THE MAKING OF UNITED STATES INTERNATIONAL ECONOMIC POLICY

Principles, Problems, and Proposals for Reform

STEPHEN D. COHEN

Foreword by Paul Volcker

Fifth Edition

2000

PRAEGER

Westport, Connecticut
London

1 The Content of International Economic Policy

> Economic forces are in fact political forces. Economics can be treated neither as a minor accessory of history, nor as an independent science in the light of which history can be interpreted. . . . The science of economics presupposes a given political order, and cannot be profitably studied in isolation from politics.
>
> —E. H. Carr, 1939

This book examines, explains, and critiques the processes by which the U.S. government formulates and implements a series of measures collectively known as international economic policy. Before turning to these tasks, it is imperative to first explain fully and precisely what is being examined and why its unique nature creates a unique policymaking process. The implicit thesis is that international economic policy should be thought of as existing in a third dimension, not simply as a subset of either foreign policy or domestic economic policy. It is a separate, distinguishable policy that transcends its component policy sectors. The balancing act necessary to reconcile the frequently conflicting priorities of its internal and external elements is what gives international economic policy its substantive importance and unique character. This complex reconciliation act also presents decision-makers with unique procedural challenges.

"International economic policy" is a term infused with value judgment and one that is often misinterpreted. I have used the term throughout this book in lieu of the more commonly used phrase "foreign economic policy." I strongly believe that the former is the preferable term because in today's world, policymaking in this area must take account of too many questions of *domestic* economic and political policy to be considered "foreign." It increasingly is

formulated by agencies whose jurisdiction centers on domestic policy. International economic interdependence has blurred the dividing line between domestic economic performance and global economic trends. The term "foreign economic policy" connotes a subdivision of foreign policy and is, therefore, an oversimplification. International economic policy is best viewed as an integrated whole, defying simple classification as domestic or foreign. It should not be compartmentalized into either an international political or a domestic economic policy framework. Downplaying the expanding linkage between domestic economic policy management objectives and international economic relations is inconsistent with a full and accurate understanding of this book's subject matter.

Finally, it is critical not to make the error of equating international economic policy with its most widely recognized component, foreign trade. The former is an umbrella term encompassing many other important issue areas, such as international finance and assistance to poor countries.

DEFINITION AND SCOPE

International economic policies, in the broadest sense, are usually efforts by governments to modify the ways in which goods, services, and capital would otherwise flow across national boundaries if a completely free market situation prevailed. "Policy" in this case is a substitute for the laissez-faire (hands-off) option, that is, the government's choosing to do absolutely nothing to interfere with the outcome of free market forces. Most international economic policies adopted by a sovereign government represent political guidelines designed to limit or expand cross-border transactions in accordance with its collective perceptions of what is in the best interest of the country. These interventions take the form, among other things, of import barriers, export promotion efforts, grants to alleviate poverty in developing countries, and short-term loans to assist countries suffering severe capital flight or speculative attacks on their currencies.

Government officials in every country believe that most of the time they are a better alternative than the greed-driven market mechanism to assure that economic activities, domestic and foreign, are compatible with the national interest and well-being of the population at large. Even in the United States, policymakers justify their efforts to offset market forces by arguing that economic efficiency is not always the highest priority goal. National security or social stability may be deemed to be more important in any given situation. Furthermore, no government feels the obligation to ignore the instabilities associated with occasional "market failure." All governments are prepared to intervene when they perceive markets to be acting irrationally or verging on panic. (This explains, for example, official interventions in the foreign exchange market when currencies are gyrating wildly.)

A second broad definition of the nature of international economic policy applies to those less frequent occasions when it moves in the opposite direction. Governments periodically seek freer markets by negotiating reductions or elimination of governmentally imposed impediments to global transactions, namely, barriers to trade and restrictions on capital movements. A third broad definition applies to sporadic efforts to modify existing regulations of international markets. In this case, policy consists of negotiators pursuing agreements that would broaden the rules of the international trade, monetary, or investment systems and/or enhance the power of an international economic organization to interpret and enforce these rules.

An all-inclusive definition is that international economic policy is the aggregate of a country's ongoing efforts to deal with its disparate and multifaceted relationship with the world economy. It represents the sum total of actions by nation-states intended to affect the economic environment beyond their national jurisdiction. Such policy is a hybrid, combining elements of foreign policy with economic policy.

Sovereign governments constantly assess their precise needs, objectives, and values. International economic policies serve as important means to the end of achieving domestic and external political and economic goals that the official sector has determined would enhance the country's national interests. Whether invoked unilaterally, bilaterally, trilaterally, or multilaterally, these policies collectively set the agenda of economic relations among governments.

An optimum international economic policy expands a country's domestic economic strength, improves international political relations, and enhances global economic efficiency. All too often, however, it is an either/or case, and considerations of global efficiency are unceremoniously brushed aside by perceptions of domestic or international political necessity. First-best international economic policies are less common than second-best measures. All governments repeatedly bend to internal political pressures and provide economic benefits to narrowly focused but vociferous (and sometimes well-financed) interest groups at the expense of the long-term welfare of the general population.

Many criteria can—and should—be used to demonstrate the varied characteristics of international economic policies. Appreciation of the extent of the heterogeneity of substance is critically important to understanding the inevitability of a heterogeneous policymaking process. There can be no "one size fits all" decision-making procedure because there is no single form of international economic policy to be decided. The lack of uniformity in what is being considered necessitates modifications to policymaking dynamics.

One method of disaggregating the broad concept of "international economic policy" is to look at precisely which economic sector is being addressed. In most cases these policies are formulated to affect one of several defined "systems" that comprise the international economic order. The trade and monetary systems are the most important and the systems with the most clearly defined rules and obligations. More informal, abstract systems relate to international financial, investment, development, energy, and science and technology issues. A relatively new "quasi system" involves efforts by the major industrialized countries (the Group of Seven) to coordinate domestic monetary and fiscal pol-

icies to enhance international economic stability and efficiency. Sometimes multilateral coordination is replaced by (usually unsolicited) offerings of advice by one government to another on how to remedy alleged deficiencies in existing internal policies, for example, U.S. pressures on Japan in the late 1990s to adopt stimulative economic measures.

A second means of disaggregating international economic policy is to examine the two levels (at least in market-based economies) on which these policies operate. The first consists of government-business relations, a reflection of the fact that the vast majority of international economic activities originates in the private sector. Global commerce continues to grow in size and importance, from trade in goods and services (transportation, tourism, data transmission, etc.) to capital movements (bank lending, short-term speculative money flows, purchases and sales of foreign stocks and bonds, and long-term foreign direct investment). New international economic policies usually arise in response to market-driven changes in economic transactions, for example, increased trade in the information technology sector and the rising propensity of short-term private capital to flow massively into and then out of emerging markets.

Every sovereign government on the planet intrudes in international commercial relations, ostensibly on behalf of its citizens and businesses. As part of their larger agenda to promote the well-being of the citizenry, all governments on occasion implement policies to help the private sector to increase their exports. Official "enhancements" include encouraging currency depreciation, providing subsidized export credits, and making demands for reductions in foreigners' import barriers. In other situations, the objective of policy is to restrain the business community's natural impulse to pursue profits. This can be accomplished by imposing controls on currency outflows and on export shipments or by imposing import barriers.

None of these policies is formulated and implemented in a political vacuum. Most governments act to restrict imports only after having been on the receiving end of demands for protection by agitated companies or unions. Similarly, government officials usually make demands on foreign countries to reduce their import barriers only after having been prompted to do so by complaints from domestic farmers and companies who argue that their export potential is being curtailed.

The degree to which the aggregate economic interests of consumers and friendly countries can be ignored when politicians decide to enhance the wealth of special interest groups is underscored by the barriers imposed on U.S. sugar imports. American consumers are forced to pay approximately twice the world market price for sugar as the result of the government's ongoing desire to reward a handful of large and a few thousand small domestic producers with artificially high prices.

The second level of international economic policy activity is formal government-to-government consultations. Issues that touch directly on national sovereignty or on national security—coordination of domestic macroeconomic

policy, international monetary reform, imposition of economic sanctions on countries deemed to pose a military threat, and so on—are handled by confidential negotiations among senior officials with little or no input being solicited or received from the private sector.

A third means of diagraming differences in international economic policies is to differentiate at least five different generic kinds of policies:

- long-term initiatives, such as proposing a new round of global negotiations to liberalize foreign trade flows or amendments to the articles of agreement of an international economic organization;
- quick response reactions, such as emergency assistance to a country facing mass starvation or an explosive financial crisis;
- maintenance of the policy status quo, such as rejecting an industry's request for the imposition of import barriers or calls to strip China of its most-favored-nation trade status;
- implementation of incremental policy, such as by making additional demands on China and Japan to further open their markets to U.S. goods; and
- administration of legislatively established programs, wherein policymaking by the U.S. executive branch is unusually circumscribed.

Decisions associated with the administration of international economic programs belong to a distinct stratum of policymaking. Policies are abstract articulations of national goals, whereas programs consist of relatively concrete procedures that are designed to achieve these goals. Foreign aid is a means to the policy-mandated end of helping poorer countries to develop. The escape clause and antidumping laws equate to programs that serve the policy goal of providing avenues of relief to the private sector from the adverse impact of import competition. Export promotion measures help realize the goal of increasing overseas sales of goods and services.

When administering programs, the U.S. executive branch more often than not is simply enforcing congressionally passed statutes. In a literal sense, there may be no policymaking. For example, detailed language instructs the executive branch as to how it investigates accusations that foreign companies are dumping, that is, selling goods in the United States at less than fair value, and how it determines whether such actions are injuring American producers. If both dumping and injury are found to exist, the administration has no choice about what to do next: the law unequivocally mandates imposition of dumping duties equivalent to the estimated margin of dumping of the product in question. Detailed legislative language also spells out the standards of behavior that countries must meet in order to be eligible to receive U.S. foreign aid.

In addition to these procedural criteria, policies affecting international economic relations can also be differentiated according to the relative substantive mix between the economic and political components of a policy action. Decisions on issues that are highly politically charged in the domestic or international

spheres obviously require careful consideration at a senior level. Political sensitivity is inescapable in those trade actions that would profoundly affect income distribution, either by restricting imports or by subsidizing a domestic industry targeted for development.

Policy decisions that are relatively non-politicized and technical in nature can be determined by a limited number of officials mostly, not exclusively, on their economic merits. Since policymaking is an inherently political process, no decision can be made that is 100 percent free of political overtones. The Basle Concordat (which sets out complex international standards for banking regulation) and criteria for determining whether "disorderly" trading conditions requiring intervention exist in the foreign exchange markets are two examples of relatively apolitical decisions dominated by a handful of economic specialists. Within the realm of foreign aid, the political-economic mix of decision-making can differ significantly. Determination of which countries get how much money would be a highly political exercise; evaluations of specific projects would be technical in nature; and the provision of emergency disaster aid would mainly be a simple humanitarian gesture.

A final means of disaggregating international economic policy decisions is to plot a vertical axis for ranking policies in a hierarchy based on importance and impact. They run the gamut from high-visibility, high-impact issues that attract the active attention of presidents and prime ministers, through important issues requiring decisions at ministerial level, down to issues that are so technical or narrowly focused that they are dealt with at the working level in the bureaucracy.

At the very top of the hierarchy are broad statements of principle about the desired nature of the systems comprising the global economic order: support for a floating exchange rate system over a fixed rate system or for a liberal trading system in lieu of protectionism. Approving financial aid to Russia or retaining most-favored-nation status for China requires presidential attention. Examples of decisions at the "second layer" of importance include efforts to help Mexico and Brazil deal with their debt crises in the 1980s and requests of Congress to extend the so-called fast-track negotiating authority. Modification of the language in an existing international tax treaty or approval of a small rural development grant to a non-strategic country would exemplify relatively pro forma decisions handled at the office level by a few technical specialists.

THE INTERPLAY OF ECONOMIC AND POLITICAL THEORIES

If the first step in understanding the process by which the United States makes international economic policy is appreciation of the heterogeneity of the policies being formulated, the second step is appreciation of the complex interrelationship of economics and politics in the policies being formulated. If the reader will excuse an old cliche, the economic contents of most international economic issues can be equated with the visible but relatively small tip of an iceberg. Political considerations subtly extend well below the "sea level" of these issues, even in the arcane sector of international monetary relations.

The process of making international economic policy centers on perceptions, value judgments, the setting of priorities, the making of choices, and the distribution of wealth. At the very heart of most economic policy decisions is the question of equity versus efficiency. Whether to emphasize social fairness or economic efficiency raises the very basic question of the extent (if any) to which government intervention in international economic relations is desirable. All of this is the stuff of politics—even if the vocabulary of economics dominates the discussion.

Political forces do not produce foreign trade flows. The latter usually develop from basic economic considerations: relative efficiency and the pursuit of profits. Cross-border capital flows are influenced by political conditions in countries, but they mostly originate from private financial calculations. Economic, not political, forces dictate the consequences of misaligned currency exchange rates as well as the implications of a country's failure to come to terms with a structural balance of payments deficit. Nevertheless, there probably has never been an instance in which an important international economic policy decision was made solely on the basis of an econometric calculation. At least some subjective criteria are inevitable when governments decide to respond to inward and outward flows of goods and capital. International economic policy substance can be considered the end product of a political process based on debate and compromise.

National security and domestic economic well-being are goals so highly prized by governments that each has generated a large bureaucracy operating in these two separate realms. Both the foreign policy and the economic policy agencies rightly view international economic policy as part of their jurisdiction because it affects their "constituency." Economics has become a central component in world politics, and economic strength is widely recognized as having become part of a broader definition of national security. International economic policies are directly related to the foreign policy objective of fostering the type of international environment that is most conducive to the physical and ideological well-being of that nation. At the same time, these policies directly affect the basic objectives of domestic economic policy management: growth, full employment, and price stability. As explained in the next chapter, the external sector of a country's economy is an increasingly important variable in the performance of the national economy. How well the latter performs regularly determines outcomes of national elections, so political leaders are interested in global economic events.

The growing impact of international economic relations on a country's pursuit of both internal and external goals creates the situation whereby conflicting domestic political pressures, domestic economic policy objectives, and foreign policy priorities are forever being reconciled by the juggling act that typically characterizes the international economic policymaking process. The latter is in-

trinsically concerned with the core substance of other policy areas. International economic policy is not a completely independent phenomenon. However, its unique mandate to reconcile a number of critical national priorities means that it is more than a subsidiary of domestic economic and foreign policies.

Analyses of international economic relations frequently suffer from the "two-cultures" syndrome. Many political scientists analyzing this policy sphere do not look beyond political concepts such as struggles for power and value maximization. An excessive tilt towards the political element ignores important economic considerations. For example, a liberal trade policy may not be appropriate to all countries at all times. If a country with a structural trade deficit has depleted its monetary reserves and cannot attract additional capital inflows from abroad, it must reduce imports to a level it can afford. A reduction in imports in such circumstances is not considered protectionism or a political sellout to domestic interest groups.

Most American economists analyzing international economic relations also display professional myopia. In their search for optimum efficiency, they tend to dismiss political constraints and social factors as shallow aberrations or boring anachronisms that eventually will be swept aside by the irresistible logic of good economic theory.

Put simply, politics is about the determination of who gets what, when, and how. As such, the political process is an exercise in maximizing power, influence, prestige, and, last but not least, wealth. A number of competing theories have arisen to explain the actions of national political leaders in setting the national agenda, passing laws, administering programs, and determining spending priorities. General interest democracy, pluralist bargaining among competing special interest groups, actions of elites, bureaucratic politics, and rational choice have been used as models to explain how the U.S. government works. All are necessary but not sufficient concepts for explaining how U.S. international economic policy is made.

Economics deals with the production and distribution of limited supplies of goods and services amid unlimited demand. A body of international economic theory has evolved from basic domestic economic theories. At the heart of both internal and external theories are such principles as the need for correcting a structural economic disequilibrium. International economic theory per se deals with the systems comprising the global economy. It includes ideas on why free trade is the optimal form of international commerce, the balance of payments adjustment process, and the means to accelerate economic development in less developed countries (LDCs). Parts of international economic theory are arcane. Some, being more than 200 years old, are of debatable relevance to contemporary international business transactions.

In sum, the international economic policymaking process in the United States and other countries is ultimately the byproduct of the interplay between political needs and economic objectives at both the internal and external levels. Policymakers must tread a fine line between being responsive to public opinion at home and not alienating friendly countries with overly aggressive economic policies. The net result is that an interdisciplinary approach is absolutely necessary for understanding how decision-making works. The body of knowledge accumulated in both economics and political science needs to be applied to the subject matter of this book. This approach gives appropriate attention to the theory of the "second-best," wherein political necessity prevents the selection of optimal economic measures calculated to give "first-best" economic results.

The mix between economics and politics is also evident in heated discussions regarding the most widely accepted international economic theory. Free trade based on comparative advantage creates a situation in which *all* countries gain from the increased efficiencies and output associated with an international specialization of labor based on relative efficiency. Some theoreticians have recently criticized the validity of this hallowed concept. They argue that many assumptions of the theory of free trade (e.g., constant or diminishing returns to scale) have become obsolete in an era of high technology and that a country is better advised to *induce* competitive advantage through supportive economic policies and knowledge creation. The long-running debate concerning the wisdom of the United States' maintaining a free trade posture despite the allegedly unfair and nonmarket trade practices of Japan and other countries involves a subjective clash of economic perceptions that is inherently political.

Decisions about specific foreign aid programs are another example of the interplay of economics and politics in international economic relations. Some bilateral U.S. foreign aid programs have been designed to meet national security interests and placate domestic interest groups. By way of example, neither the form nor the amount of aid given to Israel has noticeably changed for many years, despite the increasing prosperity of that country. Conversely, the nature of U.S. development assistance strategy in most LDCs was radically revised in the mid-1970s after growing empirical evidence that it was not generating adequate economic development. The old emphasis on erecting a modern industrial infrastructure in LDCs failed to produce the expected "trickle-down" benefits to the population as a whole. As a result, Congress rewrote U.S. foreign aid legislation to provide for a new "bottom-up" bilateral development approach that emphasizes such basic targets as agricultural productivity, education, health, and nutrition.

A DISTINCT PHENOMENON

International economic policy is a distinct phenomenon. Neither by process nor substance is it exclusively the economic branch of foreign policy. Nor is it exclusively the external dimension of domestic economic policy management. International economic developments have profound internal effects on every country, and they have an impact on external relationships among sovereign countries. Senior decision-makers sometimes assign the highest priority to foreign policy concerns. However, by definition, international economic policy also

touches on the interests and activities of domestic citizens and organizations. Decision-makers at other times will deem it appropriate to give priority to purely internal needs and objectives.

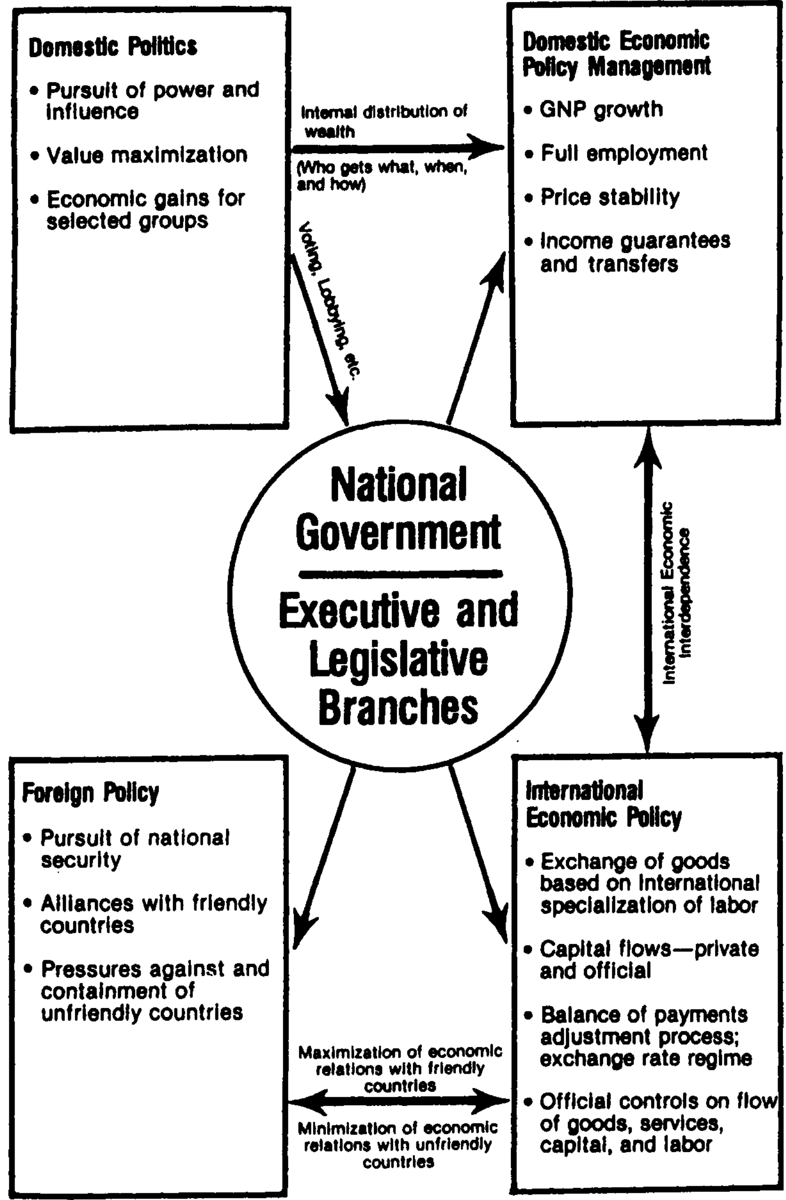
International economic policy, therefore, is a complex and constantly shifting blend of domestic policies, foreign policy, and global economic considerations. It does not fit entirely into any narrow compartment. An entity unto itself, it has its own rules, characteristics, and idiosyncrasies. International economic policy is greater than the sum of its parts. Most importantly, its dualistic nature means that in every country this policy must serve two bureaucratic masters: the domestic economic policy management apparatus and the national security network. Significantly, these are the two most important bureaucracies in the modern nation-state.

When viewed in context, international economic policy can be compared to a strategically situated four-way intersection where very important policies converge. Feeding into a single focal point are domestic political and domestic economic concerns as well as external economic and foreign policy priorities. Policymakers "direct traffic" by subjectively establishing priorities among these four concerns. International economic policy is not an independent phenomenon; it is a composite of other policies. It is unique in that it must simultaneously reconcile economic and political issues, on one level, and external and internal needs, on another. That international economic policymaking, at least among the major industrialized democracies, is an extraordinary balancing act that must accommodate potentially conflicting objectives and perspectives is graphically suggested by the flow chart in Figure 1.1.

The depiction of international economic policy as a distinctive phenomenon involving the reconciliation of usually conflicting priorities of global concerns and domestic economic policy goals has major implications for the procedural, or decision-making, function. The context in which this policy operates is rife with the pursuit of competing, yet perfectly legitimate and perhaps equally reasonable, value judgments. The result is a two-cultures situation. Some advocates want to give top priority to foreign policy considerations because they view international economic policy as being mainly the economic aspect of the pursuit of a stable, friendly, and prosperous global environment. Hence, economic considerations should be subordinate to the primary objective of good relations with other nations. The implication of this viewpoint is that primary responsibility for formulating international economic policy should be in the hands of the national security apparatus; in the United States, that would be the State Department and the National Security Council (NSC).

The second school takes the internal perspective. It attaches top priority to pleasing and strengthening domestic constituencies through a variety of means; they include increasing and protecting jobs, assisting companies and farmers to become more internationally competitive, and retaliating against foreign countries that impose restrictive import barriers. Defining international economic policy as primarily the external dimension of domestic economic policy suggests

Figure 1.1
Flow Chart of International Economic Policymaking



that primary jurisdiction should reside in ministries with domestic economic policy responsibilities, for example, the Treasury and Commerce departments.

Both schools of thought are too narrow and, therefore, inadequate. International economic policy is not an either/or choice between foreign policy and economic objectives. It is both. To approach policy formulation by consistently giving one viewpoint dominance would produce skewed policy. "Sensible" international economic policymaking must forever walk the tightrope between the conflicting priorities and values associated with domestic politics, domestic economics, international politics, and international economics.

On a case-by-case basis, and with no permanent guidelines to steer by, the decision on which way to tilt—internally or externally, or politically or economically—is often the essence of the international economic policymaking process. For example, the Clinton administration in 1999 faced a difficult balancing act in deciding how to respond to the onslaught of Russian-made steel that allegedly was being dumped in the U.S. market. Imposition of prohibitive antidumping duties would have blocked further steel imports but deprived the Russians of much needed foreign exchange and possibly destabilized their already shaky economy. However, forcing U.S. steel companies and workers to endure long-term financial hardships from unfair trade practices by America's former cold war rival would have sparked an ugly domestic political backlash. (The issue was resolved by compromise when the Russians responded to U.S. pressure and agreed "voluntarily" to reduce the volume of their steel exports.)

A near-perfect example of the four-fold dynamics of international economic policy formulation was provided by President Ronald Reagan's summer 1986 decision to allow the Soviet Union to purchase some four million tons of U.S. wheat at subsidized prices. The immediate issue was whether to put at risk hundreds of millions of dollars of potential U.S. grain exports by not responding to foreign price competition. The European Union was offering substantial discounts from world prices to the Soviets in order to shrink the massive wheat surplus that had accumulated in Western Europe.

U.S. foreign policy considerations clearly argued *against* the "double whammy" of subsidizing the consumers of a cold war rival while simultaneously offending the friendly wheat-exporting countries (Canada, Australia, and Argentina) that did not want a costly international agricultural price war. Domestic considerations, however, clearly argued in *favor* of providing governmental export subsidies. The then-faltering Midwest farm economy and the then-impending election struggle to retain Republican control of the Senate suggested that a heavy domestic political price would be paid for depriving U.S. farmers of a large, profitable export sale because of national security concerns. The president resolved the not-unexpected schism among his advisers by subordinating his usual tough Soviet stance to his desire to curry favor from the American farm community.

Another example of the four components of international economic policy existed throughout the 1990s in the form of a long-running debate over the relative merits of continuing to extend most-favored-nation (MFN) tariff treatment to China. The debate boiled down to the question of which was more likely to achieve U.S. objectives: providing or denying China the low tariffs associated with MFN status while that country failed to modify a number of social, economic, and national security policies that angered the U.S. government. Within the American political scene, civil rights activists who wanted to apply maximum pressure to force the cessation of repressive Chinese actions clashed with the business community, which advocated "constructive engagement" because it stood to be hurt financially from a downgrade in China's trade status. American importers, facing the prospect of prohibitive duties on the goods they were bringing in from China, warned of the adverse impact on U.S. consumers. Even before China threatened to retaliate with its own increases in import barriers, American exporters of aircraft, agricultural products, etc., argued that the costs to the American economy of denying MFN status would be prohibitive.

Opinion remains divided over whether a hard-line U.S. policy or a non-threatening stance was more likely to induce China to back down and modify the targets of U.S. demands: human rights violations, arms exports (including missiles), unfair trade practices, threats against Taiwan, etc. There is still no definitive answer to the question of how best to nudge Chinese behavior in the direction of American values. The Clinton administration ended the uncertainty by deciding that MFN status would not be terminated and official threats to that end would be muted.

UNIQUE ASPECTS OF U.S. INTERNATIONAL ECONOMIC POLICY

The nature of the international economic policies implemented by the United States since 1945 has been uncommonly distinctive from those of other countries. One source of this distinctiveness is the unique system of government at work in Washington. It features an unusually influential chief executive, supported by a very large number of personal advisers, whose ability to implement these polices is nevertheless heavily dependent on decisions made in the legislative branch.

The other generic source of idiosyncratic policy behavior is a trio of extraordinary economic and political factors that for more than half a century has collectively forged unique U.S. national priorities and attitudes. The first is that the U.S. economy is less sensitive to the vicissitudes of foreign trade flows than any other industrialized economy. One reason for this situation is a simple statistic: compared to all other countries, imports and exports represent a relatively small percentage of total U.S. economic output (gross domestic product). *Total* employment is therefore only marginally affected by trade.

The U.S. economy also has an unusually wide buffer between its domestic and external sectors because the U.S. government studiously avoids economic

planning. This means that unlike most of their foreign counterparts, U.S. policymakers do not view trade policy as a tool for use in achieving the larger goals of domestic industrial policy. Most policymakers in Washington, D.C. share the benign American attitude that imports are something benefiting the consumer, not something inhibiting the emergence of an industry targeted for development. Official Washington pays lip service to the idea of export expansion. However, it is not a sufficiently urgent priority that senior politicians would seriously consider promoting exports at the price of abandoning foreign policy or humanitarian objectives, giving preferential financial assistance to a small group of companies, or waiving antitrust and other regulatory provisions.

Second, U.S. international economic policy can never be totally conventional as long as the U.S. dollar serves the extraordinary role as the world's principal reserve and transactions currency. Since World War II, the United States has been the only country that can pay for *all* of its import needs by using its own currency. Every other country must rely primarily on exports to earn the foreign exchange necessary to pay for imports. The bottom line is that the substance of U.S. foreign trade policy reflects the fact that it is the least likely country in the world to observe a bumper sticker warning citizens to "Export or Die." Foreign trade does not permanently occupy a prime spot in the contemporary American psyche.

A third factor contributing to the unique profile of U.S. international economic policy has been the extraordinary role for the last half of the century of the United States in world affairs, first as leader of the free world and then as the world's lone superpower. The singularly broad global vision accompanying this status has produced an unusually frequent subordination of domestic considerations to geopolitical factors. This has manifested itself in the United States' taking the lead in promoting multilateral efforts to reduce trade barriers, an unusually tolerant acceptance (until the 1980s) of overseas barriers to American goods, and an extraordinarily high propensity to impose economic sanctions on dozens of countries in retaliation for what is deemed unacceptable political, military, or humanitarian behavior.

The U.S. government is no longer obsessed with being the chief military protector of the free world against incursions by the Soviet bloc. However, it is still fascinated with the prospect of exercising its considerable power and influence to create a world order consistent with its liberal political and market-based economic values. By comparison, the international economic policies of the rest of the world have more inward-looking and regional orientations. Enhancement of domestic prosperity is a much more pervasive theme in their international policies. To promote domestic growth and employment, most other governments expend far more resources than the United States in providing export loans at concessional rates, extending subsidies and import protection to stimulate favored industrial sectors, and so on. The "Plowden Report" of 1964 surveyed the entire purpose and structure of the British diplomatic service and concluded:

> The survival of Britain, let alone her influence, depends on trade. The work of our representatives overseas must be increasingly dedicated to the support of British trade. Economic and political motives intertwine throughout our foreign policy and have always done so; but economic and commercial work has now assumed a position of fundamental importance. It must be regarded as a first charge on the resources of the overseas Services.[2]

The perspective of a country with the global interests of the United States perforce must be broader. Policy reflects purpose. The purpose of U.S. international economic policy "is not simply to defend but to construct, not simply to react to events in a world which others shape but to initiate so as ourselves to shape a world order in which we can live peaceably and prosper," Anthony Solomon has written.[3]

HISTORICAL OVERVIEW

The first manifestation of a cohesive, interactive U.S. international economic policy did not appear until the 1930s. Before then, the U.S. government paid little attention to matters involving the world economy. On those occasions when it was forced to do so, "it played a lone hand without much regard for the interests of other countries."[4] No grand U.S. design for the international economy existed, mainly because the United States was not yet an important enough economic power to need or warrant an ambitious agenda. Amidst a philosophy based on economic nationalism and isolation, there was little vigorous or ongoing pursuit of specific policy objectives in economic relations with foreign governments.

The first sign of change came in the realm of trade relations. For the first 140 years of the Republic, that which passed for U.S. trade policy was minimalist. From the earliest years of its existence, the Congress had listened to the demands of domestic interest groups and unilaterally established the U.S. tariff schedule to protect key constituents. U.S. tariffs were relatively high and inflexible. The interests of exporters mattered little. Since it had minuscule discretionary tariff-setting authority, the administration did little more than passively collect tariffs. Statements were occasionally issued to criticize certain restrictive foreign practices to which the United States objected, for example, the British system of imperial preferences within the Empire.

A historic turning point occurred in 1934 with the passage of the Reciprocal Trade Agreements Act. This landmark legislation authorized the first meaningful transfer of authority to reduce tariffs from the legislative to the executive branch. The State Department thereupon set out to reverse the Depression-era surge in protectionist measures around the world by negotiating bilateral, reciprocal tariff-cutting agreements within the limits authorized.

The short leash provided by Congress notwithstanding, the statute did represent the beginnings of a calculated effort by the executive branch to influence

international trade relations as a means to the end of achieving domestic economic and foreign policy objectives. The driving force behind the legislation, the then–Secretary of State Cordell Hull, believed that a direct relationship existed between an open international economy and a peaceful, cooperative world political order. For practical reasons, however, the immediate objective of the newly established Trade Agreements Program was marketed to Congress as a part of the New Deal stimulus package. The anticipated net boost to exports from foreign trade liberalization was promoted as a further means of dragging the American economy out of the depths of the Depression, not as a means of making cheaper imports available to consumers. The next six years of U.S. international economic policy were devoted to bilateral tariff-cutting negotiations, with 28 agreements being successfully concluded. By 1941, the clouds of war had reappeared. Economic policy objectives were quickly subordinated to achieving victory: resources were to be denied to the enemy and provided to allies.

An activist, comprehensive U.S. international economic policy that ventured beyond tariff-cutting negotiations was one of the many far-reaching changes produced by World War II. Prior to 1945, the United States had no ambition to be a political-military superpower; it preferred an isolationist foreign policy. Prior to 1945, the dollar was not the linchpin of the international monetary system; the U.S. balance of payments experienced the same constraints as other countries. Except in South and Central America, the LDCs were mostly colonies of European nations, and no permanent U.S. foreign aid program existed. A growing number of U.S. corporations were operating on a multinational basis, but not on a scale large enough to cause any dramatic impact, meaningful controversy, or need for official policies on foreign investment. Widespread controls severely limited the movement of international capital so that there was infrequent need for policies to deal with destabilizing capital flows.

A permanent leadership role for the United States in the international economic order was inevitable once superpower status was thrust upon it, initially because of its relative economic strength and later because of its military power. The first fruit of American economic leadership was the 1944 Bretton Woods Agreement. It contained the blueprints for key structures—the International Monetary Fund and the World Bank—that would be created once the postwar international economic order was inaugurated. By the late 1940s, the perceived urgency of strengthening the free world and containing Soviet power led U.S. officials at the highest political levels to chart a new global strategy. The United States would use the bountiful resources of its large, strong, and undamaged economy to help finance the rebuilding of the war-shattered economies in Western Europe and Asia (mainly Japan) that remained outside the communist bloc. An implicit bargain was struck. The relatively import-impervious American market would remain wide open to the exports of Western Europe and Japan, and they in turn would follow the U.S. lead in waging cold war.

Postwar U.S. international economic policy has passed through two distinct stages.[5] For nearly 25 years after 1945, U.S. policy was overwhelmingly designed to maximize and accommodate national security needs. Widespread economic destruction in Europe and Asia meant that in the initial postwar period, the U.S. economy, a veritable colossus amidst economic weakness, could easily absorb imports at the same time it could afford to accept temporary foreign discrimination against American goods. More than any other country, the United States pushed for multilateral tariff-cutting negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT), which took effect in 1948. Going one step further, U.S. negotiators until the 1960s were generally willing to concede greater tariff reductions than they demanded, a reflection of the asymmetric distribution of economic power that characterized the early postwar years.

There was little opposition to the proposition that the United States could also afford what was up to then the world's largest foreign aid program by far: the multibillion dollar Marshall Plan to help finance European economic rebuilding. (A separate aid program operated in Japan.) Furthermore, the costs to the United States of the balance of payments deficits that it began incurring in 1950 were minimal.[6] European countries with surpluses eagerly held onto their newly acquired U.S. dollars to build private bank accounts and replenish their governments' monetary reserves. Even the propensity of other countries to periodically devalue the exchange rate of their currencies in order to enhance national competitiveness was of little concern to Washington at this time.

The bottom line calculation was simple. All of these costs constituted a very small economic price to be paid for the far greater political benefits of encouraging restoration of economic prosperity and political stability in the noncommunist world. Furthermore, in the U.S. government's thinking, magnanimity in helping friendly countries to rebuild served to promote a liberal, market-based international economic order that would prevent repetition of the disastrous beggar-thy-neighbor policies of the 1930s.

International economic policy, in short, served foreign policy objectives. Since attention to national security priorities caused no real damage to the U.S. economy through the mid-1960s, there simply was no conflict between "good" foreign policy and "good" international economic policy. Attaining a consensus definition of the U.S. national interest in the initial postwar era was relatively easy. The unprecedented rates of sustained, non-inflationary growth that constituted what became known as the "golden age" of the world economy confirmed U.S. officialdom's confidence in the wisdom of their master game plan.

When they first begin, even massive turnarounds in broad economic trends are usually not detectable. With 20/20 hindsight, we now know that convergence in the relative economic strength between the United States and Western Europe and Japan had subtly, quietly began to build up a full head of steam in the 1960s. Undisputed U.S. hegemony and the very skewed balance of power in the immediate post–World War II period had been transitory phenomena, not a natural or permanent state of affairs. Not until the onset of the 1970s were the

effects of this massive shift fully visible, most notably in the long descent of the large U.S. merchandise trade surplus into deficit. With little forewarning, an entirely new era of U.S. international economic policy had arrived.

International economic policymakers and institutions were slow to cope with the speed and severity of unfolding structural changes associated with the ongoing economic resurgence of Western Europe and Japan. To compound the pressures engendered by these changes, isolationist urges in the United States, fueled by popular discontent with the war in Vietnam, had begun to resurface. The burden of acting as the world's "policeman" had brought considerable disenchantment within the United States about its role in world affairs. In addition, President Johnson's refusal to pay for the costs of fighting the war through higher taxes led to relatively high rates of U.S. inflation. This trend accelerated the inevitable decline in relative U.S. industrial competitiveness. The international monetary system by 1970 was being stretched to its breaking point by the chronic balance of payments surpluses of several West European countries and growth in the chronic U.S. balance of payments deficits. Ironically, a significant cause of the deteriorating U.S. economic position, aside from internal mistakes, was the very success of the U.S. external policy priority of restoring the economic vigor of its major trading partners.

Slowly but steadily, the suspicion spread among Americans that the international economic order was now working against them. Many Americans felt that their country was no longer able to "hold its own" in global competition. Edward Fried eloquently described the resulting sense of malaise:

> The United States grappled with a stubborn inflation, a deteriorating position in foreign trade, high defense costs, and, beginning in 1969, serious unemployment. Its balance of payments deficit, chronic though reasonably stable for two decades, suddenly grew much larger and became subject to alarmist interpretations. Western Europe and Japan, on the other hand, were characterized by prosperity, continuing balance of payments surpluses, strong foreign trade positions, and comparatively low defense costs. . . . Did not this contrast between the United States and its once economically prostrate industrial partners mean that there was something "unfair" about the ground rules governing our foreign economic relations and something misguided about our foreign economic policy? Was the United States not over-emphasizing the importance of foreign relations in foreign economic policy and thereby paying a heavy economic price?[7]

These questions all were answered in the affirmative when, on August 15, 1971, President Nixon announced what he called the New Economic Policy (NEP).[8] This monumental shift in U.S. economic philosophy can be compared to the swing of a giant pendulum away from a foreign policy–dominant U.S. international economic policy towards a middle ground where domestic interests were no less than an equal partner. What was once the unquestioned priority of cultivating a global environment consistent with U.S. values was pushed aside. The most pressing short-term need was deemed to be restoration of U.S. balance of payments equilibrium through the draconian measures of terminating dollar-gold convertibility (to induce an exchange rate realignment) and imposing a 10 percent tariff surcharge (to encourage reduced trade barriers in other countries). No national security adviser was invited to attend the historic weekend meeting at Camp David when the NEP was quickly crafted and the world economic order was changed forever. In the wake of the decisions made there, an international monetary system based on fixed exchange rates would be effectively ended. The trading system was merely given a severe jolt in the short term by the protectionist act of the leading champion of liberal trade.

The era of "foreign policy imperative" in U.S. international economic policy was over. The rise of U.S. economic problems and the decline of the communist threat to Western Europe and Japan sealed the shift to a new era. That the policy center of gravity had shifted inward in 1971 was vividly demonstrated by the ultra hard-line negotiating strategy pursued by the then–secretary of treasury, John Connally. He effectively ran U.S. international economic policy in the period following the New Economic Policy and saw his mandate as correcting U.S. economic problems, not accommodating the demands and sensitivities of other finance ministers.[9]

From the 1970s through the present, the cumulative record of U.S. international economic policy has been neither dogmatically universalist nor nationalist. Generally speaking, decision-makers have sought a "happy medium" between domestic and external priorities on a case-by-case basis. U.S. policies were generally outward-looking, seeking to liberalize trade barriers or to calm unstable international financial markets. However, domestic economic and political interests were ignored or overruled in few instances—a situation related to the increased presence of Congress in an increasingly politicized U.S. international economic policymaking process.

Beginning in 1973, a continuing onslaught of international financial shocks forced much of U.S. policy to be reactive, that is, it sought to contain unanticipated disruptions that posed an immediate threat to world economic stability. Washington seldom had the luxury of formulating proactive international financial policy in advance. The sudden permanent collapse of the fixed exchange rate system in 1973 necessitated establishment of a new set of rules and arrangements to operate a floating rate system. The swift and large rise in oil prices later that year, commonly referred to as "the first oil shock," produced global inflation, an economic slowdown among oil importing countries, massive strains to the international monetary system, and a frenzied search for palliatives.

Just as stability was returning to the international economy, the Iranian revolution triggered the second oil shock in 1979. To break the back of the double-digit inflation that resulted, central banks in the industrialized countries unleashed extremely tight monetary policy. This action did succeed in lowering inflation. Unfortunately, soaring interest rates also triggered two major crises: (1) the worst worldwide decline in economic growth since the Depression and (2) an external debt crisis among LDCs that slashed their growth rates and put

the international banking system at risk when they could no longer service their debts.

When the ramifications of the United States' adopting "Reaganomics" materialized, international economic relations hit another turning point. Despite the prophesies of supply-side economists, the slashing of tax rates and a sharp increase in defense expenditures produced a surge in the federal budget deficit. This led to relatively high real interest rates in the United States, which in turn was a major factor in causing the unprecedented overvaluation in the dollar's exchange rate. The end product of this chain reaction was the ballooning of the U.S. trade deficit that continued into the late 1990s. Record-shattering trade deficits failed to elicit the old-fashioned protectionist trade policies that might have been expected. Instead, U.S. trade policymakers opted to correct the trade deficit through increased exports. The specific means chosen to foster this increase was pressuring trading partners to provide "reciprocity," meaning that American goods should be granted the same access to overseas markets as foreign producers have to the allegedly open U.S. market (see Chapter 10). The commitment of recent administrations to export expansion, however, has been limited by a common policy inconsistency. All of them readily resorted (or were required by legislative dictum) to the use of export controls as a means of expressing dissatisfaction with undesirable foreign behavior.

The very inexact science of seeking the right balance between external and internal goals produced a heterogeneous series of policy initiatives in the 1980s and 1990s. The U.S. government during the 1980s continued to make numerous anti–free trade demands on other countries, mostly the rising export powers in Asia. U.S. trade officials convinced them to "voluntarily" restrict their exports of automobiles, steel, textiles and apparel, televisions, and so on to the American market. Quite a different policy emphasis prevailed in the 1990s. The United States was in the forefront of promoting regional free trade agreements in the Western Hemisphere and the Pacific Basin and in pushing for a successful conclusion of the Uruguay Round of multilateral trade negotiations.

When Japan's industrial sector seemed poised to push the U.S. economy into permanent eclipse in the late 1980s, public opinion polls showed more Americans believed that Japan, not the Soviet Union, was the greatest threat to U.S. national security. The "Japanese challenge" elicited unusually intense U.S. demands that Japan further open its market. It also precipitated heated domestic discussions about the efficacy of a radical departure in American economic ideology: dropping traditional reliance on market forces and emulating the Japanese model of government-business collaboration via industrial policy. Domestic economic policy debates began to merge with external economic policy concerns like never before, leaving no clear delineation between the two (see Chapter 11).

The pace of dramatic, unanticipated shifts in the international order intensified in the 1990s. Within months after starting the decade burdened by self-doubts about the future of their country, Americans watched in pleasant surprise the

unfolding of U.S. triumphalism. First, the Soviet Union imploded. This caused complications for policymakers by eliminating the defining element of post–World War II U.S. foreign policy strategy. As the cold war faded into history, U.S. international economic policy could be made with less worry about the need to financially support troubled countries lest they go over to "the other side." Second, downsized industrial sector companies, a booming information technology sector, and an economy enjoying steady, inflation-free growth put the United States on an upward trajectory, just as a slow-growth Japanese economy with a crippled banking sector was on a sharply downward trajectory. As the world's lone superpower, whose visions of capitalism and democracy were spreading throughout the planet, the United States was exerting economic and military power and cultural influence on a scale that perhaps exceeded even the extraordinary level of the late 1940s.

The American public allowed itself only a brief period of rejoicing. On the political-military side, concern grew about threats of terrorism and rogue countries possessing weapons of mass destruction. In the late 1990s, two significant challenges emerged to the continued pursuit of a liberal international economic order. First, an unforeseen protest against the process of "globalization," specifically its impact on relatively less skilled American workers and on the environment, was launched on a number of fronts in the public and private sectors. The second challenge took the form of a sudden disillusionment by some with free markets in general and free movements of international capital in particular (see Chapter 12).

The velocity and crushing volume of private capital outflows from LDCs, first from Mexico in 1994–1995, then from East Asian countries in 1997–1998, and the failure of market reforms to take hold in Russia suggested to some that developing countries should reject the U.S. model and move back toward increased government controls over economic activity. The intense worldwide controversy concerning the lending practices by the International Monetary Fund (i.e., whether they were disastrously restrictive or excessively generous bailouts) symbolized a divisiveness even among economic specialists as to how to deal with the spreading contagion of market instability.

NOTES

1. Benjamin J. Cohen, *American Foreign Economic Policy* (New York: Harper and Row, 1968), p. 10.
2. "Report of the Committee on Representational Services Overseas" (London: Her Majesty's Stationery Office, 1972), p. 3.
3. Anthony M. Solomon, "Administration of a Multipurpose Economic Diplomacy," *Public Administration Review* 24 (November–December 1969): 585.
4. Richard S. Gardner, *Sterling-Dollar Diplomacy* (New York: McGraw-Hill, 1969), p. 1.
5. As suggested in Chapter 12, it is possible that U.S. international economic policy

entered a third stage in the late 1990s, when it began to focus on reducing the alleged damage wrought by "globalization."

6. The U.S. balance of payments deficits through the 1960s were caused by large net capital outflows from the federal government and the private sector that exceeded the surpluses in the trade account.

7. Edward Fried, "Foreign Economic Policy: The Search for a Strategy," in *The Next Phase in Foreign Policy*, Henry Owen and Morton Halperin, eds. (Washington, D.C.: Brookings Institution, 1973), p. 161.

8. The New Economic Policy was focused primarily on domestic economic problems associated with stagflation. Wage and price controls were the most significant component of the policy package.

9. By unleashing market turmoil that forced countries to let their exchange rates float, the New Economic Policy produced considerable instability and uncertainty in the foreign exchange markets. Secretary Connally for many weeks rejected European and Japanese pleas for a quick agreement to re-fix exchange rates; in late 1970, he was ordered to seek a compromise by President Nixon when foreign policy concerns dictated a settlement.

2 The Importance of International Economic Policy

> The supreme difficulty of our generation . . . is that our achievements on the economic plane of life have outstripped our progress on the political plane to the extent that our economics and our politics are perpetually falling out of gear with one another. On the economic plane, the world has been organized into a single all-embracing unit of activity. On the political plane, [nation-states] have been growing . . . more numerous and the national consciousness more acute. The tension between these two antithetical tendencies has been producing a series of jolts . . . in the social life of humanity.
>
> —*The Economist*, 1930

> In this post Cold War world, our national security rests more than ever on our economic strength. Our foreign and commercial policies must be integrated if we are to accomplish our objective at home and abroad.
>
> —William Clinton, 1996

International economic policy is a combination of nothing less than the two highest-priority goals of the modern nation-state: national security and economic prosperity. It has grown steadily in importance because in the largest sense, international economic policy has the daunting task of trying to manage international economic interdependence—the concentric circle linking two global mega-trends of the second half of the twentieth century and beyond:

- The increased intrusion of governments in their domestic economies because electorates hold them responsible for good economic performance; and
- The increased intrusion of economic issues in the day-to-day conduct of international relations.