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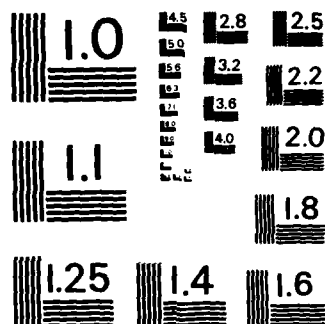
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ESSAYS ON ECONOMIC POLICY AND FOREIGN POLICY

Charles Wolf, Jr.

March 1985

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Charles Wolf, Jr.

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PREFACE

All but one of the nineteen essays in these pages were previously published as "op-ed" articles--sometimes in a slightly abbreviated form--in *The Wall Street Journal*, *The Los Angeles Times*, *The New York Times*, *The Washington Post*, and *Newsweek*, during the three years between November 1981 and November 1984. I have collected them here to make them more accessible. I also hope that the collection will make the individual pieces more interesting by suggesting relationships among them.

The essays are grouped into two sections dealing, respectively, with economic policy (Section I), and with foreign policy (Section II). Sometimes this division is arbitrary: for example, the discussion of international debt (which is in Section I) bears on foreign policy, and the discussion of Western lending to the Soviet Union (which is in Section II) bears on economic policy.

The single essay that was not previously published ("Another Look Through the Pipeline") deals with the Soviet Union's gas pipeline to Western Europe. The reason it wasn't previously published was that, by the time I'd finished writing it in November 1982, the editors to whom I sent it thought the issue was "old hat." I'm including it here both because it is of the same genre as the other essays, and also because the issue with which it deals, while it may have seemed dead at the end of 1982, is actually quite alive, although not well, in 1985.

Charles Wolf, Jr.

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I. ECONOMIC POLICY

1. Why Economists Disagree*

Economists and economics have never been as visible, audible and publicized as they are now. Nor have the disagreements and divergent forecasts within the profession ever been as rife.

One consequence of this babble of prophesy is that the repute of economics and its practitioners has fallen to one of its lowest points in the 200 years since publication of the *Wealth of Nations*. The reason is simply that the testimony of professional economists is offered on almost any side of each major economic policy issue.

Is the Reagan tax program inflationary? "Yes," says Walter Heller. "No," says Milton Friedman. "Not necessarily," says Murray Weidenbaum. How do high interest rates relate to inflation? "They contribute to it" (through indexing and cost of living adjustments), says economist X. "They're caused by it," says economist Y. "They result from efforts to control it" (through tighter monetary policy), says economist Z.

How will interest rates behave in the next year? Why has the dollar appreciated 30 percent against some European currencies in the past year? Will lower marginal tax rates raise or reduce revenue?

On these and other key issues, the opinions of economists are spread as widely as forecasts of next month's weather.

As economists can be found on any side of these questions, the public has come to suspect that they are available as "hired guns"-- whoever has a particular interest in espousing some economic policy can find some reputable economist to endorse it. It is one thing for lawyers to have such a reputation, for lawyers are trained to be advocates: experts in organizing the best possible case for either side of an issue.

The analogy is admittedly imperfect. In general, *any* reputable lawyer can be found to defend almost any legally tenable position. The situation for economists is a bit different: it seems there's always *some* economist willing to back any side of most economic policy issues.

*A slightly abbreviated version of this essay was published by *Newsweek* on November 2, 1981.

But economists are supposed to be scientists: schooled in seeking, testing and finding "truth," and in acknowledging error when they encounter it. Even if their science is "dismal," it's still supposed to be science.

Why then are their disagreements so sharp? There are four reasons:

1. Economists use different benchmarks (often not spelling them out). When Brookings' economist George Perry asserts that Ronald Reagan's tax plan is inflationary, he is taking as his benchmark the Reagan expenditure budget already enacted by Congress. (The tax reductions are inflationary *given* that budget.) When Friedman and others rebut Perry, they're comparing Reagan's *package* of lower budget and lower taxes with the higher budget and higher taxes of Jimmy Carter's original program for fiscal year 1982--a different benchmark. (A deficit of specified size will have a smaller inflationary impact at a lower level of total government spending: the Reagan budget for 1982 involves a lower spending level than the Carter budget it replaced.)

2. Economists often make different assumptions about the time period to which their conclusions apply. When Yale economist James Tobin asserts that lower tax rates will increase consumer spending, and macroeconomist Michael Evans contends instead that they will stimulate investment, each has a different period in mind: Tobin's is short-run, Evans' longer-run.

3. Economists are usually reluctant to acknowledge the full extent of their ignorance. One of the great economists of an earlier age, Frank Knight, made a distinction between "risk" (knowing the odds), and "uncertainty" (not even knowing enough to calculate them). Ignorance is another name for this kind of uncertainty. And the plain fact is that economists share a degree of ignorance whose extent they are understandably loath to admit.

We are on relatively solid ground in the domain of "microeconomics"-- determination of prices in competitive or monopolistic markets, predicting the effects of minimum wages on employment, and so on. Our ignorance is formidable in the domain of macroeconomics: the interactions among monetary policy, tax policy, government spending and government regulations in determining aggregate

employment, investment and inflation, for all these effects depend on expectations: what is expected to occur will affect what does occur. If prices are expected to rise, consumer spending will tend to aggravate the rise, and vice versa.

But the embarrassing truth is that we just don't know how expectations are determined: whether they're "adaptive," based on recent experience; or "rational," based not only on experience but also on estimates of how this experience will be altered as a result of "expected" government action or inaction, and other "relevant" factors.

4. Finally, economists have differing values. Just as there are deep ethical divisions among physicists and engineers over the development of new weapons systems, economists sometimes (often?) disagree on economic policies for reasons of pure (or impure) ideological preference. (Of course, to the extent that ignorance prevails, the room that's left for judgements based only on preferences is thereby enlarged.)

When John Galbraith decries cuts in minimum social security benefits or in student loans, he's probably motivated about equally by a distaste for the market's solutions (or a disbelief in their adequacy) and a predilection for government action to remedy them. When Friedman argues in favor of these cuts in government programs, his convictions are no doubt equally strong in the opposite direction: enthusiasm for the market's solutions, and distaste for the failures of meddling government.

Moreover, these normative differences are no less real than those that lead Edward Teller to argue strongly for ballistic missile defense and Herbert York to argue with equal vehemence against it.

Recently, I had occasion to consult consecutively three orthopedic surgeons about a ligament injury: one recommended immediate surgery; the second suggested a cast for six weeks, and then surgery, *maybe*; the third proposed a rest and rehabilitation.

Perhaps economics doesn't look so bad if it's compared with medicine. Whether this should be viewed as ground for solace or grief is another question.

2. *The Liberal-Conservative Switch**

In case you haven't noticed, fully accredited "liberals" are now advocating policies and programs formerly espoused by equally-anointed "conservatives," while conservatives have adopted positions formerly assumed by liberals. The switch has been confined to only a few specific issues--budget deficits, trade deficits, and protectionism. However, their importance and timeliness--when considered along with other confusing uses of the liberal-conservative labels--make this familiar terminology a semantic and political travesty. The term "liberal" is now about as appropriately applied to the conservative "right" as to the liberal "left."

Consider, for example, the issue that is the centerpiece of much recent liberal political rhetoric: namely, budget deficits. Citing a forecast by the Congressional Budget Office that federal deficits would rise from \$178 billion in 1985 to \$263 billion by 1989, Mr. Mondale characterized such deficits as "obscene." He concluded that drastic reductions in these deficits are the most compelling economic issue facing the country.

While the "conservative" Republican stance on this issue varies from more or less "centrist" Republicans to so-called "radical" ones, there is a common element to this diversity. The conservatives--whether relatively concerned about budget deficits (like Senator Dole), or relatively indifferent to them (like Congressman Kemp)--typically evince a much more relaxed attitude toward the deficits than do "liberals." For most liberals, eliminating budget deficits is the number 1 economic issue facing the country. For most conservatives, deficits, although not unimportant, rank well behind such issues as avoiding tax increases, curtailing the growth of government spending, and maintaining price stability.

*A slightly abbreviated version of this essay was published under the title "Economic Labels--The Switch is On" by *The Los Angeles Times*, on November 16, 1984.

The contrast is striking when one recalls that, not long ago, the positions were exactly reversed. Then, conservatives viewed the federal deficit as a threat to the free enterprise system and a sign of the profligate expansion of government. Liberals, on the other hand, were either mildly or highly enthusiastic about deficits, rarely regarding them as a worry, and then only one of secondary or tertiary importance behind other, more compelling issues such as unemployment, and the desirability of increasing government spending for both domestic and foreign policy purposes. Indeed, the New Deal, the Fair Deal, and the Great Society--which provide the philosophical underpinnings of the "liberal" approach to government--were predicated on the acceptability, if not desirability, of sustained budget deficits.

Criticism of U.S. trade deficits by "liberals" has been only slightly less vehement than that of budget deficits. Because liberals typically view the trade deficit as representing an export of jobs abroad and a loss of jobs at home, they have become strong advocates for protection of the U.S. market against "excessive" or "unfair" foreign competition.

It is true that the conservatives' recent record on free trade has been mixed: for example, the Administration rejected import quotas for copper, but accepted higher tariffs on Japanese motorcycles. Nevertheless, as between the two groups, liberal Democrats are now more staunchly protectionist than conservative Republicans. For example, Mr. Mondale has advocated rigid quotas to reduce imported steel from its present 25 percent share of the U.S. market to no more than 17 percent. By contrast, the Administration has opposed steel quotas, and instead has favored voluntary "restraint" by exporters to limit their share of the U.S. market to no more than 25 percent.

In sum, "conservatives,"--whose lineage traces back to the notoriously protective Smoot-Hawley Tariff Act of 1929--now urge relatively "liberal" trade policies while "liberals"--whose lineage traces back to GATT and to generalized reductions in international trade barriers--now advocate relatively severe forms of protection.

A similar switch in the meaning of the liberal-conservative labels arises in another context: namely, in discussions of economic reforms in foreign countries. For example, the Central Committee of the Chinese Communist party recently approved an extraordinary economic plan endorsing free market incentives, flexible prices, income and wage differentials based on productivity, and the ending of subsidies for more than a million state enterprises. According to *The Wall Street Journal*, a diplomat from one socialist-led government of Western Europe characterized this remarkable plan as "much more liberal (sic) than I had expected."

Use of the term "liberal" to describe such reforms in China, as well as their counterpart and antecedent in Hungary's "market socialism," is now a generally accepted practice. "Liberalization" is also a familiar way of characterizing similar measures favored by the socialist government of France, and by the relatively few successful developing countries (such as Korea, Taiwan, Malaysia, Hong Kong, and Singapore) which have long since adopted such policies.

The common core of such liberalizing reforms lies, of course, in the relative emphasis they accord to reliance on the free market rather than on government in the allocation of economic resources. This use of the term "liberal" derives from the fact that all of these reforms can be traced to the common intellectual legacy of so-called "liberal" or neo-classical economics. But this is the same legacy that constitutes the core of the Reagan Administration's "conservative" economic policies: namely, reduced government intervention in the free market, strengthened incentives for private investment, work and saving, and greater reliance on competition.

There is an oxymoronic quality to all of this: what is "liberal" in China and Hungary, or even in France and the developing countries, is "conservative" in the United States! Once again, we encounter the liberal-conservative switch, and once again the semantic travesty of the standard labels.

Discussion in the media and elsewhere would be much clearer if it referred simply to the relative reliance to be placed on markets or on governments, and consigned the overused "liberal" and "conservative" labels to the shelf for a long rest period.

3. What's Good About the Trade Deficit?*

Many economists and economic scribes have arrived at a surprising degree of consensus about a particular paradigm to describe the current problems of the U.S. economy. The consensus is surprising because the paradigm itself is seriously flawed.

The paradigm consists of four propositions: first, government deficits are responsible for high interest rates; second, high interest rates are responsible for the "overvalued" dollar; third, the overvalued dollar is responsible for the huge increase in the U.S. trade deficit; and, finally, the trade deficit is just plain bad.

The validity of the propositions is limited and decreases as one moves down the list.

Consider the first proposition. As Secretary Regan keeps reminding us, empirical analysis shows no statistically significant historical relationship between budget deficits and interest rates. Over the past three years, while the deficit has more than tripled, the prime rate of interest has fallen from 18.9 percent to 11 percent. Adjusting interest rates for inflation to approximate the "real" rate of interest doesn't change the picture very much: during the same period the real rate fell from 10 percent to 7 percent, notwithstanding the tripled deficit.

Nevertheless, there is common sense validity to the notion that larger government borrowing will, other things being equal, exert upward pressure on interest rates. (However, one point that's usually neglected by those who advance this argument is that efforts to reduce the deficit by increasing taxes may also exert upward pressure on interest rates because increased taxes will result in decreased private savings, rather than simply in reduced private spending.)

Next, consider the proposition about high interest rates as the principal explanation for appreciation of the dollar. Since 1981, the dollar's exchange value has risen by about 23 percent relative to a trade-weighted average of other currencies. Doubtless high U.S.

*A slightly abbreviated version of this essay was published under the title "Reigning Wisdom's Shaky Economic Ground" by *The Wall Street Journal* on March 14, 1984.

interest rates relative to those prevailing abroad are partly responsible for the preference of holders of foreign assets to exchange them for dollars. But it is equally certain that high interest rates are only one among several explanations. Other contributory factors include: (1) the relative attractiveness of equity investment and direct investment in U.S. businesses whose sales, profits and market values have been expected by foreign investors to rise with continued progress of the American recovery; (2) the relatively lower prices of real property even in such premium U.S. markets as New York and Los Angeles compared with Paris, London, and Tokyo; (3) the demand by foreign debtor countries for dollars to help service their huge dollar debts, thereby resulting in a move by these countries from non-dollar to dollar assets; and (4) the relative immunity from political risk of assets held in the U.S. compared with holdings in other countries.

These four factors, together with high U.S. interest rates, have contributed to appreciation of the dollar by increasing the demand for dollar assets among holders of foreign assets. The dollar is, in this respect, just like a commodity: when demand for it rises, its "price" will increase in terms of other currencies. So the effect of these several influences has been to raise the dollar's price. How the five factors rate in terms of their relative influence on the exchange rate of the dollar is not a matter of knowledge, but of conjecture sometimes slanted by the commentator's political partisanship. Moreover, their relative strength has surely varied substantially at different times during the past two or three years. It is thus remarkable how frequently the dollar's appreciation is attributed to high interest rates alone.

What about the third link in the reasoning chain: namely, that the appreciation or "overvaluation" of the dollar is primarily responsible for the large and growing U.S. trade deficit? In 1983, the U.S. trade deficit rose to \$70 billion compared with \$43 billion in 1982--an increase of 60 percent in current prices. According to the standard paradigm, appreciation of the dollar is the cause of the increased deficit. Why? Because overvaluation of the dollar, like a tax on exports, raises the prices charged in foreign currencies for U.S. exports, thereby tending to reduce these exports. Also, so the argument

goes, overvaluation acts like a subsidy on U.S. imports because it enables foreign exporters to charge lower dollar prices and still make a profit on costs they have incurred in their own domestic currencies.

Once again, the argument has partial, but limited, validity. The principal explanation for the increased U.S. trade deficit is the rapid pace of the U.S. economic recovery which resulted in a rate of real growth in U.S. gross national product over 6 percent in 1983--more than twice the rate in most of the other OECD countries. This, rather than the dollar's appreciation, is the main reason for the 6 percent increase in U.S. imports, from \$254 billion in 1982 to \$269 billion in 1983, because the responsiveness of U.S. imports to increases in our national income is greater than the responsiveness of imports to lowered prices. (In economists' jargon, the income elasticity of demand for imports is greater than their price elasticity.)

The rapid rate of economic growth in the U.S. also has contributed to the reduction of U.S. exports of about 5 percent, from \$212 billion in 1982 to \$200 billion in 1983. When domestic demand grows rapidly, and production capacity is strained in the short-run, producers typically tend to satisfy domestic demand rather than potential foreign demand. As a result, exports suffer.

Still another major factor accounting for the reduction of U.S. exports in 1983 was the sharp decrease in U.S. bank lending to developing countries, especially in Latin America. Such lending, even when not strictly "tied" to U.S. exports, usually facilitates and encourages U.S. exports to the borrowing countries. Diminished U.S. lending accounts to a very considerable extent for the shift during the past two years in the U.S. trade balance with Latin America's eight largest debtor countries from a \$5.8 billion surplus to a \$14.5 billion deficit--a swing of over \$20 billion. This alone explains almost two-thirds of the total increase in the U.S. trade deficit in that period.

Thus, multiple factors besides appreciation of the dollar have contributed significantly to the large U.S. trade deficit.

Finally, how bad is the current and pending U.S. trade deficit? The answer is that there are both positive and negative entries on the ledger.

On the negative side, the trade deficit means reduced employment in the U.S. export sector. Yet even this does not warrant the glib generalizations and loose estimates that have been made about "lost" jobs resulting from the trade deficit. Such estimates overlook the fact that foreign capital inflow which, on the one hand, contributes to the trade deficit by raising the exchange value of the dollar, results, on the other hand, in creating jobs for U.S. workers in manufacturing, housing, and capital goods industries, as well. Whether such capital inflow takes the form of acquiring corporate bonds or equities, or direct investment, or government bonds, it contributes to financing business plant and equipment, construction, or consumer or government spending. Jobs lost in the export sector are thus counterbalanced by jobs gained in other sectors. And there is no particular reason to believe that the "labor intensiveness" of the export sector (reckoned in jobs per dollar of exports) is any greater than the labor intensiveness of the sectors benefiting from foreign capital inflows. The "jobs lost" argument is partly valid, but largely exaggeration.

On the positive side of the ledger, increased exports from the European countries to the United States are a stimulus to their recovery. In effect, the U.S. trade deficit acts as a transmitter of the U.S. recovery abroad. And Europe's recovery is of benefit to the world economy, and surely to the foundations of the Western alliance.

Moreover, a U.S. trade deficit with either or both Europe and the principal debtor countries of Latin America, is virtually essential if these countries are to earn the dollar surpluses necessary for servicing and at least partially repaying their huge dollar debts. Hence, the U.S. trade deficit mitigates, rather than complicates, the world's current financial predicament.

Finally, the trade deficit in itself helps to ease inflationary pressures in the economy (whereas a trade surplus adds to them), and higher imports themselves reflect consumer preferences and contribute to consumer well being.

There is thus more to be said in favor of the trade deficit than against it.

In sum, the familiar economic paradigm is no stronger than the weakest of its four linked propositions. And all of them are vulnerable.

4. *The Huddle Over High Interest Rates and the Overvalued Dollar**

According to an argument prematurely accepted as valid in much of Western Europe, as well as in various political, financial, and media circles in the United States, high U.S. interest rates and the overvalued dollar, which they ostensibly cause, are preventing economic recovery in Europe and threatening to abort it in the United States. The near unanimity with which certain influential commentators on both sides of the Atlantic have adopted this position should alert us to the possibility that it may be flawed. Well, it is!

The argument involves several parts. First, it is said, high U.S. interest rates draw capital from Europe and elsewhere into the United States. (The high rates themselves are usually attributed to large U.S. budgetary deficits, although there is some disagreement on this point. Other explanations include the overly tight (or, alternatively, fitfully loose) monetary policy of Mr. Volcker, and the distorting effects of a U.S. tax structure which converts nominal interest rates of 12 or 13 percent into after-tax, inflation-adjusted rates of only 3 or 4 percent).

Second, it is argued, the attraction of foreign capital to the U.S. depletes the supply of savings and financing available for European investment. The resulting upward pressure on European interest rates suppresses nascent recovery there before it can gather momentum.

Third, the inflow of foreign capital to the U.S. allegedly boosts the exchange value of the dollar above what is warranted by the dollar's purchasing power. The result, so the argument goes, is that U.S. exports are less able to compete in foreign markets, and foreign imports acquire a competitive advantage in the U.S. market. For both reasons, unemployment in the U.S. stays high and may rise again, and recovery here will be set back.

*A slightly abbreviated version of this essay was published under the title "The Muscular Dollar" by *The New York Times* on November 8, 1983.

So goes the argument. What about its flaws?

One flaw lies in ascribing to high U.S. interest rates the exclusive, or at least predominant, responsibility for the dollar's high exchange value, rather than recognizing that they are only one among several causes, and probably not the most important one. The second flaw is failing to recognize that a strong dollar has multiple effects, some of which stimulate recovery abroad, even while others may damp at home.

In a generally free foreign exchange market, such as we currently have, exchange parities depend on the relative demands for and supplies of the various currencies. That the dollar has appreciated in the past eighteen months relative to the principal European currencies by 16-40 percent (the lower figure relates to the German mark, the upper one to the French franc, while the pound and lire are in between), simply means that the demand for dollars by holders of foreign currencies has increased relative to the available dollar supply. Just as the price of a vintage wine rises if consumer demand for it increases, so the "price" of dollars will rise if demand for dollars increases among holders of foreign currencies.

What accounts for this increased demand for dollars? There are many contributing causes. First, foreign demand for dollars has risen because foreign asset holders want to buy U.S. equities in the belief that stock prices will increase as progress of the American recovery brings with it higher sales and profits for U.S. businesses. The sharp rise of over 55 percent in the past year in the New York Stock Exchange index has amply justified this belief.

Second, demand for dollars has risen because of the desire by foreign asset holders to buy real property in the U.S. Notwithstanding the appreciated dollar, real estate prices in the U.S.--even in such premium markets as New York, Los Angeles, and their environs--are still lower than in London, Paris and Tokyo.

Third, demand for dollars has increased because holders of foreign assets believe--justifiably, it would seem--that control of inflation in the U.S. is, and is likely to be, more effective than abroad. Acquiring dollar assets provides protection against this financial risk.

Finally, dollar demand has strengthened because of the relative immunity from political risk enjoyed by dollar assets compared with non-dollar assets. Nationalization of businesses and banks by a Socialist government in France, electoral gains in the West German Bundestag by the frenetic "Greens," and the choice by the British Labor Party of a leader who is apparently anti-NATO, anti-defense, and anti-U.S., makes holders of assets in those countries understandably anxious to relinquish the assets they have in exchange for the dollars they covet.

Estimating how much weight should be assigned to each of the five sources (the four above plus high interest rates) in explaining the dollar's appreciation has not been attempted, and would be extremely difficult. Assigning equal weight to the five is not less foolish, though perhaps less disingenuous, than assigning all of the weight to high interest rates alone. Between 1980 and 1982, officially-reported foreign holdings of dollar assets in the U.S. increased by 60 percent, from \$54.9 billion to \$87.9 billion. No doubt all five reasons for the dollar's appreciation have influenced these acquisitions.

Simply put, the dollar's exchange value has risen relative to other currencies because it has become more valuable in terms of the various "values" or aims that asset holders seek. So, the first flaw in the original argument amounts to a truism: the dollar's value has increased because it has become more valuable to people who formerly held non-dollar assets. The dollar is no more "overvalued" now because it exchanges for 8 French francs than it was eighteen months ago when it exchanged for 5.75.

The second flaw derives from the fact that a strong dollar has positive, growth-promoting effects, as well as negative, growth-restraining ones. From the standpoint of Western Europe, the stronger dollar represents capital outflow, hence a reduction of funds for domestic investment, and upward pressure on European interest rates. Yet, at the same time, the strong dollar also improves the competitive position of European exports compared with U.S. exports, both in world markets and in the American market, thereby boosting European employment and production, and strengthening incentives for European investment.

From the U.S. standpoint, the strong dollar impairs the competitive position of U.S. exporters, as well as intensifying import competition in the U.S. market. Yet, at the same time, the strong dollar also improves prospects for servicing the enormous international dollar debt of the precariously-situated third-world debtors (Brazil, Mexico and Argentina), the more robust but still acutely export-dependent ones (Korea and Taiwan), and at least one major debtor among the developed countries (France). Inasmuch as the international debt predicament is itself a serious threat to economic recovery, and to the solvency of the principal American banks, the stimulus to dollar-earning exports that is provided by a strong dollar is a boon, rather than a bane to the U.S. recovery itself.

In sum, the "high-interest-rate-strong-dollar" chorus should change its plaintive tune. The strength of the dollar isn't primarily due to high interest rates, and a strong dollar has as much good as bad to be said for it.

5. *Public Deficits and Private Savings**

Public budget deficits are too high and should be reduced. Private savings are too low and should be increased. The presidential candidates and the party platforms agree on the first proposition; their disagreement relates only to the means to be used and the urgency of using them. Where the candidates stand on the second proposition can only be surmised because, while devoting ample if not excessive verbiage to the first proposition, they have scarcely addressed the second.

This omission is noteworthy because the two issues are related and, as between them, the savings issue is more important. The two issues are related because private savings provide a cushion for public deficits: the private sector is obliged to spend less than its after-tax earnings to enable the public sector to spend more than its tax receipts.

Yet the savings issue is more important than the deficit issue in three fundamental respects. First, if private savings were higher, deficits would be less troublesome--perhaps they would even be tolerable--and interest rates would be lower. (Moreover, the size of the deficit would be reduced because each percentage point reduction in interest rates that would result from higher savings would lower by about \$12 billion the annual budget costs of carrying the nation's \$1.5 trillion debt). Second, if deficits are reduced not by lowering government spending, but instead by taxes whose effect is to decrease private savings, the economy's predicament may be as bad with the lower deficit as it was with the higher one.

Finally, if U.S. savings rates continue to be as low as they've been, let alone declining further, the American economy will have serious downstream problems of sustaining investment, productivity growth, innovation, and international competitiveness, *regardless of what happens to the deficit.*

*A slightly abbreviated version of this essay was published under the title "Our Problem Isn't So Much Borrowing," by *The Wall Street Journal* on September 28, 1984.

Thus, the savings rate is a serious problem quite apart from the budget deficit, whereas the deficit is a more or less serious problem depending on whether the savings rate is, respectively, low or high.

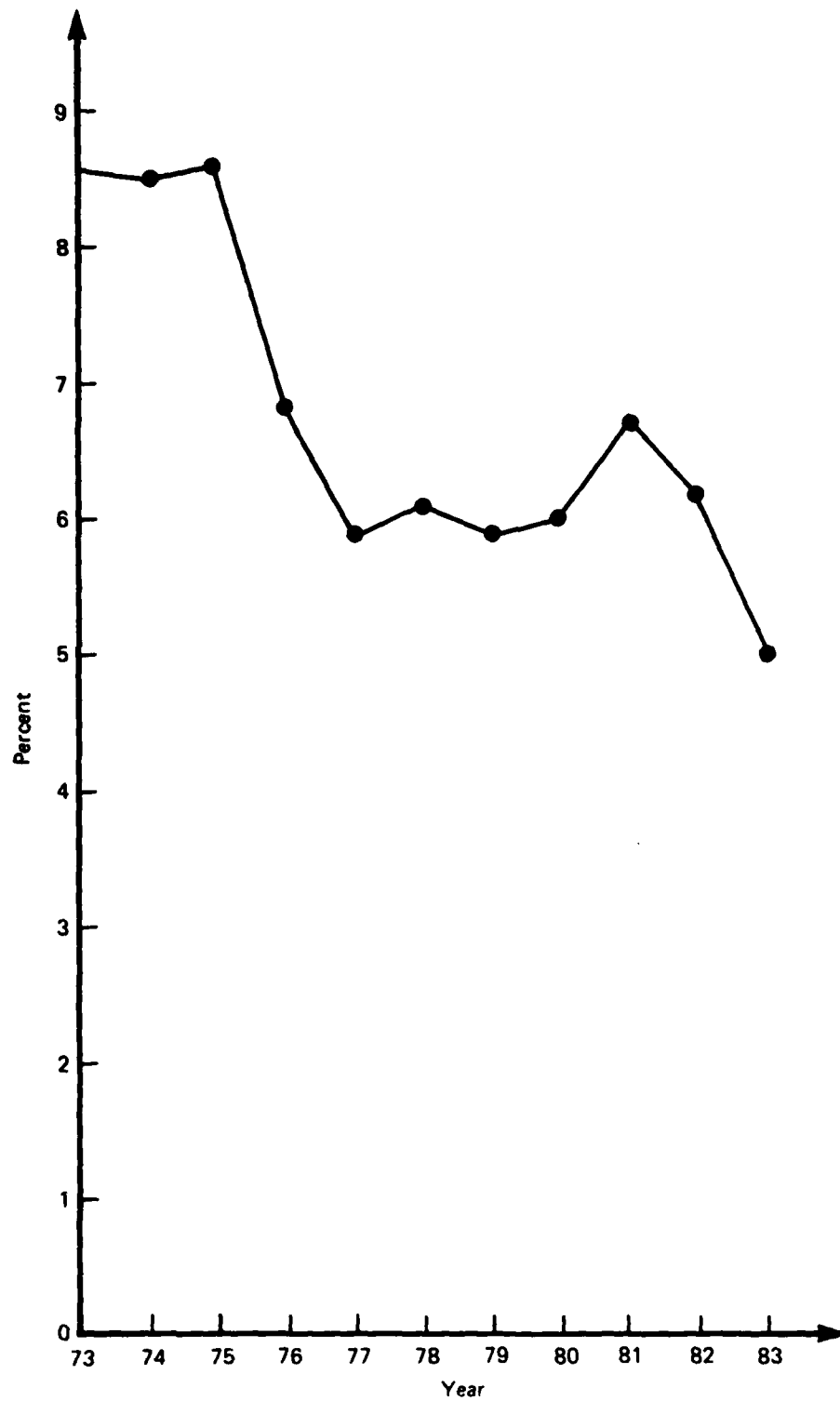
Since 1970, U.S. gross private saving (which includes personal saving, undistributed corporate profits, and capital consumption allowances) has varied between 16 percent and 18 percent of GNP; probably the actual variation has been greater than the estimate. Lest even this 2 percent variation be dismissed as insignificant, it should be noted that, at current GNP levels, it represents over \$70 billion. This is more than 40 percent of the fiscal year 1984 federal budget deficit of \$170 billion, and 60 percent of the total public sector deficit of \$120 billion which results from consolidating the federal deficit with the \$50 billion surplus of the state budgets.

Apart from its limited, though not negligible, variability, the U.S. gross savings rate is appreciably lower than that of certain other major industrial countries (Japan's rate is 27 percent and Germany's is 21 percent), although comparable to that of others (the savings rate in the United Kingdom and Sweden is 16 percent).

Personal saving in the U.S.--which is typically between a quarter and a third of gross private saving--has shown a sharper and more puzzling variation than the gross rate, declining from 8.6 percent of disposable personal income in 1973 to only 5 percent by 1983. The fluctuating but generally downward trend in the intervening years is shown in the chart on the next page. As the chart indicates, the U.S. personal saving rate declined by 28 percent in the years between 1981 and 1983 (from 6.9 percent to 5 percent).

The 10-year decline in the U.S. savings rate is all the more extraordinary because it occurred during a period when real per capita disposable personal income rose by 15 percent! Richer individuals and families usually save more than poorer ones, so increased per capita income would generally be expected to lead to higher, rather than lower, savings rates.

Neither demand-side (Keynesian) nor supply-side economics provides a satisfactory explanation for the puzzling pattern of U.S. savings. Keynesian economics has usually assumed that aggregate savings rates are



SOURCE: U.S. Department of Commerce.

Fig. 1 — Personal saving as percent of personal disposable income

fixed, when in fact they vary. Moreover, the recent decline in personal savings rates is especially awkward for Keynesians who have generally viewed higher real personal income levels as conducive to *higher* savings rates rather than the lower ones that have actually ensued.

Nor does supply-side economics solve the puzzle. Reducing taxes on income and on capital gains, and providing increased tax shelters for retirement accounts, were supposed by supply-siders to strengthen incentives to save. Yet the Administration has provided these inducements and, *mirabile dictu*, personal savings rates have declined!

Perhaps the passage of time is part of the explanation: the tax changes may have to be in effect for a longer period if people are to adjust their behavior accordingly. Moreover, the structure of taxes, as well as their rates, still provides a disincentive to save. When interest income that's received from savings is subject to tax, while interest payments to meet borrowing costs are tax deductible, the result is an incentive to borrow and spend rather than to save and lend. (It's worth noting that in Japan, interest income on savings deposits is tax exempt.)

Inflationary expectations are yet another important, if elusive, factor affecting savings: if people expect prices to be higher in the future, they'll be disinclined to save. Although there has been a dramatic abatement of inflation in the past three years, skepticism about its permanence has probably not yet been dispelled. Disbelief that price stability will be maintained perhaps accounts for a disposition to spend while prices are relatively attractive, rather than to save for a future when dollars may be worth substantially less.

Although the determinants of savings rates--why they rise and fall, and why they're much higher in some economies than in others--are at best imperfectly understood, the subject deserves more analysis, discussion and debate than it has received. Instead of repeating the familiar, and almost ritualized, arguments about budget deficits and how they can be reduced, it would be a step forward if the presidential candidates were to address the even more important issue of private savings and how they can be increased.

6. *Those Puzzling Interest Rates**

Why are interest rates so high? The question has dominated economic discussion in recent months, resulting in a remarkable consensus: Everyone agrees that no one knows the answer!

On theoretical empirical grounds, interest rates "should" (and normally do) equal the rate of inflation plus the real rate of return on capital. But current figures are way out of line. Inflation is now running below 8 percent. And historically the return on capital runs about 3 percent or 4 percent. Add them together and interest rates "should" be 11 to 12 percent. But prevailing rates are now about 16 percent.

That leaves a lot to be explained--4 percent to 5 percent, or between a quarter and a third of the current interest rate. So what explains the excessive cost of borrowing money these days?

It seems clear that there isn't a single explanation for high interest rates, but many contributory ones: inflationary expectations; the large government deficits, and the government's borrowing to finance them; uncertainties about Federal Reserve policies, including both worries that these policies will remain restrictive and fears that they won't.

While all of these play a part, another important explanation is generally overlooked: the tax deductibility of interest payments. Its special importance can be grasped by slightly reformulating the original question. The result will suggest both an answer to the question, and a way of reducing pressure on credit markets, thereby easing interest rates.

Interest rates--the price of credit--are determined by the interaction between lenders and borrowers, just as commodity prices are determined by the interaction between sellers and buyers. That lenders are willing to lend at prevailing high rates is not puzzling: the reason is quite simply that "the price is right." The problem lies in explaining the behavior of borrowers.

*A slightly abbreviated version of this essay was published under the title "Take the Tax Deduction Out of Borrowing and Interest Rates Will Fall" by *The Los Angeles Times* on June 27, 1982.

Therefore, rather than asking, "Why are interest rates so high?", ask instead, "Why are borrowers willing to pay such high rates?", or alternatively, "How can they afford to do so?"

Of course, borrowers come in many shapes and sizes, but they can generally be divided into three categories: government, business, and households.

Among the three categories, the government's willingness and ability to pay high interest rates is easiest to explain: Once spending and tax legislation have been enacted, the amount of government borrowing is mandated by law. Government will borrow this amount, regardless of the rate it has to pay.

For business to be willing to borrow, its expected real rate of return on borrowed money must at least equal the difference between the cost of borrowing and the rate of inflation. For example, if interest rates are 16 percent and inflation is 7 percent or 8 percent, the real rate of return expected by businesses must be at least 8 percent or 9 percent. Otherwise, borrowing will simply add more to costs than revenues, thereby reducing earnings.

Under current economic conditions, few businesses can meet this condition.

For households, the situation is different. Households borrow largely for consumption, not for investment. Most household borrowing is devoted to purchases of durable consumers' goods--cars, appliances, recreational gear, and housing. These purchases yield services over a long period, but they are consumption, not production services.

For households to be willing to borrow, the benefits of doing so must exceed the costs. Inflation automatically provides some benefit because borrowing makes it possible for households to buy at currently lower prices rather than the higher ones expected to prevail later.

Further benefits from borrowing arise from what economists call "pure time preference" (or just plain "eagerness"): even with stable prices earlier consumption is generally preferred to later, and borrowing permits earlier consumption.

The household's cost of borrowing has a special twist to it because interest payments can be deducted from taxable income. Hence, the household's cost of borrowing is not the market rate of interest, but rather that rate adjusted for the deductibility of interest payments from taxable income.

If, for example, a particular household's income is subject to a marginal tax rate (federal plus state) of 40 percent, and the prevailing rate of interest is 16 percent, the household's net cost of borrowing works out to only 9.6 percent. (40 percent of the interest payments would otherwise have been drained away as taxes, so this interest expense really costs the household nothing.) Tax deductibility of interest payments thus makes the household's net cost of borrowing much less than the market interest rate.

So, if the rate of inflation is 8 percent, and the household is willing to pay a premium as low as 1.7 percent to be able to consume sooner (by borrowing), it will go ahead and borrow when interest rates are 16 percent because the benefit from borrowing (8 percent plus 1.7 percent) exceeds its effective cost (9.6 percent). Of course, for households with higher incomes and higher marginal tax rates, the net costs of borrowing are lower still.

The answer to the earlier question is now clear: among borrowers willing to pay the prevailing high interest rates, consumer borrowers are prominent because they are able to avoid a substantial fraction of the nominal interest charge. Quantitatively, consumers loom large in the credit market: total consumer borrowing, including residential mortgage borrowing, in 1981 was over \$500 billion, more than three times greater than borrowing by non-farm business. While most new consumer borrowing replaces prior consumer debt that is repaid, a shrinking of total "float" would appreciably ease the pressure of credit demand on aggregate credit supply.

This account also suggests how interest rates might be lowered: by capping the tax deductibility of household interest payments. The result would likely be a considerable reduction in credit demands by consumers, and lower interest rates.

Moreover, since higher income groups derive relatively greater benefits from the tax deductibility of interest payments, reducing the deductibility allowance by, say, a third or a half, would impinge more on these groups. In the semantics of public finance, this would therefore be a "progressive" change in the tax structure.

Finally, putting such a cap on the interest rate deduction would tend to make borrowing relatively easier for business than for consumers, thereby facilitating the transfer of aggregate savings toward investment in plant and equipment and away from durable consumer goods and housing. Such a transfer would contribute to a more productive and healthy economy in the long run.

7. *Is the Economy Poised or Paralyzed?**

Seldom have the models and forecasters been as close to agreement as in their recent predictions of a meager recovery in the U.S. economy. Both supply-side and Keynesian models have registered similar forecasts of scanty U.S. economic growth in 1983, ranging from the Council of Economic Advisors' estimate of 1 1/2 percent to 2 percent, to the 2-3 percent estimates of the CBO, DRI, Wharton, Chase and assorted other models in this crowded field. A similar consensus applies to their forecasts of 1983 unemployment (above 10 percent), and budget deficits (\$190-\$200 billion).

The modelers are probably right. But the probability is, I surmise, only 2 to 1 or 3 to 1, rather than 10 to 1. Put another way, there are a number of reasons why these predictions may be quite wrong.

One reason is simply that these large econometric models of the U.S. economy have so often been wrong in the past in their year-in-advance forecasts of the economy's performance. Consequently, a consensus of gloomy forecasts provides almost as much ground for optimism as pessimism.

There are other, and stronger reasons why the economy may do much better than expected. The most important, and usually overlooked, reason concerns the effect of increased price stability on spending decisions, by business and households, especially households. Just as inflation tends to stimulate current spending because prices are expected to be higher in the future, so deflation leads to postponement of current spending because prices are expected to be *lower* in the future. When prices eventually stabilize, the postponed spending that has accumulated will reach the market.

Actually, the extraordinary reversal of inflation that occurred in the American economy in the past two years has not produced real *deflation* (falling prices), but *disinflation*: that is, a dramatic slowing of the previous inflation. But the effect has been similar to

*A slightly abbreviated version of this essay was published under the title "Hidden Potential for Economic Takeoff?" by *The Los Angeles Times* on February 4, 1983.

that of falling prices for several reasons: first, because some prices actually were falling (gasoline, foods, certain electronic goods and appliances), thereby nurturing expectations that they would continue to do so, and others might follow suit; and second, because the unspent income could realize a return (e.g., from money market funds, the new money market deposit accounts, fixed debt, etc.) that was considerably higher than the sharply decreased rate at which prices continued to rise. For both reasons, incentives to postpone spending grew stronger as disinflation proceeded.

But this process, and these incentives, are at or near an end. In 1982, consumer prices rose only 3.9 percent (compared with 8.9 percent and 11.4 percent in 1981 and 1980, respectively), and in the last quarter of 1982 the increase was only three-tenths of 1 percent! This rate isn't going to get lower. Indeed, some modest increase is more likely than a further decline. This, together with the declining yield on savings and the reduced cost of borrowing, means that incentives will favor spending rather than postponing.

Moreover, the liquid assets available to finance this deferred spending are enormous. For example, between the first quarter of 1980 and the third quarter of 1982, household financial assets grew by over 30 percent, from \$3.9 trillion to \$5.1 trillion. And continuation of foreign capital inflow is likely to add further to these already abundant means to finance increased spending.

If, and as, spending--especially household spending--rises, industry should be in a position to respond rapidly and efficiently. Starting from today's low level of capacity utilization in manufacturing industry (currently at only 68 percent compared with 79 percent in 1981), output can readily be increased without encountering bottlenecks of equipment, materials or labor that otherwise would push prices upwards. Moreover, the weeding out of higher-cost firms through the painful spate of bankruptcies in the past year--the so-called "molting" of American industry--should enhance the efficiency with which production can respond to increased spending.

What is the bottom line? Unfortunately, it's blurred. All of the factors I've described could well make the economy more buoyant, and its prospects much brighter than suggested by the accepted forecasts. The

economy may be poised for a rapid rate of annual growth of 5 percent or 6 percent rather than 2 percent, as well as for sharper reductions of unemployment and deficits, than those that have been predicted.

On the other hand, all of these factors might not be enough. High rates of current unemployment may tend to discourage spending by those who remain employed, as a precaution in case their own jobs are lost. Pressure on money markets from government borrowing may sustain excessively high real interest rates that will depress business investment. And reduced access to foreign markets, due to both recession and protection, may diminish exports.

The bottom line is admittedly blurred. Yet the likelihood of substantial economic improvement is much greater than suggested by the melancholy consensus of the models and modelers.

8. *The Hazards of Economic Forecasting**

As we absorb the daily barrage of predictions about outyear budget and trade deficits, higher interest rates, economic "overheating," and resumed inflation, prudence suggests we should ask three general questions about economic forecasts: How reliable are they? Why? What should be done about them?

The answer to the first question is: "Not very." Consider a few examples:

- At the start of 1983, both supply-side and Keynesian forecasting models predicted only modest economic growth in the United States for the ensuing year. The Council of Economic Advisors' initial growth forecast for 1983 was between 1 1/2 percent and 2 percent, while the forecasts of the Congressional Budget Office, Data Resources, Inc., Wharton, Chase, and a number of others were half again larger. In fact, the actual 1983 rate was over 6 percent! The actual record was thus more than double the consensus of the principal forecasters.
- In July 1983, after three quarters of the fiscal year had elapsed, the Administration's own forecast of the expected budget deficit for the entire fiscal year 1983 was \$212 billion. Three months later, the actual deficit turned out to be only \$195 billion, an error of 8 percent. For the current fiscal year the Administration has forecast a deficit of \$179 billion. But, according to some estimates by non-government forecasters made in April after two quarters had elapsed, the deficit is likely to be only \$162 billion--at least 9 percent less than the government's own forecast.
- In March 1984, the Department of Commerce's "flash" estimate of the first quarter's real GNP growth rate was 7.2 percent. By the middle of May, the actual rate turned out to be 8.8 percent, a 22 percent error.

*A slightly abbreviated version of this essay was published under the title "Pin a Tail on the Forecasts" by *The New York Times* on June 30, 1984.

The examples are illustrative, not exhaustive. They could be multiplied many times.

Why are forecasts so frequently wide of the mark? The principal reason is ignorance rather than partisanship. The errors are not confined to forecasters of one policy persuasion or another. They are made by supply siders and Keynesians, by both government and business forecasters, by academics and research firms, by Republicans and Democrats. Forecasting errors are made on all sides of the policy spectrum simply because economists are much less knowledgeable about macroeconomics than about microeconomics. Indeed, while economists mainly talk about macroeconomics, what they really know about is microeconomics.

The answer to the third question ("What to do about the forecasts?") is a combination of piety and common sense. The common sense is that economic forecasts should be taken with plenty of seasoning: not ignored, but certainly not taken too seriously. This caution is especially warranted for forecasts that are in the distant future. The more distant is the forecast, the less reliable it's likely to be. "Distance" here means a year or even less, as the preceding examples suggest.

The piety is that the forecasts should be improved. Improving them depends fundamentally on replacing macroeconomic ignorance with macroeconomic knowledge. This is bound to be a difficult and slow process for reasons that are both familiar and enduring. However, while this process proceeds at its inevitably glacial pace, two simple improvements could be made easily and quickly.

The first improvement would be to have forecasts presented not as *point* estimates (for example, it was absurd for the Treasury to forecast a 1983 Federal budget deficit of exactly \$195.4 billion), but instead as a *range*, together with an indication of the probabilities associated with several different parts of the range. In other words, economic forecasts should be expressed in a form that conveys at least as much information about the true uncertainty of the estimates as is conveyed in standard weather predictions: For example, "overcast and cooler with a 40 percent chance of showers," might be paralleled by a prediction of

the following sort: "GNP growth rate of 5 percent, with a 50 percent chance that the rate will be 2 percent lower." This is easy to do with current computerized macro economic models. One reason the forecasts are so rarely presented this way is because the modelers are reluctant to highlight the real uncertainty surrounding their forecasts. Users of the forecasts should insist that this reluctance be overcome.

A second improvement would be to keep a box score, or "batting average" for each of the principal forecasters, as a regular, continuing, and readily accessible record. For example, six indicators could be tabulated for each major forecaster's annual predictions: GNP growth; the inflation rate (that is, the change in GNP deflator, or in the producer price index, or in the consumer price index); the year-end level of employment (a much more reliable statistic than the unemployment rate); the federal budget deficit for the year as a whole; the year-end prime rate of interest; and the year-end exchange rate of the dollar (say, relative to the yen, or the mark, or the European Currency Unit.) To keep the system simple, one point could be assigned to each forecast that is no more than 5 percent above or below the actual value at the end of the year, with pro rated reductions in score tied to the degree of inaccuracy of the forecast. Six would be a perfect score.

Who would keep score? Candidates with a possible institutional interest, as well as the necessary competence, include the National Bureau of Economic Research, the Department of Commerce, The Brookings Institution, The American Enterprise Institute, *The Wall Street Journal*, *The New York Times*, *The Los Angeles Times*, or even the Rand Corporation.

A simple innovation of this sort would help to inform the unwary public about the best and the worst, as well as about how bad even the best are. It would also tend, over time, to improve the forecasts themselves. As Samuel Johnson once observed, "...when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully." So too, the prospect of having one's score duly registered at the end of each year would make the forecasters more accountable and more responsible. Over a period of several years, the market would be likely to assure that the better ones survive and the others would succumb. Hence, the prevailing forecasts would be improved.

9. What's Wrong with 'Trickle-Down?'

What's wrong with "trickle-down?"

From the clamor over David Stockman's "trickle-down" gaffe, one would infer that the obvious answer is: "Everything!"

As a means of improving the economy's performance, trickle down is unfair, ineffective, and ill-conceived. It smacks of special privilege and special interests, making the rich richer while hinting that the rest of us may benefit later on. It is elitist, undemocratic, and perhaps even un-American!

But, wait a minute. Rhetoric aside, the question can't be seriously answered without two prior steps: defining what "trickle-down" actually means; and considering the alternatives.

Asked about his use of the term as quoted in William Greider's *Atlantic* article, Stockman admitted he really wasn't "certain what 'trickle-down' means." You will look in vain for it in economics texts: trickle-down is not part of the economist's formal code.

However, there are several plausible ways of describing it:

(1) Measures to stimulate investment (by tax writeoffs, accelerated depreciation, lower taxes on investment income, etc.) will, in turn and in time, increase production and consumption throughout the economy. Since the investment share of gross national product is quite small (5-10 percent is a generous estimate), such measures really amount to providing incentives for the few, who do most of the investing, to generate subsequent benefits for the many: hence, "trickle-down."

Ironically, this formulation is no less consistent with Keynesian "demand-management" economics than with Kemp-Roth "supply-side" economics. What it amounts to is the Keynesian investment multiplier, without some of the latter's technical trimmings: if an initial increase in investment can be stimulated, it will increase total output by an amount that, eventually, will exceed the initial increase in investment.

*A slightly abbreviated version of this essay was published under the title "The Case for 'Trickle-Down'" by *The Los Angeles Times* on January 20, 1982.

An example of this version of trickle-down, referred to by Stockman in his indiscreetly candid remarks, is the 1981 Economic Recovery Tax Act's reduction of the maximum tax rate on investment income from 70 percent to 50 percent. Its intended supply-side effect is to strengthen incentives to save and invest, with the prospect of generating larger increases in output downstream, and thereby moving the economy forward.

(2) Another version of trickle-down focuses not on numerical multipliers, but on a vision of the capitalist system and what makes it work. The intellectual heritage in this case is Schumpeter and his theory of capitalism, rather than Keynes or supply-side economics. This version emphasizes entrepreneurship and innovation as the mainsprings of economic growth and technological progress.

But the successful entrepreneurs and innovators are very few. A larger number will try. They will spot an opportunity for a new product, or a new way of producing an old one, and take the chance. But only a few will achieve big successes. Their imitators are more numerous, and their ultimate beneficiaries are the rest of us. Providing an environment in which innovation and entrepreneurship can flourish is one way of trying to move a stagnant economy toward progress and growth. But the catalytic role of the few successful entrepreneurs is crucial.

Again, "trickle-down."

So much for describing it. What about the alternatives?

One set of alternatives seeks to bring about growth and progress by efforts from below, from the grass roots: not "trickle-down," but "bubble-up," so to speak--another term which is not in the economist's code.

West Germany's "codetermination" (*mit bestimmung*) movement is an example. Companies employing more than 1,000 workers are required to reserve half the seats on their corporate boards of directors for workers' representatives, who thereby participate directly in shaping corporate investment, employment and production policies.

Yugoslavia's workers' councils, and Solidarity's proposed system of worker "self-management" in Poland, are other examples of efforts to promote change and progress from below rather than above.

An extreme version of "bubble-up" was Mao Tse Tung's cultural revolution in the 1960s, with its Luddite attacks on large scale production facilities and centralized decision-making, and its hapless experiment with small scale technology and decentralized decision-making (recall the fiasco of "backyard" steel furnaces).

Another alternative to trickle-down is the "big-push" by government: centralized planning and investment to direct the economy along certain lines determined by a national plan. Direct government action may be the chosen instrument, or indirect measures--for example, tariff protection, subsidized loans, or preferential tax treatment--may be used instead, for the same ends.

The Soviet command economy is one variant of this approach. "Perspective planning" in France is a more permissive variant, although under the Mitterand government commands are plainly increasing while permissiveness is decreasing.

What, then, is wrong with trickle-down? The generally accepted answer is arguable. Once "trickle-down" is defined and compared with the alternatives, the balance of advantage is by no means clear. The original metaphor sounds much worse than it really is, while the alternatives are uncertain at best and unpromising at least. "Trickle-down" isn't all wrong or all bad, and the alternatives aren't all right or all good.

An assessment of trickle-down is like an assessment of the process of growing older: the phenomenon is not entirely appealing, but it doesn't look so bad when compared with the alternatives!

*10. Reaganomics, Keynesian Economics, and the Current Recovery**

However perverse and "unfair" the record of Reaganomics has seemed to its opponents during the past two years, they must concede that its current status and prospects are enormously better than a year ago.

Consider the following indicators: In the first half of 1983, GNP grew at an annual rate of over 5.6 percent net of inflation, compared with prior forecasts of only 3 to 4 percent; consumer prices have increased only 2 percent, about as close to price stability as our inflation-prone and indexed economy is likely to achieve; employment increased by nearly 500,000 in the first half of the year, and another 500,000 in July; unemployment, though still high at 9.5 percent, has fallen by nearly 1 percent since January 1st; manufacturing capacity utilization increased from 68 percent to 75 percent; and labor productivity has risen, while labor costs per unit of output actually decreased for the first time in eight years.

How can these improvements be explained? A strong resurgence of consumer demand is the principal explanation. In the first half of 1983, total consumer spending increased over 10 percent, thereby providing a powerful demand stimulus to the entire economy, which is reflected in the previously cited indicators.

It is both odd and ironic that "Reaganomics" is undergoing redemption at the hands of consumer demand: "odd" because unexpected, and "ironic" because, hitherto, consumer demand has occupied a much more central role in the liberal Democratic policies of Keynesian economics than the conservative Republican policies of Reaganomics.

In Keynesian economics, boosting consumer demand is essential for economic recovery because output and employment are assumed to be highly responsive to demand. Hence, Keynesian economics is often designated as "demand management," or "demand-side" economics.

*A slightly abbreviated version of this essay was published under the title "Hold the Cheers for Reaganomics" by *The Los Angeles Times* on August 18, 1983.

By contrast, the principal components of "classical" Reaganomics--reduced taxes (especially business taxes), diminished government regulation, reduced government spending--are only peripherally concerned with consumer spending. Instead, Reaganomics focuses on the need to lower costs and increase incentives on the supply-side of the economy. (Even reductions in personal income taxes have received their main justification in Reaganomic policies as a means of inducing supply-side responses: namely, increased labor effort, higher productivity, and increased consumer *saving*, rather than spending.) Hence, the familiar "supply-side" label that has appropriately been applied to Reaganomics.

In Keynesian economics, demand occupies center stage, and supply is an understudy. In Reaganomics, the roles are exactly reversed. How then can Reaganomics claim credit for an economic recovery triggered by economic actions and actors to which it accords only a secondary role?

The answer is that such claims warrant seasoning with the usual grains of salt. The recovery has occurred through a mechanism that was neither articulated nor anticipated by the original proponents of Reaganomics. That mechanism is the termination of rapid inflation in 1981, its replacement by disinflation (a dramatic slowing of the previous inflation) in mid 1982, the achievement of price stability--at least temporarily--in late 1982, and the ensuing jump in consumer demand in 1983. In turn, the suppression and extrusion of inflation in 1981 and 1982 are attributable to the admittedly painful monetary restraint of Federal Reserve policy, rather than to the supply-side policies directly advocated by the White House.

When inflation gallops, as it did in the high double-digit years of 1979 and 1980, consumer spending is stimulated by expectations that future prices will exceed current ones. Eventually, this stimulus may be capped by a fear that something must be saved against the day when the bubble will burst. In any event, if and when inflation slows down (disinflation) as it did in 1981, and some prices actually fall as they did in 1982, consumer spending contracts for two reasons: first, because consumers expect future prices to be *less* than current ones, so it makes sense to defer spending; and second, because consumers feel

insecure about their own continued employment, so precautionary saving increases.

During 1982, consumers retreated from the market, in the process amassing a huge volume of liquid assets: household financial assets grew by 16 percent between 1981 and the end of 1982, from \$4,657 billion to \$5,395 billion. Reversal of this retreat, and the resurgence of consumer spending was triggered by price stability, further galvanized by a suspicion that stability may be only temporary. With stable prices, there is no longer a reason to defer spending in anticipation of lower prices in the future; with the suspicion that stability may be temporary, there is every reason to reenter the market quickly before prices start to rise again.

In sum, disinflation and price stability account for the resurgence of consumer spending, and output and employment have responded to this rise in demand in nice conformity to the precepts of Keynesian economics. The result has been the substantial recovery that has occurred thus far in 1983. None of this is really due to Reaganomics, whose supply-side effects remain to be realized. Indeed, the likelihood that these effects will ensue henceforth--albeit after a considerably longer lag than their advocates had originally envisaged--provides a strong reason for believing the economic recovery will be sustained for a considerably longer time than the often erring, but always undaunted, forecasters have recently predicted.

Although Reaganomics may claim some credit for the favorable turn of economic events, the claim should be more muted than it's likely to be. The boost to consumer demand, and thereby to the entire economy, has resulted not from Reaganomics, but from the price stability induced by the Federal Reserve's monetary restraint, with only moral, rather than operational, support from the Administration. Ironically, Keynesian economics provides a better guide to understanding and explaining the recovery than does Reaganomics.

11. *Clearing the Haze Around International Debt**

Despite the widespread concern about international debt, most of its essentials have been ignored or obscured.

One neglected point is that the *real* costs, as distinct from the accounting costs, of the \$700 billion owed by the developing countries and Eastern Europe *have already been incurred*. These costs are the goods and services, the commodities and machinery, already exported to the debtor countries by the creditors. The real costs are the benefits forgone by the creditors (principally but not exclusively by the U.S.) because their factors of production--labor, capital, and materials--were used for the benefit of external borrowers, rather than for internal investment, research and development, and consumption in the lending countries themselves.

Consider, for example, how much higher *current* U.S. productivity would be if a significant share of the 1970s' loans to Latin America had instead financed new investment and R&D in the United States, or if Western European loans to the Soviet Union and Eastern Europe had instead financed investment and R&D within the European Economic Community.

If the real costs of these loans are already "sunk," why all the hullabaloo about the debt?

The hullabaloo revolves around a dilemma: how to maximize repayment of the expended loans without jeopardizing political stability in the debtor countries. Bankers are principally concerned with the first horn of this dilemma, governments in both the creditor and debtor countries principally with the second. And no one really knows how best to reconcile the two.

One view is that repayment will be maximized by providing additional funds to the debtors to help get their economic houses in order--to maintain essential imports, to reduce inflation without severely curtailing consumption or precipitating acute deflation, to

*A slightly abbreviated version of this essay was published under the title "Foreign Loans: At Issue is Who Bears the Cost" by *The Los Angeles Times* on September 9, 1984.

boost output and exports, and thereby to be better able to service prior debts as well as new loans. According to this view, new loans are also necessary to avoid the serious political instability that might result in the debtor countries if their imports, consumption, and output were to decline further, absent the new financing. For example, nascent democracy in Argentina might be severely jeopardized as a result.

Based on this reasoning, most governments in both creditor and debtor countries favor some form of new lending, subsidized either by government underwriting of commercial lending, by additions to the concessional lending pool of the International Monetary Fund, or by other means.

A sharply different view is that the necessary economic housekeeping by the debtors depends on their own efforts to reallocate resources from consumption to investment and exports. Since the necessary resource shifts are only about 4 or 5 percent of the debtors' GNPs, political stability isn't likely to be significantly affected. If these reallocation efforts are genuine and promising, it is argued, the debtors will be able to service their debt and regain normal access to international capital markets fairly soon. If, on the other hand, their efforts are not promising, then any new lending would simply be throwing good money after bad.

This position runs the risk that the debtors--at least the most severely beleaguered ones--may simply default, as Bolivia has already done. Even so, it can be argued, the defaulting debtors will be obliged to repay eventually in order to regain access to international capital markets. Hence, the argument runs, the creditors will recover more of what they're owed anyhow, without having incurred the added costs of new lending.

In between these two positions lie numerous possible compromises to reconcile the various conflicting aims. Proposals to reschedule existing debts, to place an arbitrary "cap" on interest rates charged to debtors, to confine debt service to a specified amount while allowing maturities to vary, or to provide new loans through the IMF, are the elements of these compromises. Such proposals for concessions by creditors would entail various conditions to be accepted by the debtors.

Whatever the compromises that emerge--and they're likely to differ for different countries--there's little doubt that the ensuing repayments will be worth substantially less than the original loans. So the ultimate issue--indeed, the haziest part of the international debt predicament--is how this loss is to be divided among bank management, bank stockholders, depositors, and governments (which is to say, the public). Whose balance sheet will suffer and by how much?

Except for the bankers, most observers agree, at least tacitly, that the burden should be principally borne by bank management and stockholders, with depositors held harmless, and taxpayers as the burden-carrier of last resort. Because management and stockholders have previously realized gains from increases in bank earnings, it is appropriate that they should incur losses when these earnings decline.

It's equally appropriate that depositors should be protected, both because of the special fiduciary character of the banks' relation to their individual depositors (in contrast to their stockholders), and also because insolvency in the major banks could have serious systemic repercussions because the smaller regional banks hold deposits in the major international ones. Protection of depositors is already implied by the Federal Deposit Insurance Corporation's speedy intervention in the Continental Illinois debacle earlier this year.

But protecting depositors means that the general public is likely to bear part of the burden. The reason is that losses from the original loans may be so great that not only will bank earnings decline further (from non-accrual of interest payments), but the portfolio value of many of these international loans will be sharply reduced as well. The net losses may well be sufficiently large that, to avoid insolvency of some of the major banks and thus protect depositors, the Federal Reserve may have to stand as a lender of last resort. This safety net implies that the Fed would be willing to make loans on the banks' discounted assets in amounts sufficient to preserve solvency--that is, a positive net worth--of the threatened banks. And this is where the taxpayers' burden arises. Lending by the Fed to relieve or reduce the banks' exposure to their soured loans represents, ultimately, a claim on the earnings and savings of the public at large.

If this is the bad news, the good news is that such action by the Federal Reserve needn't cause concern about triggering inflation. Increases in the reserves of some banks due to such action by the Fed can be fully or partly offset, for the banking system as a whole, by open market operations (Fed sales of government securities to the non-affected banks), designed to keep the money supply within the established target range. One alternative to Fed involvement lies in a U.S. decision to provide additional capital for IMF lending to the beleaguered debtors. In this case, taxpayers would bear the burden more directly, because these funds would have to come from U.S. tax revenues.

When the dust settles, effective management of the debt predicament can be partly judged by the extent to which the imposed burden on the public has been kept within limited bounds.

12. *A Non-Protectionist Case for Less Foreign Trade**

Right-thinking people generally agree on certain basic propositions about international trade: for example, trade is good; more trade is better than less; and exports are better than imports. The agreement extends, with only rare exceptions, to all parts of the political spectrum, to both sides of the Atlantic, and to the "Third World" as well as the other two.

This is another example of conventional wisdom concealing palpable unwisdom. In fact, each of the foregoing propositions about trade is either arguable or simply wrong.

The view that trade is "good" is based on the intuitively appealing notion that *both* parties to a transaction must benefit or else the transaction would not occur. On the contrary, the *countries* involved in the transaction may lose even while the immediate *parties* benefit. This will be true if, as is often the case, the exporter receives a subsidy from government, and hence the price he charges may be less than the true costs of production; or, if, though this occurs less often, the importer receives a government subsidy (for example, to encourage some particular type of favored imports, such as high technology products), and hence the country's real economic costs may be higher than the price actually paid by the importer. Genuine gains from trade result only if the trade occurs without subsidies.

That *more* trade may *not* be better than less trade follows from the same point. If transactions are subsidized, increased trade will only mean greater subsidies, higher real costs, and a larger waste of resources in the subsidizing economies.

Finally, the belief that exports are "better" for the economy than imports is simply wrong. The performance of an economy is, in general, reflected by the consumption and investment it can sustain. More of both are better than less, and growth in either is better than none. Imports provide additional resources that *contribute* to meeting

*A slightly abbreviated version of this essay was published under the title "Less Trade May be Better Than More" by *The Los Angeles Times* on April 28, 1983.

consumption or investment demands, while exports *subtract* resources from what's available to meet these demands. Hence, in this sense, imports are "better" than exports. Exports simply provide a means of paying for imports.

Misunderstandings about these points have contributed to the international financial predicament in which the world economy now finds itself, as well as to innumerable other policy mistakes and mischief in the international economy.

In the past several decades, governments in the industrial countries have installed a pervasive network of subsidies designed to promote foreign trade, especially exports. These have taken many forms: export credits, extended on preferential interest and repayment terms; longer-term loan guarantees, intended to make risky loans riskless to the lender and to enable borrowers to increase their imports, usually from the lending country; preferential tax treatment of income derived from foreign sales; and various other means to allow or encourage producers to charge lower prices for exports than for domestic sales.

The tremendous increase in international lending in the 1970s, to both the developing countries and to the countries of Eastern Europe, is partly due to these same misconceptions. The petrodollar surpluses of the early and late 1970s were recycled abroad in part due to a general belief that doing so would result in expanded exports for the recyclers. In hindsight, it is entirely plausible that the world economy as a whole would be better off if more of these resources had been directed toward the domestic economies of the developed countries in accord with more accurate consideration of comparative costs and risks, rather than diverted to Eastern Europe and the LDC's due to the distortions introduced by trade subsidies.

What is the bottom line?

From the standpoint of public understanding, congressional deliberations, and media attention, it should not be assumed that foreign trade is good in itself and hence deserving of special subsidies or protection.

From the standpoint of public policy, international trade negotiations--between the U.S. and Japan, the U.S. and the countries of Western Europe, and in the GATT and other international forums--should

move beyond the traditional agenda of tariffs and non-tariff barriers. Instead, more attention should be devoted to identifying and gradually eliminating the pervasive network of hidden and overt subsidies to foreign trade that virtually all of the industrialized countries maintain.

How much of an effect would the multilateral elimination of subsidies have on U.S. foreign trade? In 1982, U.S. merchandise exports were \$212 billion and imports were \$244 billion, together representing 14.9 percent of the gross national product. Multilateral elimination of subsidies, negotiated between the U.S. and its principal trading partners, might reduce these figures by perhaps 10 to 20 percent. Taxpayers, the general public, and world economic growth would be the beneficiaries of such a re-orientation.

II. FOREIGN POLICY

13. Prospects for the Soviet Empire*

What are the prospects for demise of the Soviet Empire, or for its survival and expansion?

Six or eight years ago the question would have seemed irrelevant, and its answer obvious. Survival of the Soviet system at home and its continued control in Eastern Europe were taken for granted. At the same time, expansion of its influence and control abroad seemed unthreatening, as well as slow and uneven. Now the question is distinctly relevant and timely, and its answer neither obvious nor certain.

One plausible answer is, from the U.S. point of view, guardedly optimistic. Not since the early years following the Russian revolution of 1917 have the fundamental weaknesses and vulnerabilities of the Soviet system been as evident as they currently are. Soviet economic growth has sharply declined from an annual average of about 5 percent in the 1960s to about 3 percent in the 1970s. For the 1980s, the prospects are for a further decline. Labor productivity has also declined, while increasing inputs of capital have been accompanied by diminished yields in both industry and agriculture.

In social terms, the system has fared still worse. Among developed countries, the Soviet Union is unique in showing *increased* mortality rates for its population as a whole over the past decade, as well as a *decline* in life expectancy. Infant mortality has risen by 50 percent in the past decade, and is currently three times that of the United States.

While its economic and social performance have thus deteriorated, the brutishness with which the system crushes political dissent has remain unchanged. In short, the Soviet system has lost whatever economic, social, or political appeal it might once have offered for foreign emulation. Whether as a consequence, or coincidence, clear and increasing signs have appeared of divisiveness within its established domain in Eastern Europe, and in other parts of its empire outside

*A slightly abbreviated version of this essay was published under the title "Soviet Empire-Builders Push On--How Far Will They Go?" by *The Los Angeles Times* on February 24, 1982.

Europe. Poland is, of course, the most dramatic example. Rumania's deviant foreign policy, and Hungary's economic experimentation with market incentives, provide other examples of divergence and restiveness.

Furthermore, the costs of sustaining the Soviet Union's expanded imperial domain have grown enormously to an amount that may be one fifth as large as its total military expenditures. These costs include subsidies on export and import trade with Eastern Europe and other client states, economic and military aid, and military operating costs in support of Cuban and East German proxy forces. They don't include the potentially large additional costs that may impinge on the Soviet Union as a residual guarantor of the \$70 billion of Polish and other East European external debt.

In light of the system's economic and social shortcomings at home, and the restiveness and rising costs associated with its expansion abroad, the cohesion and sustainability of the Soviet empire would now seem uncertain.

Unfortunately, this is only one plausible answer to the original question. A quite different, more pessimistic answer is also plausible.

While its social and economic performance has deteriorated sharply in the past decade, the Soviet Union has achieved dramatic success in expanding its military power: in strategic forces, tactical forces, and external projection forces; in naval, ground, and air forces; in conventional as well as nuclear forces. With its massive growth of military power as a backup, the Soviet Union has developed an effective formula for expanding its empire, a formula that seems not much affected by the flaws of the parent system or the empire's rising costs.

This formula begins with the inevitable and intractable tensions and instabilities--social, economic, ethnic, and political--in the third world, and even in parts of the "first" world. In these troubled waters, the Soviet Union has successfully navigated, by employing a wide range of policy instruments to expand its domain: trade subsidies and direct economic and financial assistance; grants and credits for weapons; training and logistic support for Cuban and East German proxy forces for combat; internal security and police roles in Africa and the Middle East; and, in exceptional circumstances such as Afghanistan, Soviet occupation forces, as well.

The formula has been applied in a selective, pragmatic and controlled manner to expand Soviet influence in Angola, Ethiopia, South Yemen, Vietnam, Cambodia, Laos, Benin, Madagascar, Congo-Brazzaville, Nicaragua, Syria and Libya, while maintaining Soviet dominion in Eastern Europe, Cuba, and North Korea. While there have been some Soviet setbacks (e.g., Somalia and Egypt, and the current troubles in Poland) during this period, the gains realized by the Soviet empire have vastly exceeded its losses. Neither the disarray in the Western alliance, nor the character of the emerging U.S. defense build-up, provides a reason to think this process will be stopped, let alone reversed.

Which of the two plausible answers is more realistic?

Certainly, the Kremlin leadership is more keenly aware than ever before of the formidable costs, fractiousness, and burdens of empire. And certainly the myriad difficulties and shortfalls within the Soviet system seem likely to increase and to warrant more resources and attention at home.

Yet there is every reason to think that expansion of the empire rates very high among the values cherished by Soviet leaders. And there is no reason to think they are not prepared to bear still greater costs to propitiate the empire's further growth. Moreover, the process of further expansion through support for "fraternal" states can be so contrived and manipulated by the leadership that failure to pursue it is itself viewed as a threat to the Soviet Union, while persisting in doing so both preempts the threat and extenuates the need for economic and social sacrifices at home. Rather than viewing Afghanistan or Poland as halting the course of expansion, Soviet leadership is more likely to view them as difficulties that have been managed satisfactorily, if not painlessly.

With disunity rife in the Western alliance, and U.S. foreign and defense policies yet to provide an effective counterweight, it would seem quite erroneous to think that the Soviet empire has reached its peak, and even more in error to think its position is precarious--like that facing the Romans when Alaric and the Goths laid siege to the city.

Realism, unfortunately, lies closer to the pessimistic than the optimistic answer.

14. *The Costs of the Soviet Empire**

The costs of empire impose a burden on the Soviet economy. Along with numerous other more-familiar factors, these costs have contributed to its sharply diminished performance. The costs translate into appreciable reductions in potential growth of Soviet civil consumption or military production. Yet such burdensome consequences are likely to be viewed by the Kremlin as imperative because of the broader political purposes the empire is believed to serve.

Many of the major questions associated with the Soviet empire cannot be answered conclusively, but considerable light is shed by recent Rand research on its costs during the 1971-80 decade.** To start with, "empire" and "costs" must be defined. In a geographic sense, there are three Soviet "empires:" the empire within the boundaries of the Soviet state; the geographically contiguous empire; and the empire "abroad." European writers usually have the first of these definitions in mind when they use the term: namely, the multinational Soviet state consisting of 15 distinct national republics and over 60 nationalities. The definition used in this article focuses instead on the *external* parts of the empire: the contiguous countries of Eastern Europe and Afghanistan; and the countries abroad which, unlike those of Eastern Europe, had not previously experienced Russian influence or control. This second part of the external empire includes Cuba, Vietnam, Angola, South Yemen, Ethiopia, Mozambique, Libya, Syria, Nicaragua and North Korea.

Clearly, this definition covers a wide variety of situations: satellites, allies, spheres of Soviet influence, and more or less "friendly," if not "fraternal," states. Yet this variety is entirely consistent with the characteristics of the Roman, Ottoman, British, French, Japanese and other empires of the past. Hobson's classic study

*A slightly abbreviated version of this essay was published by *The Wall Street Journal* on January 30, 1984.

**See Charles Wolf, Jr., K. C. Yeh, Edmund Brunner, et. al., *The Costs of the Soviet Empire*, The Rand Corporation, R-3073/1-NA, September 1983.

of the 19th century British empire referred to "quibbles" over the definition of "empire," and the "sliding scale of political terminology" applied to it. The term is used here in the same sense to cover all the various forms of political sway and influence exercised by the Soviet Union, at a cost to its economy.

Moreover, some costs that are properly attributable to the Soviet empire may be incurred in and on countries that are not currently within the empire. For example, costs may be incurred in countries that are targets for expanding the empire's domain in the future (such as India), or for thwarting and disrupting opposition to its future expansion; Soviet support for covert destabilization activities in Turkey is an example of this latter type of cost.

In sum, empire costs encompass those costs incurred by the Soviet Union to maintain or increase its control in countries it already dominates, to acquire influence perhaps leading to future control in countries that seem promising candidates, and to thwart or subvert countries opposed to it.

The principal components of these costs are: (1) implicit trade subsidies covering both the underpricing relative to world market prices of Soviet exports, such as oil, to Eastern Europe, Cuba and Vietnam, and the premiums above world market prices paid by the Soviets for imports, such as Cuban sugar, from these countries; (2) export credits extended by the Soviet Union with doubtful prospects of repayment; (3) Soviet military aid deliveries, net of hard currency military sales; (4) economic aid deliveries net of repayments; (5) incremental costs of Soviet military operations in Afghanistan; and (6) costs of Soviet covert, destabilization activities in the third world.

With the single exception of military operations in Afghanistan, the following estimates exclude the costs of Soviet military forces, even though large elements of these forces (for example, the 32 Soviet divisions in Eastern Europe and the tremendous expansion in recent years of Soviet naval forces) clearly contribute to the Soviet imperial enterprise. The reason for this exclusion is that these military forces also contribute to defense of the Soviet state; hence, imputation to the empire of some part of their total cost would inevitably be arbitrary.

Clearly, enormous data problems bedevil these estimates. But the "bottom line," even if blurred, is interesting and substantial. In constant 1981 dollars, using official exchange rates, costs of the Soviet empire rose from about \$18 billion in 1971 to \$24 billion in 1976 and about \$41 billion in 1980, an annual growth rate of nearly 9 percent for the decade as a whole. As a proportion of published CIA estimates of Soviet GNP, the costs of empire rose from about 1.1 percent in 1971 to approximately 2.7 percent at the end of the decade, averaging 1.6 percent over the period. As a ratio to Soviet military spending, the costs of empire rose from 9 percent to 19 percent during the decade, averaging about 13 percent.

The picture is even more striking if these data are expressed in rubles rather than dollars. The ruble figures are relatively much larger than the dollar figures when the hard currency parts of empire costs are converted to rubles at realistic, rather than official, exchange rates. (Realistic rates represent the ratios between internal ruble prices and external dollar prices of Soviet hard currency imports during each year of the past decade.) Expressed thus in rubles, with which the Soviets carry on the bulk of their economic activity, the costs of empire rose from 1.8 percent of Soviet ruble GNP in 1971 to 3.6 percent in 1976 and 6.6 percent in 1980, averaging 3.5 percent for the decade as a whole. As a ratio to Soviet military spending, costs in rubles rose from 14 percent in 1971 to 28 percent in 1976, and 50 percent in 1980, averaging 28 percent. The annual average growth rate of the ruble costs of empire was over 16 percent for the decade.

Are the Soviet costs of empire large or small? Obviously, the answer depends on the criteria one adopts.

Costs are clearly twice as large in rubles as in dollars, relative to Soviet GNP. And it is the larger measurement that probably reflects the calculus of Soviet decision-makers.

The Soviet empire burden is also very large compared with the roughly corresponding categories of U.S. costs, covering U.S. economic aid, military aid, and official export credits. As a share of the respective GNPs, the Soviet cost in dollars was over three times the comparable U.S. figure, and in rubles was over eight times the U.S. figure during the past decade.

Another sizing criterion is the burden imposed on the Soviet economy--evidently another of the numerous factors contributing to the declining performance of the Soviet economy in recent years. As a crude measure of this burden, each increase of 1 percent in the annual share of empire costs in Soviet GNP translates into a reduction of between .6 percent and 1 percent in the annual growth rate of Soviet military production, or about .3 percent in annual growth in civil consumption. For example, if empire costs rose from an annual level of, say, 1 percent to 6 percent of Soviet GNP, annual consumption growth would be reduced by about 1.5 percent. Alternatively, such an increase would reduce annual growth in military production by about 3 percent or 4 percent.

The ultimate criterion is, of course, not economic, but political and strategic. How large do the costs of empire appear relative to the political and strategic benefits attributed to the empire by the Soviet leadership? Plainly, this most significant criterion for evaluating Soviet empire costs is also the least measurable. It encompasses both tangible elements, such as bases in Cuba, Vietnam and elsewhere, that increase the effectiveness of Soviet military forces, as well as less tangible, but perhaps even more important elements, such as international political prestige, Russian national pride, the ideological imperative of "assisting" the inevitable march of history toward communist domination, and a putative justification in the leadership's eyes for the sacrifices imposed by the Soviet system on its populace. (That this justification is unlikely to be persuasive to Soviet consumers is both true and immaterial.) In the aggregate, these benefits of empire may, from the Politburo's viewpoint, amply justify its costs. They suggest that Soviet efforts to expand the empire are likely to continue.

The Soviet Union's Imperial phase has been aptly described by Milovan Djilas on the basis of his long experience with communism in the Soviet Union and Yugoslavia:

Soviet communism...is a military empire. It was transformed into a military empire in Stalin's time. Internally, such structures usually rot;...but to avoid internal problems, they may go for expansion...if it is stopped, the process of rotting will go faster.

15. *The Underlying Disagreement About
How to Deal with the Soviet Union**

With growing prospects that the United States and the Soviet Union will start talking in a few months about anti-satellite weapons, it's timely to consider why experts on the Soviet Union with apparently equal qualifications, so often disagree sharply on how to deal with the Soviets.

Consider the expertise represented by the following pairs of individuals and institutions: George Kennan and Paul Nitze; Cyrus Vance and Zbigniew Brzezinski; Marshall Shulman and Richard Pipes; Tom Wicker and William Safire; *The New York Times* and *The Wall Street Journal*; the Foreign Service and the military services; The Brookings Institution and The Hoover Institution. Policies favored by each member of these pairs typically and predictably differ from those favored by the other member. Moreover, the differences apply equally to issues drawn from the past (should the SALT II Agreement have been ratified?), the present (should some concessions be offered by the U.S. to persuade the Soviets to resume the START negotiations?), and the future (should arms control agreements with the Soviets be sought in the absence of strict verification provisions, or should credits to the Soviets be encouraged by Western governments to expand East-West trade and to improve East-West relations?).

These persistent differences are accounted for by fundamentally differing beliefs or premises about the nature of the Soviet system and the principal objectives of its leadership. The contrasting beliefs can be usefully characterized as "mirror-imaging" (MI) and "power-maximizing" (PM), representing opposite ends of a spectrum along which are arrayed the members of the previously cited pairs. (In each pair, the first member is situated at or close to the mirror-imaging end of the spectrum, while the second member is at or close to the power-maximizing end.)

*A slightly abbreviated version of this essay was published under the title "Why the Experts Disagree About the Soviets" by *The Washington Post* on July 25, 1984.

Of course, the MI-PM dichotomy is an oversimplification. Positions are often more complex than this strict binary choice implies; various nuances and combinations do occur. Nevertheless, the distinction conveys something that is crucial for explaining and anticipating the sharply different stances taken by experts, as well as by non-experts including presidential candidates.

The mirror-imaging view of the Soviet system and its leadership holds that apparent Soviet aggressiveness, expansionism, and preoccupation with enhanced military capabilities, are reflections of Russian history and culture. These preoccupations, it is acknowledged, may border on paranoia and consequently may take aggressive forms. However, such manifestations are considered by mirror-imagers to be understandable reactions to Soviet and Russian history, including the experience of Western efforts to abort the Bolshevik Revolution, the 20 million casualties suffered by the Soviet Union in World War II, and the periodic devastation experienced by Russia at the hands of foreign invaders. Preoccupation with military strength, and the priority given to resource allocations for the military, are to be explained, according to the mirror-imaging view, mainly by this historical legacy.

Nevertheless, according to MI, the long-term aims of the Soviet Union have something in common with our own: human betterment and well being, social progress, peace, prosperity, and social justice. Hence, according to adherents of MI, a more forthcoming Western policy--one that combines concessions with firmness--is likely to produce over time a symmetrical rather than an exploitative response from the Soviet leadership, and perhaps also an irenic evolution of the Soviet system. In the absence of such concessions, mirror-imagers tend to view prospective Soviet behavior with concern if not alarm, lest a hostile international environment, combined with increased Soviet economic stringency at home, arouse the Soviets' latent paranoia and provoke Soviet aggression. These presumed Soviet behavioral responses to alternative Western policies are the core of the mirror-imaging view.

By contrast, the power-maximizing view holds that, whatever the grim experiences of Soviet and Russian history, and whatever the philosophical and ideological antecedents of Soviet communism, the

overriding objective of the system is to maximize the political and military power of the Soviet state at home, and to expand it abroad. According to power-maximizers, concessions made to the Soviets and agreements and transactions with them, are fair game for exploitation and deception in the interests of maximizing Soviet power and expansion. The PM position denies, or at least seriously doubts, that economic and social betterment are important goals of the system as it really operates. Instead, holders of this position view the deferral of these goals as readily acceptable to the Soviet leadership, perhaps even obscurely welcomed by it, because of the overriding preference for strengthening Soviet vigilance and power in response to the alleged ubiquity of external and internal threats.

Differences between the mirror-imaging and power-maximizing views lead to predictable differences in the policies that their adherents advocate. For example, mirror-imagers tend to look with favor on negotiations that are initiated or facilitated by Western concessions, and trade that is expanded by using, if necessary, one or another type of subsidy. By contrast, power-maximizers tend to favor negotiations without any initial concessions, and trade without any subsidies, preferring no negotiations to concessionary ones and no trade or limited trade to subsidized trade. Power-maximizers tend to emphasize the zero-sum nature of negotiations and other transactions with the Soviet Union (what the Soviets gain, the West and the U.S. lose), while mirror-imagers tend to emphasize the positive-sum character of such transactions (both sides can gain from them).

Unfortunately, there is no way to provide a definitive test of which of these views--mirror-imaging or power-maximizing--is closer to the truth. Consequently, one is forced to rely on impressions, judgments, and experience--on insight as much as on eyesight--to make up one's mind.

One can also adopt a "hedging" strategy that tries to minimize regret. For example, suppose you pick the mirror-imaging view, then how badly off are we if that view is wrong? If, instead, you go with the power-maximizers, then how badly off are we if this view is wrong? So, one basis for choosing is simply to minimize how badly off we are if the view we adopt is wrong!

As the presidential campaign moves into high gear, differences between the candidates and their party platforms on this issue will be clear enough, even if the roundabout rhetoric that's employed sometimes tries to straddle both positions. In choosing between the two positions, a reflective person should proceed the same way that porcupines make love: carefully!

*16. The Coming Debate Over Western Lending to the Soviet Union**

If and as the current international debt predicament is brought under some degree of control, influential members of the business, financial, and media communities in the U.S. and Western Europe will convince themselves that Western lending to the Soviet Union should be encouraged. They will then try to convince others, as well as to influence government policies in the same direction. A debate will ensue whose manifest content will focus on economic considerations, although its underlying assumptions and motives will be fundamentally political.

The politics of the argument--the pros and cons of more extensive economic relations with the Soviet Union--will be a repetition of what has been frequently, if inconclusively, debated in the past. What will be new are the economic and financial contentions: specifically, the putative creditworthiness of the Soviet Union, and its apparently favorable credentials among potential international borrowers. Just as it is current U.S. policy to allow, and even actively encourage *unsubsidized* East-West trade (excluding trade in military-related technology), as reflected in the recent U.S.-Soviet grain agreement, so, it will be argued, lending to the Soviets on normal commercial terms should be encouraged, as well.

This scenario may seem far-fetched in the midst of Soviet intransigence in the current INF and START negotiations, and in the aftermath of the "termination" of KAL Flight 007. However, it is worth recalling how typically short-lived is international indignation on such matters. Consequently, it is pertinent to evaluate the economic arguments that will be made in favor of expanded lending to the Soviets, for these are the terms in which the foreseeable debate will be formulated.

*A slightly abbreviated version of this essay was published under the title "When Bankers Start Looking to Moscow" by *The Wall Street Journal* on November 28, 1983.

On first glance, the argument is not without merit. Between the middle of 1981 and 1983, the Soviet Union's gross hard currency debt to Western commercial banks declined slightly from \$14.1 billion to \$13.9 billion, while its hard currency deposits in Western banks rose substantially from \$3.6 billion to \$10.0 billion, (probably due in considerable measure to increased Soviet gold sales). Thus, in the past two years, *net* Soviet commercial bank debt actually fell from \$10.5 billion to only \$4.0 billion. If government debt, which is largely in the form of short-term export credits, is added to these figures, Soviet gross debt is about \$21 billion, and its net debt is \$11 billion. Interest and principal payments on these debts absorb less than 15 percent of Soviet hard-currency export earnings, a figure that is remarkably small when compared not only to the corresponding percentages for such precariously situated debtors as Poland, Brazil, Mexico and Argentina, but also to such relatively reliable borrowers as France and Italy.

Viewed through the lenses bankers typically use in appraising financial risk, this would seem to establish the Soviet Union as a creditworthy borrower. This view will be especially congenial to the international departments of some of the world's major banks because its adoption might help to compensate for their sharply reduced lending activity in Latin America and Eastern Europe. By comparison with other potential international borrowers, it will be suggested, the Soviets deserve an A or AA rating!

From this reasoning, the argument will be carried one step further. If the Soviets themselves appear reluctant to borrow (whether for reasons of financial conservatism on their part, or for more subtle negotiatory ones), Western bankers should, it will be argued, undertake to "market" loans to the Soviet Union: that is, persuade its leadership to borrow Western money. To help lubricate the process, various types of government subsidy will be advocated: for example, loan guarantees, export credit insurance, or tax preferment extended by Western governments to promote financial and trade transactions with the Soviet Union.

Now let's consider some possible flaws in the argument.

The Soviet Union's hard currency balance of international payments, and hence its creditworthiness, is unusually sensitive to the behavior of four commodities: three on the export side (energy--principally oil--arms, and gold); and one on the import side (grain). Prospects for all of these are extremely tenuous over the next several years.

Among the Soviets' three major hard currency exports, energy is by far the largest, comprising over 55 percent of its annual hard currency export revenues of about \$30-\$35 billion. World market prospects for oil are also the most precarious of the three. The 15 percent decline in nominal oil prices in 1983 compelled the Soviets to increase the volume of their oil exports to avoid the loss of hard currency revenues that would otherwise have ensued. Their ability to compensate for continued softness in world oil prices in the future by increasing the volume of exports of natural gas are likely to provide only a partial offset.

Hard currency arms sales in the mid and late 1980s are also likely to drop. In the late 1970s and early 1980s, Soviet arms sales were typically \$7 or \$8 billion annually. OPEC surplus revenues, which, in the past, have directly or indirectly fueled the arms market, aren't likely to be available to do so in the 1980s, and the current world debt predicament will have a further damping effect on credits to finance arms sales. Hence, the outlook for Soviet hard currency earnings from this source, too, are unpromising.

Finally, while gold prices may fluctuate in the coming years, their prospects are not bright. Gold prices tend to move with inflation: when inflation advances, gold prices advance still faster; when inflation recedes, so do gold prices. Hence, the prospect that global inflation will continue to diminish compared with the past decade suggests that current annual Soviet earnings of \$2.0 to \$2.5 billion from gold sales are more likely to fall than to rise in the future.

Turning to grain imports, Soviet agreements recently concluded with Canada and Argentina, as well as with the United States, obligate it to import a minimum of 18.5 million metric tons per annum over the next 5 years. The maximum imports allowed under the U.S.-Soviet agreement would raise this figure to 21.5 million tons. In addition, the Soviets

have imported more than 3 million tons from Australia in each of the past three years, and are more likely to increase than to reduce this in the future. Thus, annual Soviet grain imports from all suppliers are likely to be not less than 25 million tons, and may be as high as 35 or even 50 million tons, depending on the vagaries of weather and Soviet agricultural performance. Depending on world grain prices--also a profoundly uncertain factor--Soviet requirements for hard currency to finance its essential grain imports will be between \$5 billion and \$8 billion annually, and perhaps even more. When further allowance is made for the hard-currency costs of "normal" Soviet imports of machinery, non-grain food, and raw materials, as well as the non-negligible costs of the Soviet Union's external empire, the financial picture that emerges is cloudy indeed.

In sum, the Soviet Union is a much more risky borrower than would seem indicated by the types of data bankers typically look at. Especially in light of the past decade's demonstration that the judgments of international bankers are remarkably fallible, the forthcoming debate on Western lending to the Soviet Union should be treated with abundant caution and limited credulity. Based on the economics of the case, to say nothing of the politics, "cash on the barrelhead" is a more prudent policy for the West to follow in transactions with the Soviet Union than lending money to it.

17. Another Look Through the Pipeline

Since President Reagan, on June 18th, 1982, embargoed the use of certain American compressor technology by European licensees involved in the Yamal gas pipeline, hardly a single good word has been expressed on behalf of the action by European governments, or by the American or European media. Columnists and editorialists, foreign ministries and trade ministries, in public and in private, have tried to outdo one another in the quantity and severity of their criticisms. The result is a curious and unnoticed phenomenon: the remarkable disproportion between the President's limited action, and the magnitude of the reaction. By contrast, European government and media reactions were far weaker to other, more far-reaching U.S. actions in the recent past: for example, cancellation of the neutron bomb; the planned deployment of cruise missiles and Pershing II nuclear forces; the prevalence of high U.S. inflation and low interest rates.

Yet it is evident that the embargo--whether for good or ill--is really of limited material consequence.

First, it is generally acknowledged, as well as emphasized, that the embargo on General Electric compressor technology will delay only slightly, if at all, completion and operation of the pipeline.

Second, the volume of gas through the 42-inch diameter, 3500-mile pipeline will be only slightly reduced if the originally planned 125 GE-designed, 25 megawatt turbines were wholly or partly replaced by a larger number of 8MW or 10MW turbines, which both the Europeans and Russians can produce with their own technology. The increased cost involved in such a modification plan would probably amount to no more than one or two percent of the \$12 to \$15 billion cost of the entire Yamal pipeline project.

Finally, despite exaggerated reports in the press, the number of European jobs that might be jeopardized by the embargo is minuscule. Assuming that each of the 125 GE-type turbines required by the original pipeline design costs \$5 to \$6 million to produce, and that average annual labor productivity in the four principal GE licensees (Alsthom-Atlantique in France; AEG-Kanis in Germany; Nuovo Pignone in

Italy; and John Brown in the U.K.) is \$25,000, the total number of jobs at risk is between 25,000 and 30,000 man-years.

Even this number is surely too high. If the original plan had been followed, production of the turbines would likely have been spread over 18 months or two years, so the *annual* job loss would be between 12,500 and 20,000, and these losses would be spread among the four producing countries. Moreover, most of these "lost" jobs would likely be made up by production of the older-style turbines. With unemployment in Western Europe manufacturing already running over 10 percent, the number of additional jobs jeopardized by the U.S. embargo is well within the margin of error of the aggregate unemployment estimates, and would probably have been imperceptible if the furor of the past weeks had not made the appearance seem so much worse than the reality.

So, why the disproportion between the modest scope of the Reagan action and the extreme reaction by European governments and both the U.S. and European media?

Where such disproportions occur, their underlying motivations are often very different from their ostensible motivations. In this case, too, I suspect we have to look for other explanations than the actual injury or penalty foisted on the Europeans and their Soviet partners.

One familiar, but I think disingenuous, explanation is that the reaction is due to the insult, rather than the injury, conveyed by the President's action. The Europeans and their supporters in the American media argue that the embargo represents an assertion of American "extra-territoriality," and an infringement upon their sovereignty. As a French visitor recently commented to me: "You're treating us as though we are the fifty-first state!"

T. S. Eliot once observed that one can learn a lot by taking note of what people do *not* say. What my French visitor did not say is that the President's action draws on provisions of American law (the Export Administration Act of 1979) that are directly reflected in agreements freely negotiated between the U.S. licensor (GE) and the European licensees. There was certainly no "extra-territorial" arm-twisting involved in inducing the European companies to enter into these agreements in the first place. Moreover, it can as plausibly be argued that the disavowals by President Mitterand and Chancellor Schmidt of the

credit restrictions thought by the Americans to have been agreed upon at Versailles in June, were just as demeaning to the United States as the embargo is to the Europeans. In this sense, the Europeans are as much sinners as they are sinned against.

A second possible explanation for the disproportionate reaction is the tactic of "smoke screen" or "cover-up." The numerous agreements involved in the pipeline deal engage a single actor on the Soviet side and a huge cast on the Western side, including numerous banks, suppliers of equipment, and distributors of gas within each country, as well as several governments. The separate agreements for each facet of the deal--credits and credit guarantees, repayment schedules, supplier prices and delivery schedules, floor prices and ceiling prices of delivered gas, etc.--are immensely complex, as well as shrouded in proprietary secrecy. As a result, there is probably no person or government on the Western side who really knows what the "bottom line" of the transaction is: whether, or under what circumstances, and with what likelihood the Yamal pipeline is a good deal for both sides, or a "rip off" by one.

The chance that the latter is, in fact, the answer, and that the beneficiary is the Soviet Union, may be sufficiently great that no participant on the Western side has any incentive to find out for sure, nor to want anyone else to do so!

If this is the case, then the overreaction to the U.S. embargo may be understandable: it may be a means of covering the pipeline in the protective garb of national "pride" and "sovereignty," thereby diverting attention from its real economic and financial disadvantages. The furor over the U.S. embargo may thus be a means of covering up a latent "Yamalgate."

One final question about the pipeline furor remains to be answered: If the actual cost and time penalties are as small as I've suggested, why did President Reagan impose the embargo at all?

On December 18, 1981--five days after martial law was forcibly established in Poland--President Reagan stipulated that the United States would levy additional sanctions on the Soviet Union if martial law had not been relieved within six months. Essentially, this declaration left four options to be considered on June 18th: (1)

restrict all new credits to the Soviet Union; (2) reimpose the U.S. grain embargo; (3) extend to U.S. subsidiaries and licensees abroad the embargo on equipment and technology exports to the Soviet Union that had previously been applied to U.S. firms on December 18th; (4) do nothing.

The first option was effectively scotched by the post-Versailles disclaimers of President Mitterand and Chancellor Schmidt. Doing nothing would have seriously eroded U.S. credibility--a loose and limited, but important, source of stability and predictability in the world arena. All things considered, a good case can be made for the proposition that the President chose the best, or the least bad, of the remaining options.

Still, it is possible that the first option--credit restrictions--may now be resurrected as a compromise in return for U.S. remission of the June 18th embargo. This may be a fortunate outcome because the first option is probably the best of the four. If any further credits to the Soviet Union were to be limited in size, and extended without the numerous subsidies that have accompanied them in the past, the real resource penalties imposed on the Soviet economy would exceed those associated with the June 18th embargo on U.S. technology and equipment. Agreement within the Western Alliance on a joint policy along these lines would be a significant achievement.

*18. International Debt and Arms Limitation**

Not every cloud has a silver lining, but when one appears, it's worth attention. In this case, the cloud is the \$700 billion of international debt owed by the developing countries and Eastern Europe. The silver lining is the improved outlook for arms limitation which the cloud portends.

The arms likely to be limited aren't the nuclear weapons of the United States and the Soviet Union. They are instead the possibly more destabilizing and hardly less worrisome aircraft, missiles, artillery, armor, naval and surface weapons--about \$30 billion of which are sold each year on the international weapons market, principally by the United States, the Soviet Union, and France, as well as other suppliers. More than three quarters of this amount is sold to developing countries.

In the past, this market has been fueled by two sources of finance: credit, extended by the governments and commercial banks of supplier countries; and dollar earnings of oil exporting countries, used either to buy weapons directly or to finance purchases by others. The two sources have often been linked because some of the earnings of the oil exporters were loaned or given by them to other arms buyers (e.g., Saudi Arabia's subventions to Syria), or were intermediated by OPEC's depository banks in the West in the form of loans to supposedly credit-worthy borrowers, often resulting--directly or indirectly--in financing arms purchases.

Currently, the precarious predicament of international debtors and creditors foreshadows a significant reduction in the availability of cash and credit for weapon purchases. And the erosion of OPEC earnings, due to continued slack in oil prices and sales, will further restrain financing available for weapon purchases.

Between 1971 and 1980, military equipment valued at about \$200 billion (expressed in constant 1979 prices) was traded on world markets, of which 75 percent was imported by developing countries. In 1980, one

*A slightly abbreviated version of this essay was published under the title "Nations' Heavy Debts May Mean Less Traffic in Arms" by *The Los Angeles Times* on March 19, 1984.

third of total sales was imported by countries of the Mid East, 19 percent by Africa, 13 percent by Asia, and 10 percent by Latin America. About 50 percent of the total was financed by credit. Arms sales were usually sweetened by substantial subsidies provided through below-market interest rates, long grace periods and amortization schedules, government insurance of commercial bank credits, supplier price rebates, and various combinations of these inducements.

The situation currently facing sellers and buyers has changed dramatically. Prospective buyers will, in general, have more limited access to international credit for two reasons: first, because petrodollars will not be flowing into international financial markets in such profusion as they did a few years earlier; and second, because international bankers and foreign governments are now more aware that repayment prospects are, in many cases, much bleaker than was believed to be the case in the '70s and early '80s. Prospective sellers now must realize that future arms sales will have to be more heavily subsidized than in the past because of the reduced liquidity and precarious solvency of prospective buyers. Larger subsidies and reduced prospects of repayment essentially imply diminished economic incentives to sell.

Of course, both political and economic considerations will limit the force of this argument. For example, some prospective buyers, like Saudi Arabia, will still have ample means to finance arms imports (as reflected by the Saudis' recent agreement to pay \$4 billion over several years for an advanced air defense system to be provided by France). And the major supplying countries, notably the U.S. and the Soviet Union, will have sufficiently strong political reasons to continue supplying arms to such countries as Israel, Egypt and El Salvador, in the U.S. case, and Cuba and Syria, in the Soviet case, notwithstanding deterioration in the prospects of repayment by these recipients. For the Soviets, this general deterioration in repayment prospects will be particularly burdensome because its arms sales in recent years have been a lucrative source of cherished hard currency earnings--to a much greater extent than has been true for the U.S.

Nevertheless, while the arms traffic certainly will continue, the prognosis is for its level to decrease significantly in the coming years. This may not always be beneficial. In some cases weapons

modernization and improvement can increase military stability: the military balance on the Korean peninsula is a case in point. However, on the whole, diminished arms traffic is generally to be preferred to its increase, and the debt overhand is likely to place a damper on the weapons market.

There is a silver lining to the international financial cloud, even if it's not spectacular.

19. *Third World: Myths and Realities**

When Alexander M. Haig Jr. testified before the Senate Foreign Relations Committee on his nomination as Secretary of State, he observed that the Third World ("a misleading term if ever there was one") is a myth. "Recent American foreign policy," Haig said, "has suffered from the misperception which lumps together nations as diverse as Brazil and Libya, Indonesia and South Yemen, Cuba and Kuwait...[The] failure to tailor policy to the individual circumstances of developing nations has frequently aggravated the very internal stresses which Western policy should seek instead to diminish."

Following Haig's lead, it may be timely to try to separate myths from realities, because the conventional wisdom about the so-called Third World is more conventional than wise.

Myth: The "Third World," consisting of some 130 less-developed nations, is a reasonably cohesive entity, unified by similar interests and ideologies that enable its members to act effectively and in concert.

Reality: The nations of the Third World are, in fact, divided in many more ways and by many more conflicting interests than those that unify them. Of course, it is a fact that certain attitudes--intense nationalism, hypersensitivity to foreign condescension, a liking, perhaps waning, for socialist ideology, to name a few--are shared by many developing nations. But more objective circumstances tend to divide them. For example, the Third World includes oil importers (Brazil, India, Pakistan) and oil exporters (Saudi Arabia, Libya, Iraq, Mexico, Venezuela); rapidly growing economies (Korea, Brazil, Singapore) and slowly growing or stagnating ones (most of the remaining nations); centrally planned economies as well as market economies; major international debtors (Brazil, Mexico, Turkey) and major international creditors (Saudi Arabia, Libya, Kuwait); communist nations, pro-communist nations and vigorously anti-communist nations (as well as many in between); nations ruled by military regimes and nations that profess the primacy of civil over military control.

*A slightly abbreviated version of this essay was published by *The Los Angeles Times* on January 27, 1981.

The rhetoric of Third World unity is more spurious than real. The reality of the Third World is cultural, political and economic diversity.

Thus, almost any action by the Reagan Administration is likely to evoke support from some Third World nations, opposition from others and indifference from many. Our policy-makers would be well advised to think about the "Third World" as a plural, not a singular, entity.

Myth: Achieving significant and sustained economic development in the Third World is an overwhelming and intractable problem, made even more difficult by the rigidity and discrimination of the present international economic order.

Reality: Achieving rapid and sustained development, within the current international economic order, is a much less formidable problem than is usually supposed. The means and methods for realizing economic development are well known, have been widely demonstrated and are generally acknowledged even if they are not widely adopted. By and large, these recipes have been amply demonstrated by the impressive development of the small number of Third World nations (Brazil, Korea, Taiwan and Singapore) that have maintained average rates of real economic growth of 9 percent annually during the 1970s.

These nations have made economic progress possible by achieving political stability, including infrequent changes of government. In addition, such nations have provided a hospitable economic climate for market forces and market prices, have encouraged infusions of foreign capital and the selective import of foreign technology, and have avoided hyperinflation.

Orientation toward the market, while typical of these relatively successful Third World nations, does not necessarily imply private ownership, or an inactive role for government. Where government interventions occur, they usually are selective and limited in number.

As to the rigidity and adverse effects of the present economic international order, and the sometimes shrill call for a "new international economic order," again the reality departs sharply from the myth. In fact, the "old" order has been remarkably flexible, rather than rigid, and hospitable rather than resistant to development in the Third World.

For example, the drastic shift from a regime of fixed exchange rates to fluctuating ones, the recycling of several hundred billion dollars of petrodollars over the last half dozen years, and the transfer of technology, are all indications of the adaptability of the present international economic setup to changing needs and forces.

Myth: Economic development is essential for political stability and democratization in the Third World.

Reality: There is no significant relationship between economic development and either political stability or democratization. Nations such as South Korea have developed dramatically without significant progress toward democracy. Nations such as India have maintained relatively democratic and stable institutions without notable success in economic development. In some nations--for example, Iran--rapid economic development has brought with it political instability. And in some nations, such as Turkey, adverse economic conditions have provided an environment in which terrorism has flourished and emerging democratic institutions have been set back.

Perhaps there is a weak relationship between economic progress and political stability. If an economy stagnates and if unemployment is high, it is probably easier for opposition to be kindled, simply because idle hands are more likely to be mischievous ones.

Myth: The primary objective of Third World nations is to modernize their economies as rapidly as they can.

Reality: On the contrary, most Third World leaders have other goals and objectives. These include achieving greater national recognition and prestige in the international community; acquiring "modern" and "advanced" military equipment; pursuing ideological preferences; and agitating for international redistribution of income, rather than domestic economic growth.

If one looks at behavior rather than rhetoric, development is among the goals and priorities of most of the nations of the Third World, but not at the top of the list.

There is a paradox in all this: If development is accorded primary emphasis among national objectives, success seems to depend on imposing limits on the scope and character of government intervention. Few Third

World leaders are willing to let go the reins of control and unleash the market forces that can help their economies grow.

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