THE MAKING OF UNITED STATES INTERNATIONAL ECONOMIC POLICY

Principles, Problems, and Proposals for Reform

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Fifth Edition

2000

PRAEGER

Westport, Connecticut
London

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.

THE GROWING SIGNIFICANCE OF INTERNATIONAL ECONOMIC INTERDEPENDENCE

It was not until the 1970s that U.S. international economic policy was transformed from an obscure backwater tended by anonymous specialists to a politicized issue deemed important by both political parties, multiple interest groups, and (occasionally) presidents. Politicalization means that political leaders realize that international commerce has grown so much that it is an important pocketbook issue among their constituents and an important vehicle for delivering promises to the electorate. Political leaders in countries more integrated into the world economy than is the United States have long understood the substantial impact of the ever-tightening linkage among national economies on domestic economic policy management. In the new world order of the post–cold war era, ideological hostilities among major countries have virtually disappeared as market-based economies replaced government-controlled, command economies on a nearly universal basis. Meanwhile, the ongoing intensification of international economic interdependence in both quantitative and qualitative terms continues unabated.

Interdependence has no precise, all-encompassing definition. As the term is used here, it has both political and economic characteristics. Politically, interdependence offers opportunities to politicians to achieve economic goals more efficiently in a multilateral context than by unilateral means. The clearest proof that presidents and prime ministers believe that it is important to them is the annual economic summit meeting held since the mid-1970s by the leaders of the seven major industrial countries.

As goods, services, capital, and labor become even more internationally mobile, interdependence creates anxiety by diminishing governments' control over what was once considered strictly domestic policy. Macroeconomic policies sometimes must be changed to conform with externally imposed conditions, inflation can be imported, domestic industries are sometimes swamped by foreign competition, and so on. Suggesting diminished internal control over national economic destiny is absolutely *not* the same thing as asserting that interdependence (often referred to as globalization) has significantly diminished national sovereignty, that is, the government's ability to legally control domestic laws, institutions, and policies. A good case for diminished sovereignty amidst rising interdependence can only be made by pointing to those less developed countries who reluctantly have bowed to tremendous pressure to follow the harsh dictates of the industrial country-dominated multilateral economic organizations, namely the International Monetary Fund (IMF).

The traditional foreign policy adage that countries should not intrude into the internal affairs of other sovereign states has been overtaken by events that have redefined "internal." Today there are few changes in domestic economic conditions in the large industrial countries that do *not* have external implications. The Group of Seven industrialized countries have repeatedly tried to coordinate their monetary and fiscal policies since the mid-1980s. Competition policy and labor standards are gradually being introduced to the agenda of multilateral trade negotiations. Japanese and U.S. trade negotiators have appropriately given each other advice on such "internal" subjects as education, saving rates, length of workdays, antitrust enforcement, land use, and time horizons for planning by business executives.

Economically, interdependence reflects speed in the form of the quickening transmission of global (external) economic events and trends to individual national economies. It represents magnitude in the form of the growing importance of what is happening in other economies as a determinant of economic health in one's own economy. Interdependence explains why the vast majority of economic problems are now beyond the capacity of a single country to solve and require concerted multilateral actions.

To some extent, interdependence is more a matter of perception than empirical measurement. Furthermore, it is incorrect to argue that interdependence among countries is totally new. Only the degree of its intensity and the rising concern it engenders among national political leaders are without precedent. Reliance by countries on foreign suppliers for goods that are unavailable or produced inefficiently at home goes back many hundreds of years. Inflows of foreign capital during the nineteenth century played a pivotal role in the economic development of the United States. Historical data indicate that during the latter part of the nineteenth century, a steadily rising share of industrialized countries' output was channeled into foreign trade. However, this trend was reversed by two world wars and the global depression of the 1930s. Merchandise exports as a percent of world gross domestic product (GDP) are today about twice what they were in 1950, but only about 50 percent greater than in 1913, just prior to the start of World War I.[1]

When interdependence reemerged with a vengeance in the early 1960s, it did so in a very different world. Far more countries were important actors in the international trading system than in the Euro-centric world of the nineteenth century. Infinitely more kinds of goods and services were (and are) being produced and traded. Capital began moving across national boundaries in geometrically greater quantities because of the dismantling of controls and the rapid introduction of cheap and quick computer and global telecommunications technologies.

More importantly, the quantitative and qualitative increase in global interdependence surfaced in a different economic policymaking world. It was only after the Keynesian revolution of the 1930s that governments learned how to apply counter-cyclical fiscal stimuli to cure recessions. As discussed in the next section, governments in the post–World War era accept an exceptional degree of responsibility for the achievement of economic growth, full employment, price stability, and income transfers.

Among major countries, the United States is the least conscious of the spiraling impact of international economic interdependence. The fact that the U.S.

economy is still relatively insulated from the world economy (mainly because foreign trade is a relatively small percentage of GDP and the extraordinary international role of the dollar) is responsible for the average American's being less sensitized to the growing importance of international economics than people elsewhere. Popular recognition of the impact of the external economic sector has grown only very slowly, despite the observation made as early as 1949 in a U.S. government study that "the traditional line of demarcation between domestic and foreign problems has completely disappeared, and the governmental organization must be shaped to formulate and execute national policies which have both domestic and foreign aspects."[2] This thought is widely understood in some European countries where upwards of one-half of all goods produced are exported and one-half of all goods consumed are imported.

The extraordinary surge in the intensity and extent of international economic interdependence was caused in part by post–World War II changes in the basic workings of international business. Geographical distances and national borders became less relevant to executives of multinational corporations than at any time in history. Goods can be moved from one side of the world to the other more quickly and cheaply than ever before, thanks to new modes of sea and air transportation. Design engineers and production lines can operate thousands of miles apart thanks to sophisticated data transmission technology. Finally, the lion's share of reductions in and elimination of barriers to international trade and capital movements have been enacted since the 1950s.

The economics of high-tech production are dictating the consolidation of global economic production into fewer and bigger multinational corporations, most of which aggressively sell their goods in every major market on the planet. Economic necessity now precludes large manufacturing corporations from concentrating only on their home market. The ever-rising fixed costs associated with developing and manufacturing capital intensive, high-technology products necessitate economies of scale. Research and development expenses and retooling costs to produce a new generation of jet aircraft, semiconductor, or supercomputer are now measured in billions of dollars. To remain a competitive, low-cost producer in the high-tech sector, a corporation needs to amortize high fixed costs over a maximum sales volume. This is why global marketing strategies have become the norm.

The quest for "bigness" and maximum global presence to pay for product innovation, consolidate costs, and prevent being outflanked by fast-growing competitors is repeatedly demonstrated by the endless wave of mergers and strategic alliances being consummated by already large multinational companies (a process described as "whales consuming other whales"). Financial success and survival by high-tech companies increasingly require a successful presence in the "triad": the markets of North America, Europe, and Japan and the Pacific Basin.

Measuring the net intensification of international economic interdependence is a tricky, exacting process. Strictly speaking, there should be demonstrable increases in the sensitivity of individual domestic economies to external trends and in the velocity of transmission effects from country to country. Although the net increment of interdependence cannot be measured precisely (a process that would require voluminous data on price and income elasticities, the effects of exchange rate changes, the impact of overseas wages, etc.), it can be inferred by utilizing the very basic aphorism that everything is relative. Large absolute increases in international trade and investment are not inherently significant to the management of domestic economies *unless* they are increasing *faster* than domestic production. The boom in international trade and finance would not be a statistically significant indicator of increased interdependence if their rise merely kept pace with, or even trailed, the growth in domestic production around the world.

Increases in international trade and capital flows in fact are meeting the criterion of large relative growth. Foreign trade since the 1950s has consistently grown faster in percentage terms than the estimated rate for aggregate world GDP expressed either in nominal or real terms. This relative rate of increase becomes more dramatic if merchandise trade is related only to increased domestic production of goods; in that way, the rapid rise of the service sector as a component of the GDP of industrialized countries is factored out of the statistics. The share of total world production of goods accounted for by exports of manufactured goods almost quadrupled between 1950 and the mid-1990s: exports rose from an estimated 8.9 percent of goods produced worldwide in 1950 to 31.4 percent in 1990.[3]

The volume of world exports expressed as a percentage of total global output rose from an estimated 2.5 percent in the 1950s to 14 percent in the mid-1980s.[4] According to calculations by the World Trade Organization (WTO), trade volume increased by fifteen-fold between the early 1950s and mid-1990s, while real global production increased only six-fold. The proportion of trade as a share of global income tripled during the same period of time from 7 to 21 percent.[5] WTO data also indicate that world exports increased more than twice as much on average as did world GDP between 1987 and 1997.[6] The nominal value of world trade has increased almost sixty-fold since 1955. From an estimated $94 billion in that year, total merchandise trade grew to $903 billion in 1975, and to $5.3 trillion in 1997.[7]

The consistently faster relative growth of trade has a simple statistical effect but significant economic and political implications: the foreign trade sector has been growing as a percentage of virtually every country's gross domestic product. Exports of goods thereby have become an increasingly important source of national economic growth, while merchandise imports have become an increasingly important potential source of domestic economic disruption.

Foreign direct investment also has grown geometrically faster than world GDP since the end of World War II. The data are inexact and incomplete, but one estimate has the value of such investment by all countries increasing by a factor of nearly 25 (more than five times as much as the increase in world GDP), from

about $68 billion at year-end 1960 to about $1.8 trillion at year-end 1991.[8] Foreign direct investment from 1986 through 1995 grew more than twice as fast as gross fixed capital formation around the world, "indicating an increasing internationalization of national production systems." A report by the United Nations Conference on Trade and Development goes on to conclude that "The upward trend manifested in all of the indicators of international production, in absolute terms as well as in relation to various macroeconomic indicators, suggests that international production is becoming a more significant element in the world economy."[9]

Economic interdependence is demonstrated even more dramatically by the effects of what has become an integrated global capital market. Armed with instantaneous data transmission and new financial techniques to hedge the risk of financial transactions, tens of thousands of investors, speculators, and corporations in dozens of countries conduct a continuous, round-the-clock, global plebiscite on the relative merits of national currencies, stocks, and bonds. The single largest market in the world today is the foreign exchange market, where *daily* turnover was estimated to be $1.5 trillion in 1998.[10] Foreign exchange transactions dwarf the value of the "hard" international business transactions: foreign trade, foreign direct investment, international purchases of stocks and bonds, overseas bank loans and deposits, and so on. All of these transactions combined probably are little more than $20 trillion annually—the equivalent of about three weeks' turnover in the foreign exchange markets. Therefore, the vast majority of foreign exchange transactions facilitate relatively short-term, "hot money" flows made in response to interest rate differentials or outright speculation about future exchange rate movements.

International borrowing from commercial banks is another category of trans-border transaction that has grown geometrically since the early 1970s. Bank lending to foreign borrowers surged almost overnight when the Organization of Petroleum Exporting Countries (OPEC) triggered the first oil price shock in 1973 and wrought havoc with the balance of payments positions of oil-importing countries. Net new international bank lending rose from an estimated $33 billion in 1973 to some $500 billion in 1997.[11] The Bank for International Settlements estimates that the stock of outstanding foreign bank loans grew to $8.5 billion at the end of September 1997—almost 30 times the level of 25 years earlier.[12] Whereas the outstanding stock of international bank lending in 1980 was equivalent to only 4 percent of the industrialized countries' aggregate gross domestic product, this percentage soared to 44 percent of their total output in 1991.[13]

The boom in international bank lending unquestionably helped several developing countries gain access to much needed capital to pay for imports. However, in retrospect, virtually all of these countries borrowed too much, as seen by the onset of the global debt crisis in the 1980s, where the solvency of big debtor countries and many big commercial banks was at risk for several years.

International financial interdependence is also manifested in more frequent concerted movements in stock prices around the world. It is no longer uncommon for sharp price rises or drops in one region to immediately prompt comparable movements in stock markets everywhere else. The increasing sensitivity among the world's investors was perhaps most vividly displayed during the worldwide stock market crash of October 1987 that left no major market unscathed. The unexpected speed and size of worldwide price declines produced a temporary reduction of about $1.2 trillion in global stock market capitalization. Many investors in many different countries dumped stocks because they perceived the stock market debacle occurring in other countries inevitably would be transmitted to their own home market.[14] The deteriorating economic situation in Asia in 1998 put a damper on stock markets around the world; major sell-offs regularly followed announcements of bad news. As the global economic outlook worsened, companies like Coca-Cola and Gillette saw their stock prices tumble because investors aggressively sold shares in American companies with above-average dependence on foreign markets for sales and profits.

In qualitative terms, interdependence complicates the lives of national political leaders and draws them into the vagaries of international economic policy by (1) eroding their control over domestic economic performance and (2) reducing the ability of an individual nation-state to deliver the increased economic prosperity promised in the informal social contract with the populace.

The growing need for countries to pursue economic objectives through regional economic institutions is strikingly illustrated by the ongoing, voluntary surrender of economic autonomy by member countries to the central institutions of the European Union. A pivotal event in world history occurred on the first day of 1999, when eleven European countries surrendered control over their monetary policy to a European central bank and began phasing out their national currencies in favor of the Euro. While military alliances have been necessary for centuries to augment the limited defense capabilities of a single country, recourse to membership in trade blocs to increase national economic performance is a late twentieth-century phenomenon. The increasing need to address economic needs on a multilateral basis can be seen in such disparate tasks as the creation of man-made liquidity in the IMF (special drawing rights), environmental protection, rescues of countries facing financial crises, and application of economic sanctions against Iraq.

The proliferation of new financial instruments and the ability of investors and speculators to quickly and cheaply move massive amounts of capital flows across national borders in search of quick profits have diminished (not eliminated) the abilities of central bankers to follow an independent monetary policy. When the U.S. Federal Reserve Board raised interest rates in 1994, it reduced the incentive to foreign investors to retain riskier assets denominated in Mexican pesos. Higher returns in the United States from the tightening of monetary policy made the international financial community less tolerant of unfolding Mexican economic problems—an attitude that had major negative consequences for that country. The one-world capital market has little sentiment regarding damage to individual countries from massive outflows of money.

The devastating effects on domestic living standards of capital flight and massive selling of the currencies and stocks of the so-called emerging markets have gone far beyond anyone's expectations. Investors and speculators have become so unforgiving of what they perceive as bad domestic economic policies that financial crises can be transmitted with lightning speed from one country to others perceived to have similar problems. In the first instance, the Mexican peso crisis of 1994–1995 triggered a few, relatively mild capital outflows from other countries, an exercise in interdependence labelled the "tequila effect." What started out in 1997 as a barely noticed loss of confidence in Thailand's economy soon mushroomed into the conflagration dubbed "Asian contagion" that sent huge economic and political shock waves throughout that continent. Investor psychology was so shaken that when the Russian government one year later announced a de facto default on its debt, shock waves hit financial markets all over the world. A few months later, in yet another extraordinary demonstration of the grip of global economic interdependence, an obscure governor of an obscure Brazilian state inadvertently unleashed another round of heavy selling in stock and bond markets. He attracted the attention of the world's financial media when he announced a moratorium in his state's debt payments to the federal government and thereby further undermined confidence in the outlook for Brazil's economy. The "flight to quality" induced by global financial contagion was so massive that investors bought so many relatively safe long-term U.S. Treasury bonds that interest rates on these instruments declined to levels not seen in four decades.

Despite a floating exchange rate system that was supposed to insulate domestic macroeconomic policy from external pressures, government officials have less flexibility than ever before in implementing economic policies on the basis of internal rather than external concerns. Floating exchange rates have not been able to arrest an accelerated transmission of macroeconomic policies from one country to another. The steady and large appreciation of the U.S. dollar's exchange rate beginning in 1981 forced western Europe to maintain interest rates far above those appropriate to the virtual absence of real growth in those countries at the time. Cries of anguish emerged, especially from West Germany, which felt compelled to support the deutsche mark with interest rates at levels high enough to discourage large capital outflows into higher yielding, dollar-denominated assets. Interdependence meant that, in turn, other western European countries were forced to follow the leader—West Germany—into a tighter monetary policy that they otherwise would not have adopted in view of stable prices in their home markets. A senior German commercial bank official moaned that the high U.S. rates were "gradually strangling Europe."[15] Otmar Emminger, former president of the Bundesbank, the German central bank, complained in 1986 that "Never before has the fiscal policy of one country . . . had such an enormous impact on the outside world."[16]

Ironically, in 1992 Germany was on the receiving end of an international outcry deploring the injurious effects on other countries of its own high interest

rates. The political unification of West and East Germany had produced large increases in budgetary outlays, the effect of which was to stimulate increases in private sector bank borrowing, the money supply, and inflationary pressures that were absolutely unacceptable to the Bundesbank. The central bank thereupon initiated a series of demand-retarding increases in domestic interest rates. Given the fact that other countries in the European Monetary System (EMS) had effectively pegged the exchange rate of their currencies to the deutsche mark, they had no choice but to immediately match these increases in interest rates, even though they were appropriate only to German economic trends. (Interest rate differentials at some point inevitably produce realignments in exchange rates.)

For the same reason, the United Kingdom had no choice but to increase its domestic interest rates in line with Germany in order to keep the pound sterling attractive to investors. The result was that an externally imposed tight monetary policy prolonged and deepened the long British recession, which otherwise would have called for expansionary macroeconomic policies. With growth and employment in Britain (and elsewhere in Western Europe) the innocent victims of German unification, speculators began to pound the pound in (an accurate) anticipation of a depreciation in its exchange rate. The British government eventually decided the costs of interdependence were too great and in late 1992 withdrew its currency from the EMS, thereby allowing a reduction in domestic interest rates and causing the pound's exchange rate to decline.

The intensification of interdependence is not greeted with unequivocal joy by governments; the only thing unequivocal is the sense of importance they attach to it. Increased interdependence suggests a higher degree of economic vulnerability to both changing economic events in other countries and the whims of market forces. It compels sovereign states to discuss and coordinate economic actions that previously would have been considered an off-limits part of their domestic domain. Nevertheless, the vast majority of countries still believe that the cost of international economic interdependence is less than its benefits.

THE EXTERNAL SECTOR'S EXPANDING IMPACT ON THE DOMESTIC ECONOMY

Two factors largely explain why international trade and capital movements have become a major concern of senior policymakers in the United States and elsewhere. The first is the aforementioned acceptance by all governments of responsibility for how well or poorly the domestic economy performs. The electorate's demand for a steady increase in the standard of living means that anything that significantly affects domestic economic performance is an important variable in determining who is president (or prime minister) and which party controls the legislative branch.

The lifespans of democratically elected governments are closely tied to their success in achieving three primary domestic economic objectives: growth, full employment, and price stability. Economic growth, in turn, is essential to a

country's achieving social objectives in a non-inflationary environment. The absence of a growing work force or profitable corporations limits the size of the tax base that generates the income to finance the social safety net of income support (retirement income, health insurance, unemployment compensation, welfare, etc.) that all democracies are expected to provide.

No government is willing to fully entrust the invisible hand of the free market with the job of achieving the level of domestic economic performance that will please voters and sustain the political status quo. All countries, some more than others, seek to enhance the market mechanism by providing financial support to, and reducing the regulatory burdens on, favored industrial sectors.

Governments have encroached on the domestic economy in all capitalist countries since World War II. Increases in the percentage of gross domestic product accounted for by governments have become a universal trend. Government expenditures as a percent of GDP in the industrial countries increased from 12 percent in 1913 to an estimated 48 percent in 1997.[17] In the United States, one of the more free market–oriented countries, total governmental expenditures as a percent of total output rose from 18 percent in 1940 to 51 percent in 1996.[18] Twenty-seven new regulatory agencies were added to the federal bureaucracy in the 20-year period commencing in 1960, and 20 of them emerged just in the 1970s.[19] Governments around the world have assigned domestic agencies a greater role in the international economic policy decision-making process because of the growing recognition that the internal impact of external events and trends is pervasive. In administrative terms, the result has been a relative diminution of foreign ministry clout in the formulation and conduct of international economic policy in both the United States and abroad.

The second factor forcing political leaders—more so in Europe, Japan, and Canada—to attach high priority to international trade and finance is what might be called the bottom line of interdependence: the increasing impact of global economic developments on how a domestic economy performs. In the words of the noted management scholar Peter Drucker, the distinction between the domestic and the international economy among industrialized countries "has ceased to be a reality. . . . An unambiguous lesson of the last 40 years is that increased participation in the world economy has become the key to domestic economic growth and prosperity."[20]

As they grow in importance, external factors increasingly enhance, alter, or disrupt domestic economic policy objectives. Policymakers cannot ignore the fact that for three decades, exports as a percent of GDP have been increasing steadily for virtually every major country (see Table 2.1), including the United States. Exports have reached a sufficiently large percentage of the average country's GDP that improving or deteriorating economic conditions among its major trading partners will have a measurable impact on domestic economic conditions. The spread of "financial contagion" beyond Asia prompted Federal Reserve Chairman Alan Greenspan to warn that "it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is

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Table 2.1
Merchandise Exports as Percent of GDP

	United States	Germany	Japan	Canada
1960	3.8	15.8	9.2	14.7
1997	8.5	24.3	10.0	34.7

Sources: "Background Paper" by Robert Solomon in Report of the Twentieth Century Fund, *Partners in Prosperity* (New York: Priority Press Publications, 1991); and International Monetary Fund, *International Financial Statistics*, October 1998.

experiencing greatly increased stress."[21] In some countries, like Saudi Arabia, governmental revenues are overwhelmingly dependent on export earnings. Canadian exports to the United States in the late 1990s had grown to the equivalent of one-third of Canada's GDP.[22] Inevitably, economic conditions in Canada are strongly influenced by trends in aggregate demand south of its border that are beyond the control of the Canadian government.

The unprecedented U.S. hunger for increased imports during the 1983–1986 period was the greatest single force for growth in the world economy during those years. This situation was described in a September 1985 speech by Karl Otto Pohl, then-president of the West German Central Bank:

> This strong performance of the U.S. economy during the past three years was also one of the main reasons why other industrialized countries were able to recover. The U.S. economy . . . accounted for about 70% of all additional growth in this area during that time. So it is only fair to say that the United States acted somewhat like a locomotive which pulled the world economy out of stagnation and recession.[23]

Imports are a classic example of how the external sector can have important positive and negative effects on domestic economic trends. Imports can provide cheaper and/or better quality goods to local consumers. They can offset local shortages. They provide competition and thus an incentive to local producers to minimize costs and maximize attention to consumers' needs. At the same time, however, imports can displace jobs and drive local companies into bankruptcy. Imports

Exports are revered by economic policymakers around the world as catalysts of GDP growth, creators of new jobs, and generators of foreign exchange earnings. Export-led growth can make the difference between stagnation and prosperity for a country. Japan and the Asian newly industrialized countries (NICs) long relied on export growth as a major source of economic growth and industrial development. Between the summers of 1982 and 1985, two-thirds of the increase in West Germany's GDP was due to increased exports of goods and services.[24] Even in the United States, where trade is still a relatively small percentage of GDP, a strong export sector can make a major contribution to Exports

overall growth. Increased exports accounted for almost one-third of U.S. GDP growth between 1991 and 1997.[25]

Since the mid-1980s, the U.S. economy has become heavily dependent on foreign investors and lenders to offset its inadequate pool of saving. Massive U.S. current account deficits (the statistical counterpart to investment outlays exceeding saving) were perforce offset by record-breaking cumulative net capital inflows of about $1.6 trillion during the 1985–1998 period.[26] Foreign investors became important sources of financing for the federal budget deficits in the 1980s and early 1990s. Holdings of U.S. Treasury debt by foreigners was estimated at about $20 billion in 1970, or about 9 percent of Treasury debt instruments held outside of U.S. government agencies. By 1997, the foreign share of Treasury securities had risen to $1.3 trillion, about 38 percent of the privately held total.[27] Senior officials in the U.S. Treasury Department became keenly aware of the impact of external factors on domestic interest rates. By the late 1980s, they were actively arguing against a hard-line trade policy toward Japan, a country buying a disproportionately high percentage of the expanding volume of Treasury IOUs used to finance the then–rapidly growing U.S. budget deficit.

One final statistic might usefully be cited in suggesting the significant contribution since the 1980s of foreign capital inflows to U.S. prosperity. In 1960 estimated foreign purchases of U.S. equities and long-term bonds (maturities of more than one year) were $14 billion. That number grew to $2.8 trillion in 1997.[28] Failure to attract the volume of foreign investments and loans needed to offset inadequate U.S. capital formation eventually would have resulted in higher domestic interest rates, depreciation of the dollar's exchange rate, and (presumably) lower U.S. growth rates.

The proliferation of foreign direct investment, another sector of international economic relations, has radically altered the importance of foreign business activity on corporate profit in the United States and many other large industrial countries. For major companies, the aforementioned need to achieve economies of scale means that marketing success in countries beyond the home market is nothing less than a matter of corporate survival. It is now common for the overseas component (which includes both exports and overseas sales by foreign subsidiaries) to account for 40 to 60 percent of total sales and profits of American and European companies. One brokerage firm estimated that in 1998, 40 to 45 percent of the profits of the stocks comprising the Standard and Poor's 500 index came from foreign sales.[29] Another calculation estimated that for the median company in the Standard and Poor's 500, the foreign share of total sales more than doubled between 1985 and 1997.[30] About half of all profits of British corporations are generated by sales outside the United Kingdom, while the United States alone accounts for an estimated one-third of Swiss companies' profits and almost two-fifths of the profits of major Dutch companies.[31]

The rapid spread of multinational corporations (MNCs) has led to an upsurge in intracorporate transactions that may now account for 20 percent of total world trade in manufactured goods. Transactions between U.S. parent companies and their majority-owned foreign affiliates accounted for an estimated 26 percent of total American exports and 17 percent of imports in 1996.[32] Many U.S. companies suffered sizable declines in their per share earnings between 1981 and 1985 simply because the dollar's appreciation meant that overseas earnings in depreciating foreign currencies translated into fewer dollars in their profit-and-loss statements.

As suggested above, interdependence is a two-edged sword. Above and beyond facilitating export-led growth, it also can create "leakage" whereby increased domestic demand induces a bigger increase in imports than growth in domestic jobs and production. For example, an overvalued dollar in the early 1980s raised the U.S. marginal propensity to import. The result was that a relatively rapid increase in aggregate domestic demand did not translate into commensurate growth in domestic output because imports were supplying a growing share of incremental internal consumption. The surge in imports in 1984 and 1985 was the main factor contributing to slower U.S. GDP growth at that time. Imports captured an estimated 52 percent growth in real U.S. domestic demand in the first quarter of 1985.[33]

The potential domestic financial cost of being plugged into the international system has perhaps never before been as effectively dramatized as by what happened to Swedish monetary policy in September 1992 in the midst of turmoil in the European foreign exchange markets. The Swedish central bank acted in dramatic fashion to protect the value of the krona by exploding its overnight lending rate to commercial banks to a spectacular 75 percent. There was a far greater shock when this rate was raised to the staggering level of 500 percent just a few days later.

THE INCREASING ROLE OF ECONOMICS IN INTERNATIONAL RELATIONS

To complete the explanation of the importance of international economic policy, it should be noted that never before in modern history have economic affairs accounted for so much of the day-to-day stuff of international relations. While there is no questioning the ultimate importance of war and peace, international economic concerns dominate the short-term foreign policy agendas of every country not debilitated by political anarchy or a military dictatorship. The concept of national security has been broadened to include economic strength and vitality. The United States and its allies went to war in 1991 to liberate Kuwait from the Iraqi invasion for reasons of economic security: to protect extensive oil reserves there and in neighboring Saudi Arabia.

From the dawn of modern history until the 1960s, countries became regional or global powers only on the basis of their military might and resolution to use it. Since the 1960s, influential state actors—Japan, Saudi Arabia, Kuwait, South Korea, Brazil, etc.—have come on the scene based on a new criterion: economic clout. The most important non-state actors, multinational corporations, also

emerged as forces to be reckoned with in the international system because of economic significance. The decisions to lend massively and then to suspend new lending caused many multinational banks to become almost as big a factor as governments in influencing the course of events in the 1980s in the major borrowing countries of Latin America. To a lesser extent, the multibillion dollar investments by "emerging market" mutual funds were major actors in many advanced developing countries in the 1990s.

In a world dominated by democratic, market-based economies, rivalry among the major powers has shifted from territorial and ideological disputes to the industrial, services, and financial sectors. The latter are venues with entirely different rules of engagement than those of traditional international politics. Modern nation-states still compete intensely with each other, but mostly with regard to faster economic growth rates, higher living standards, technological advances, and export promotion. Ideological struggles mainly involve economic questions like the optimal degree of government regulation of markets and job security.

The promotion of economics from the secondary status of "low policy" and its elevation to a major force in international relations is of relatively recent vintage. The long-held notion that international economic issues were sufficiently marginal that they could and should be compartmentalized for handling by second-tier technocrats was discredited only in the 1970s. One of the earliest reasons for this turnabout was the nuclear "balance of terror" that imposed a hopefully permanent end to the way in which powerful countries historically had resolved their major disputes. The horrible destructiveness of nuclear weapons meant that for the first time in modern history, the great powers literally were terrified of military confrontation with one another. In addition, for the first time ever, resort to warfare among the industrialized countries of Western Europe, Japan, and the United States became unthinkable because of a lack of serious political disagreements and because of the common threat from the Soviet Union.

For 20 years after World War II, international economic relations among the noncommunist countries were so harmonious that spillover of international economic disagreements into mainstream foreign policy was nonexistent. As long as the relatively benevolent hegemony of U.S. international economic policy prevailed, the Bretton Woods system of fixed exchange rates worked well and the pursuit of trade liberalization proceeded smoothly. As long as the extremely competitive U.S. industrial sector faced no significant foreign competition, the agencies with jurisdiction in domestic policy management had no problem with leaving responsibilities for the formulation and conduct of U.S. international economic policy mainly to the technicians in the State Department.

However, by the mid-1960s, a new, more complicated era in U.S. relations with the other industrialized democracies commenced. Relative economic power gradually shifted so far away from the United States and toward Western Europe and Japan that economic tensions shifted to center stage. Economic confrontations now strained relations among countries whose political-military relationship was rock solid. The new era of "economic self-defense" for the United States was ushered in by the so-called "chicken war" that began in 1963 with the then–European Community. (The United States imposed higher tariffs on several goods in retaliation for the Community's imposition of prohibitive tariffs on imported frozen chickens.) Later in the decade, the once harmonious U.S.-Japanese alliance would be rocked by trade frictions that would continue unabated through the end of the century. The importance of economics relative to political and military concerns in the foreign policies of the United States and other countries took a quantum leap when the cold war ended. The toppling of Marxism-Leninism as a force in world politics also toppled the uncontested primacy of traditional national security concerns as the centerpiece of world politics—except during relatively infrequent periods of military crisis.

Definitions of self-interest and articulation of goals in foreign policy increasingly are couched in economic terms. East-West and North-South relations during the cold war were dominated by intense, often dangerous struggles between the forces of capitalism and communism. Today, the industrialized countries view the developing countries and the former Soviet republics mainly as a battleground for exports and as countries with balance of payments adjustment problems. Countries in Asia, Africa, and Latin America that were places where the great powers competed for the ideological hearts and minds of the people during the cold war are now markets where businesspeople coldly seek profitable investments.

The unprecedented emphasis in the postwar era on improving living standards and the quality of life is yet another factor contributing to the preeminence of international economic cooperation as a global priority. In the words of Stanley Hoffman, "There is no longer a single international system dominated by strategic concerns. Military security remains an important issue, but the new concerns of world trade, energy, food, raw materials, the world monetary system—each one with its own power hierarchy—have arisen."[14]

A world economy allowing market forces to operate more freely than ever before in modern history provides a unique opportunity to generate and distribute wealth on a global basis. Countries that used to eye each other warily (e.g., Brazil and Argentina; the United States and Mexico) have joined hands in regional free trade agreements. The proven benefits in Western Europe of trading off political autonomy for greater economic efficiency and prosperity led to negotiations on timetables for large free trade areas in the Western Hemisphere and in the Asia-Pacific region. Expanded trade or the prospect of expanded trade has the power to further alter political relations among an endless number of countries whose relative efficiencies complement one another.

The growing primacy of economic relations in foreign policy is not a guarantee of harmony among states. The loss of bonding that once was forged by the common fear of the Soviet Union has made economic diplomacy more necessary than ever. Long-time political allies regularly inflict (deliberately and

inadvertently) financial hardships and dislocations on one another. Economic tensions arise between countries that have no political disagreements and harbor no historical animosities. Political and ideological compatibility between countries is insufficient to preclude escalations of economic confrontations in an era of increasing interdependence.

Disagreements among all but so-called rogue states are now dominated by such technical issues as measures utilized by governments to alter export and import flows, techniques for correcting balance of payments disequilibria, and the dangers of destabilizing private capital flows. These kinds of disagreements do not ignite military confrontations, but they do generate anger. A serious backlash against the West is a genuine possibility as countries of Southeast Asia assess the causes, costs, and cures of "Asian contagion."

International economic policies are becoming increasingly prevalent at both extremes of foreign policy. In addition to trying to draw countries closer together, they are frequently employed as negative, coercive tactics designed to compel countries to desist from actions that the imposing country or countries find to be dangerous or repugnant. Trade sanctions, withholding of aid, and the freezing of assets are an increasingly used middle ground between armed attack and total inaction when other governments are deemed to be acting in an unacceptable manner. Economic sanctions remain a popular means of inflicting pain and making a statement despite their spotty record in effecting changes in the political, military, economic, and humanitarian policies of targeted countries.

The new world order does not mark the "end of history." Competing political ideologies may be passé, and hunger for additional territory may be over, but mankind's combative nature suggests that international struggles for influence and relative advantage will continue, only through different means. Military power will be a secondary route to international power, influence, and prestige. The new profile of a powerful country is one rich in knowledge, capital, and mastery of the newest technologies. Increasingly, nations will find an inadequate tax base, lagging technology, capital scarcities, and sluggish increases in domestic standards of living to be incompatible with the ability to absorb the economic costs and demands of regional or great power status. Economic strength already begets foreign policy strength, just as economic weakness begets weakness in foreign policy.

NOTES

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7. Data sources: various GATT and WTO press releases.

8. Data source: U.S. Commerce Department, Office of Trade and Investment Analysis.

9. United Nations Conference on Trade and Development, *World Investment Report 1997*, p. xvi.

10. Data source: Bank for International Settlements website: BIS.org/press/index.htm/.

11. Data sources: Bank for International Settlements, *Annual Report*, various editions.

12. Data source: speech of Roger W. Ferguson, Jr., Federal Reserve Board press release dated 16 April 1998, p. 1.

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15. Quoted in the *Wall Street Journal*, 26 February 1981, p. 30.

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17. Data sources: *OECD Economic Outlook* 63 (June 1998) and Vito Tanzi, "The Demise of the Nation State," IMF Working Paper WP/98/120, August 1998.

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20. Peter F. Drucker, "Trade Lessons from the World Economy," *Foreign Affairs* (January–February 1994): 104.

21. Federal Reserve Board press release dated 4 September 1998.

22. Data source: "Talk of U.S. Slowdown Strikes Fear into Canada," *Wall Street Journal*, 4 December 1998, p. A2.

23. Text of address by Karl Otto Pohl, 19 September 1985, Deutsche Bundesbank, *Auszuge Aus Presseartikeln*, p. 1.

24. Robert Solomon, "Background Paper," in *Partners in Prosperity: The Report of the Twentieth Century Fund Task Force on the International Coordination of National Economic Policies* (New York: Priority Press, 1991), p. 70.

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26. Calculated from data in the 1998 *Economic Report of the President*, and the Joint Economic Committee, "Economic Indicators," April 1999. Foreign capital inflows into the United States soared to an annual rate of $215 billion in the second quarter of 1998.

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