no question, either, but that our choice of action to meet domestic objectives has suffered, notably our uninhibited use of domestic monetary policy.

The greatest challenge to successful execution of a deliberate cutback of the prevailing degree of interdependence is how and in what circumstances it could be done. It could happen through growing divisiveness, through negative actions such as those that gravely threatened the present system in the early days of the energy situation.

This, surely, would be the worst of possible worlds. But to cutback constructively -- or, as a variation, to have controlled restraints to ride out payments difficulties -- would require the type -- but not necessarily the degree -- of international institutional success and inter-governmental empathy requisite to accommodation of further

interdependence. Any sensible and constructive resolution of the problem, in fact, is going to require just this. But one road may be less difficult or more in the US interests than another.

So let us have a closer look at the impact of interdependence on policies to achieve domestic objectives.

In the broad field that has here been called micropolicies the question often comes down to whether our domestic objectives are, indeed, being served by the policies that would be under increasing discipline if interdependence continued to grow. To some extent, one's view here will be influenced by one's view of market forces as the most reliable arbiter of economic costs over time. How long, to what extent and at what cost can they be ignored?

Even without unquestioned commitment to market forces one can find it hard to share great concern over loss of subsidized exports or legal commitment to countervail in the absence of clear injury, for example, as tools by which to achieve domestic objectives.

The case can be made that, if there had been strong international discipline at the time US agricultural policies were formed, better and more effective domestic policies would have been adopted in terms of the essentially long-term objectives sought. The real need was to reduce surplus labor on the farms, raise agriculture's productivity and thus increase real farm income. We chose, in part, the route of subsidies and import quotas; the world has generally followed the same path. This route might have been followed by others irrespective of US policies (though not necessarily with the same consequences for GATT), but it is very doubtful that this was a sound vehicle for the US or others. A detailed examination of this issue may be found in Gale Johnson's World Agriculture in Disarray (Macmillan 1973), for example, beginning on page 20.

In many, if not most, cases of the type here discussed

the domestic policy option under pressure from interdependence is protection against foreign competition. Government procurement regulations and certain safety standards (see Chapter II) are such examples. It is true that the elimination -- notably the abrupt elimination -- of such uneconomic practices would cause hardships within small segments of the private economy. But would it not make sense for the US, irrespective of any international discipline, to abandon such policies as inappropriate to the broader national objectives of raising real income, reducing government expenditure, etc.?

In brief, while the interplay between domestic micro-policies and our international interests is growing, this is not likely in the broader and longer view of what is in our interests to be the area where the shoe pinches.

The shoe pinches very much and is likely to do so increasingly in the area of macro-economic policies and conditions.

There is no doubt but that the effective use of domestic monetary policy (and of forecasting) has been significantly complicated by increased interdependence. Such handicaps will intensify as interdependence increases. One's view of preferred broad approaches toward interdependence is likely to be governed substantially by this challenge.

But there is no need to exaggerate the impact of interdependence on the use, for example, of monetary policy as an instrument of domestic demand management, important as it is. The single most telling experience that has been used to illustrate interdependence's weakening of monetary policy as a domestic instrument is that of Germany in 1960. This is so in part because no less an authority than the German Bundesbank observed in its annual report for 1960 (pp. 41, 42) that "In the circumstances the Bundesbank found occasion . . . to revise its credit policy, and go more by the needs of the balance-of-payments position, even though the domestic business cycle remained

in a phase of boom . . . experiences of the last year have shown clearly that one cannot keep internal activity within bounds through restrictive credit policy so long as the balance of payments . . . shows large surpluses."

The "circumstances" of Germany in 1960 were most unusual. The boom to be cooled arose rapidly and sharply, and counter-measures of monetary policy were of equal rapidity and severity. Partly in explanation of this, leading to a stubborn boom in exports and massive capital inflows despite German monetary policy, was the general conviction that the first postwar revaluation of the deutschemark was inevitable, as indeed it was, occurring in March 1961. The lessons, thus, are not uniquely that in the circumstances monetary policy could no longer be used domestically; the lessons were also in favor of a more flexible approach to exchange rate policy and avoidance of rapid starts and stops in execution of policy -- preferably a balanced application that included fiscal action. It was against repetition of precisely this latter that OECD made the recommendations summarized on page 58 above.

It is too hard to resist a note in passing that the Germans are hardly unique in having multiplied their problems by attempting to refuse an action (revaluation) that in time predictably raised living standards and acted disinflationarily, and all under the rhetoric that "It is not the healthy man who should go to the hospital;" the US resisted a healthy tax cut at roughly the same time on grounds of "fiscal integrity." There are lessons, then, also on the critical need for public enlightenment on economic issues and a skeptical approach to rhetoric and cliches.

Conclusions

Nor is there need to exaggerate the international system required to accommodate rising interdependence generally. Enough change would be required without that.

There is often an overwhelming temptation on the part of those who think seriously on these questions to design on paper the perfect system and then to stress the imperative of achieving it. This is sometimes accompanied by an isolated focus on the international framework (for example, one might as easily conclude in a treatise on domestic policy as on interdependence that greater reliance on US fiscal and less on monetary policy is necessary, although both the extent of improvement needed and perhaps the consequences of failure would be greater in the case of the latter).

It is most unlikely that in any event we shall ever see a flawless international system. It is equally unlikely that we shall ever witness flawless execution of domestic policies. Past international disruptions have reflected both these shortfalls.

Further, it is at least worth putting forward as a proposition that some friction among the leading nations in trade and finance is inevitable and can even be the spur to improvements in systems, so long as the friction operates under significant inhibitions and so long as mutual confidence prevails. Within these limits, how the friction is resolved is a more practical concern than its complete elimination from the system.

There are any number of illustrations of this in the "stop-the-clock" decisions of the EC. The history of US-Canadian relations contains a few more. So, too, might we interpret resolution of the Greer's Ferry case that so prominently involved friction between the US and the UK (see footnote 7, Chapter II and the quotation from President Eisenhower on page 70 above).

A grim illustration of the survivability of an imperfect system with high interdependence is represented by the events beginning with dollar devaluation in August 1971 and ending, at least the worst of it ended, with the Smithsonian agreement on currency alignments in December of that year. This was a rupture -- arguably deliberate --

of historic proportions. Much friction was created and there was considerable damage to mutual confidence, but the system somehow delivered.

In what circumstances, one might ask, would we have fared better during the international inflation and boom-bust economies that prevailed during 1971-75? The response must surely lie as follows: if each major country had done a better job of forecasting events and administering its own macro-economic policies and if they had jointly coordinated policies much more effectively. In this way, costs would have been reduced. If each country had taken a completely uncoordinated approach, the costs would have been far greater.

To ask if the US might have fared better during such an exceptional period if interdependence had been less intense seems, on inspection, impractical. About the only policy alternative available was for the US to cut ranks and take a "devil take the hindmost" approach toward its major economic allies. One might argue that this would have been profitable in the short run; surely, it would have been more costly in the long run than the policies actually followed.

Suppose that there had been less interdependence in 1963, when the US economy was operating at a serious level of unemployed labor and capacity and when needed stimulation was hampered by the reluctance of the Congress to reduce tax rates? Let us say that the exchange rate system was one of floating rates, that we and others were attempting more seriously to control short-term monetary movements and that foreign trade was at lower levels relative to domestic activity.

We could have used monetary policy more extensively. The dollar exchange rate would have deteriorated somewhat -- complete success in controlling short-term capital movements is not for this world -- and this would have had some inflationary impact. Followers of Milton Friedman would say that this would have worked out well. Those who believe

that fundamental imbalance within the domestic economy requires fiscal as well as monetary correction would complain that we might not have achieved what they would consider a badly needed tax reduction in 1964.

If we are to have growing interdependence, it is the inhibitions and mutual confidence referred to earlier that are essential in avoiding damaging international friction among the advanced countries that will continue to form the positive foundation of our foreign policy. These will be achieved in face of growing interdependence only by substantial improvement in international institutions, involving (to use Cooper's words) a shift from international cooperation in to international coordination of domestic policies. And, of course, the execution of domestic policies will have to be improved in any case -- substantially improved.

If this were to be done, a cohesive, deliberated but forceful initiative would be required internationally. The time to start -- or to take the first planned steps -- would be now. In this context the qualifications above about the probable permanence of an imperfect system are meant to foster realistic expectations, not to detract from the need for such an initiative.

Where one comes down -- whether one feels that this kind of game is worth the candle, or is practical -- to a large extent depends on whether one believes that a political will can be developed domestically and internationally and on how one views the alternatives.