

## Choices for the Global Economy

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**T**he global economy stands poised on the brink: strong forces are pushing the developed market economies (DMEs) to look inward for growth and stability; other forces encourage looking outward and international cooperation. On the macroeconomic front, the six-year global economic expansion is showing signs of decay. Financial and balance-of-payments deficits remain large. Unemployment rates in Europe remain high. Exchange rates are highly volatile and inflation appears ready to increase again. On the legal and institutional fronts, several major events are occurring simultaneously: Canada and the United States began an historic free trade agreement on January 1, 1989; the European Community (EC) is preparing for 1992, when many barriers to movements of goods, services and factors will be removed; the Soviet Union and China are deregulating their economies, opening up to market forces; and reform of the General Agreement on Tariffs and Trade (GATT) is under way in the current Uruguay Round, offering some hope for restrictions to the growth of managed trade and non-tariff barriers. Whither the global economy?

### End of the Reagan Era

The year 1988 marks the end of an era. From 1980 to 1988, Ronald Reagan was president of the United States. His policies, which dominated the world economy through the 1980s, were so pervasive they were given the name "Reaganomics." His policy prescriptions — cutting taxes, broadening the tax base, deregulating the economy, building up military strength, slowing the growth of government spending — were followed by most other industrialized countries, including Canada. Reaganomics was apparently successful. In November 1988, the global economy entered its seventh year of expansion, albeit an uneven and fragile one. However, Reagan leaves

a legacy of unsolved problems for his successor, George Bush, and other national leaders to handle, the foremost of which is the U.S. budget deficit and its close relation, the U.S. current account deficit.

Robert Gilpin (1987a) has recently argued that the Reagan era masked the profound developments that occurred in the world economy in the 1980s. Gilpin believes the United States, through Reaganomics, has been living on borrowed time and borrowed money (from the Japanese) and that a reckoning must occur. The Reagan years, in his view, were years of "lost opportunity." He recommended that the United States turn inward, cut back its commitments in Europe and Japan and focus on creating markets with its LDC (less developed country) neighbours.

Joseph Nye (1988), writing partly in response to Gilpin, argued that the United States does not suffer from "imperial overstretch" and should not turn inward and cut back on its overseas commitments. He argued that the United States has a strong vested interest in supporting international regimes, such as the GATT and the World Bank, that encourage international cooperation. Turning inward, in Nye's opinion, would lead to slow decay and a loss of the potential gains from participating in the changing international division of labour. The United States stands to gain more from a policy of looking outward due to its own open and decentralized internal market and political democracy.

The purpose of this chapter is to add to the debate. The author agrees with Gilpin that the Reagan era has seen a mismanagement of economic resources by the United States, leaving severe problems for Reagan's successors. However, it seems that Nye is right in his view that the United States should not turn its back on the global economy, seeking growth and stability internally. In fact, this chapter expands upon Nye by arguing that the developed market economies in general, not just the United States, can gain more by opening their economies and participating in the international division of labour than by turning inward and becoming closed in the 1990s. This is particularly true for the United States where openness is a prerequisite for successfully dealing with the Reagan legacy.

## **Multipolarity in the 1990s**

The world as we know it is drawing to a close as the post-1945 domination of the global economy by the United States ends. The

1990s and the twenty-first century will see a multipolar global economy dominated by the United States, Japan and the European Community. Without a clear and willing hegemon, the international economy could become more fragmented and regionalized. Trilateral agreements between the big three powers could lead to managed trade in many sectors, inhibiting forces of change and slowing growth. The increasing use of strategic trade and industrial policies to capture a larger share of the global rents in particular industries is also encouraging retaliation and cartelization.

Within managed sectors, the allocation of trade is determined more by political clout than by comparative advantage. Since a country's bargaining power is directly related to the size of its domestic market, the bargaining chips remain with the big three. Once the major powers have agreed to cartelize and manage a sector, that negotiated agreement often draws in smaller countries that have little or no say in the terms of the agreement. They are forced to accept the results and suffer the consequences of such negotiations (Patterson 1983). In an inward-looking world of regional blocs, small countries must align themselves with one of the blocs in order to secure access to a larger market and some protection against discriminatory treatment abroad. Small countries are therefore better off when the rules are set in advance, negotiations are multilateral and the results are non-discriminatory.

Small countries generally are forced to adopt outward-looking policies. They cannot avoid changes in the global economy, nor can they affect such changes (unless they band together to exert power through producer cartels and lobbying groups). The best small nations can do is anticipate change and cushion its effects for particular groups. This has been historically true for Canada and for the small Western European states (Katzenstein 1985).

Economies with a large domestic market, on the other hand, have the "luxury" of adopting inward-looking policies. When external crises occur, they can export the effects to other economies through "beggar-thy-neighbor" policies (a malign, zero-sum solution), they can anticipate and prepare for change (a benign, positive-sum solution), or they can go it alone by reducing their trade dependence and focusing on their domestic market. This withdrawal from the international market affects other national economies, depending on the large country's share of world trade and investment flows.

Historically, such inward-looking policies have characterized the U.S. response to external crises (for example, the global recessions of

the 1970s and the 1930s). When the United States represented a smaller share of world trade, such policies were less expensive for other members of the global economy. However, since 1945, the United States has become more trade dependent and a larger participant in the global market.

The openness of the U.S. economy to international trade and investment flows since 1945 and its leadership in international institutions were largely responsible for the enormous growth in trade and national incomes in the so-called golden age of 1945-73. The industrialized countries followed a policy of "Smith abroad and Keynes at home," that is, of encouraging the growth of unfettered international markets while supporting the development of the welfare state internally. When the world economy was growing steadily, these gains from trade could be used to redistribute domestic income more fairly. Growth was a potent antidote to domestic problems.

However, when growth slowed, distributional problems were more difficult to solve. The oil price shocks of 1973-74 and 1979, the productivity lag, stagflation, the worsening U.S. balance of payments, the rise of Japan and the NICs (newly industrialized countries), and changes in the international division of labour were challenges to the competitiveness of the U.S. economy in the 1970s and 1980s. Workers and owners of capital in the traditional heavy manufacturing industries began to suffer. The United States responded by ending the Bretton Woods monetary regime, passing restrictive trade legislation, broadening its interpretation of anti-dumping and countervailing duties, increasing its farm subsidies, negotiating voluntary export restraints and encouraging managed trade.

Gilpin claimed (1987b) that the United States is starting to act like an aging hegemon, protecting its position by exploitation of its allies, a policy he called "malign neglect." The Canada-U.S. Free Trade Agreement can be seen as an inward-looking bilateral policy (Fortress America) designed to expand the U.S.'s continental market as the United States loses its edge to the Japanese in the world market (Wolf 1987).

The European Community is also faced with the inward/outward choice. The 1957 Treaty of Rome was designed to rebuild Western Europe by removing internal barriers to trade and establishing a common external tariff wall against imports from non-members. Buffeted by the same shocks as the United States but with less economic power to withstand them, the EC has resorted to managed trade

(quotas, orderly marketing arrangements) with its competitors to lessen the adjustments to change. Slow growth and high unemployment dogged the EC through the 1970s and early 1980s.

The 1992 movement, sometimes called "Fortress Europe," arose in response to this sluggish performance. By removing many existing internal barriers to trade, Western Europe hopes to reap the advantages of a larger domestic market, substituting this market for losses in external trade. European firms are beginning a round of rationalizations, mergers and joint ventures as firms engage in "strategic partnering," positioning themselves for the anticipated larger market (Mytelka 1988).

Perceiving itself as a fragile economy, scarce in natural resources and open to buffeting by economic crises, Japan in the postwar period attempted to manage such change by foreseeing and preparing for it. The pervasive role of the Ministry of International Trade and Industry in the development of new industries through the 1945-70 period is well documented (Yamamura 1986). By positioning itself at the forefront of change, Japan has been successful at "running up the development ladder." Faced with the oil and natural-resource shocks of the 1970s, Japan's fears of economic fragility were again rekindled. The government responded by shifting resources out of heavy energy-intensive industries and into the high-tech knowledge-intensive ones. Japanese multinationals shifted labour- and energy-intensive segments of the production process to lower-wage, less-industrialized economies. Innovation centred on reducing energy requirements, increasing the role of information-based machine tools, and miniaturization. Japan's economic success at anticipating and handling change has caused severe dislocations for its European and American trading partners. Their response has been to partly close the door to Japanese exports through voluntary export restraints and other forms of managed trade. The rise of the four Tigers (Taiwan, Singapore, Hong Kong and South Korea) has exacerbated the crisis and increased the scope of managed trade by the industrialized economies.

Japan emerges as the new economic leader at the end of the Reagan era. It is not a hegemon in the traditional sense of a superior economic and military power leading a group of allies. Supported militarily under the U.S. nuclear umbrella since the war, it now returns the favour by supporting the United States economically. For the first time in this century, in the fall of 1988, Japan's real per capita gross national product (GNP) exceeded that of the United States, \$19,600 versus

\$18,362 (*South* 1988). If Japan were to withdraw its financial support from the United States and turn inward, the global economy could sink into a depression, as U.S. interest rates would have to be substantially increased. Japan stands poised for the new era, facing the choices of remaining outward looking by cooperating with European and American powers to support the seigniorage rights of the U.S. dollar, or of turning inward to use its economic might to establish its own hegemony in the Pacific.

Shoichi Akazawa, head of the Japan External Trade Organization, has recently argued that the 1990s will be the era of "Pax Consortis," where responsibilities are shared by the three superpowers (*South* 1988). Whether the United States, the European Community and Japan will encourage international cooperation through existing international institutions or move to bilateral managed accords remains to be seen. The choice of an inward-or outward-looking strategy may depend partly on how successfully the big-three developed market economies coped with global changes in the 1980s and on how their actions in the 1990s are constrained by the aftereffects of Reagan-era policies. Some insight into their likely decisions may therefore be found through an examination of their policy choices and constraints in the 1980s.

## Coping with Change in the 1980s<sup>1</sup>

### *The Legacy of the 1970s*

The 1970s are remembered for many events: for example, the U.S. dollar glut, the freeing of the dollar from gold, the OPEC (Organization of Petroleum Exporting Countries) oil price shock, floating exchange rates, stagflation, neoprotectionism, the entry of women and baby boomers into the labour force, peaks in government spending, wage and price controls, and the European Community expansion from six to ten members, among others.

Four events were particularly important in terms of their effects on policies of the big-three powers in the 1980s. The first was the oil price shocks of 1973-74 and 1979-80 when the United States was held to ransom by a group of LDC oil producers. This was the first direct signal to U.S. producers and consumers of the growing trade interdependence between the United States and other economies. U.S. security as the major world producer of processed energy-intensive manufactured

goods was threatened. Both the United States and Europe, as energy importers, found that their terms of trade deteriorated and their real incomes fell. Japan, as a major energy importer with a high exposure to the global market, was hit the most severely and underwent the most adjustment.

The second important factor was lagging productivity growth. Throughout the 1970s, productivity in the industrialized countries was flat. This lack of productivity growth worried American economists and policy makers, particularly since Japanese growth rates remained so high.<sup>2</sup> This new problem of uncompetitiveness vis-à-vis the Japanese (and the emerging NICs) due to the U.S.'s slower productivity growth dominated Reagan's economic policy throughout the 1980s. In Western Europe, slower productivity growth, accompanied by relatively rigid wages, increased structural unemployment in the EC. The non-accelerating inflation rate of unemployment rose through the 1970s and 1980s, widening the gap between potential output and the maximum output consistent with non-accelerating inflation, making European policy choices more difficult.

The third factor was the end of the Tokyo Round of GATT negotiations in 1979. Implemented over the period 1979-87, the new GATT codes outlined various types of non-tariff barriers. The intention was to reduce the spread of discriminatory, non-transparent barriers to trade such as subsidies and preferential government procurement policies. The unintended consequence of codifying such restrictions may have been to increase their use by increasing their visibility to pressure groups and inducing nations that had not previously engaged in managed trade to do so since "everyone else was."

The fourth event was Proposition 13. In 1978 the state of California held a referendum on raising property taxes. It was voted down, the first strong signal that the American public was willing to suffer lower levels of government services in return for smaller tax burdens. Proposition 13 was the first victory of supply-side economics.

Bhagwati (1987) has argued that every major change has its origins in institutions, ideas and interest groups. Proposition 13 was the vanguard of a new economic idea based on supply-side economics and monetarism: cut taxes, deregulate domestic markets and hold money-supply growth at the rate of real GNP growth. Fiscal policy was perceived to be an unwieldy macroeconomic tool. Its new purpose was to be a microeconomic one, cutting government spending as a per cent of GNP and removing distortionary taxes and expenditures, thus

freeing up funds for private investment. Supply-side policies would remove rigidities, encourage private savings, stimulate business investment and boost productivity. As the economy grew, the growing tax base would provide the revenues to cover government expenditures (the so-called Laffer curve).

### *The Early Reaganomics, 1980-85*

When Reagan was elected president of the United States in 1980, he promised tax cuts, deregulation and strong defence spending as the cure for the ills of the U.S. economy of the 1970s. The focus was on domestic policies for the domestic economy. Each nation was responsible for its own internal market and no international coordination of policies was supposedly necessary. Reagan argued that other nations should follow his example by deregulating their economies and cutting taxes. As the new economic orthodoxy spread, other countries did follow, most noticeably the United Kingdom under Margaret Thatcher.

Reagan faced a severe recession in 1981-82 as the industrialized countries tightened their monetary and fiscal policies in response to the 1979-80 oil price shock. Table 5-1 shows the general government budgetary surplus/deficit as a per cent of GNP, the nominal short-term interest rate and the real short-term interest rate for the years 1980-88. In 1981 and 1982 the deficit as a per cent of GNP and nominal and real interest rates for the Group of Seven (G-7) industrialized economies rose sharply over 1980 levels.

In 1981, however, Reagan cut taxes sharply, using supply-side economics as the rationale for the tax cut. Implementing the prescriptions of monetarism, the Federal Reserve Board targeted the money supply to the growth rate of the economy. The result was tight monetary policy and easy fiscal policy. In effect, the equation (Reaganomics = Tax Cuts + Defence Spending + Deregulation) was equivalent to an old-fashioned dose of Keynesian demand stimulus (Gilpin 1987b: 362), although it was clear that the U.S. economic policy makers did not intend this.

Thus, the United States was using fiscal policy to stimulate its economy at the same time as other economies were restricting their government spending and slowing their economies. The mismatch led to widening interest rates between the United States and Europe, an inflow of foreign capital into the United States (which peaked in 1982)



**Table 5-1**  
**Interest Rates and Deficits as a Percentage of**  
**Gross National Product, 1980-88**

	1980	1981	1982	1983	1984	1985	1986	1987	Forecast 1988
<b>Canada</b>									
(G-T)/Y	-2.8	-1.5	-5.9	-6.9	-6.4	-7.0	-5.5	-4.6	-2.2
(X-M)/Y	-0.4	-1.7	0.8	0.6	-0.4	-2.1	-1.9	-1.8	-2.3
i	13.4	18.3	14.4	9.5	11.3	9.6	9.2	8.4	9.9
i-P=r	2.8	7.5	5.4	4.5	8.2	6.7	6.7	4.1	6.0
<b>United States</b>									
(G-T)/Y	-1.3	-1.0	-3.5	-3.8	-2.8	-3.3	-3.4	-2.3	-2.2
(X-M)/Y	0.1	0.2	-0.3	-1.4	-2.8	-2.9	-3.3	-3.4	-2.6
i	13.1	15.9	12.4	9.1	10.4	8.0	6.5	6.9	8.3
i-P=r	4.0	6.3	6.0	5.3	6.7	5.0	3.8	3.6	5.1
<b>Japan</b>									
(G-T)/Y	-4.4	-3.8	-3.6	-3.7	-2.1	-0.8	-1.1	-0.4	-0.1
(X-M)/Y	-1.0	0.4	0.6	1.8	2.8	3.7	4.3	3.6	2.8
i	11.0	7.7	7.1	6.7	6.3	6.7	5.1	3.9	4.1
i-P=r	7.2	4.5	5.1	6.0	5.1	5.1	3.3	4.1	3.2
<b>West Germany</b>									
(G-T)/Y	-2.9	-3.7	-3.3	-2.5	-1.9	-1.1	-1.2	-1.7	-2.1
(X-M)/Y	-1.7	-0.5	0.8	0.8	1.6	2.6	4.4	4.0	3.8
i	9.5	12.1	8.9	5.8	6.0	5.4	4.6	4.0	5.3
i-P=r	4.7	8.1	4.5	2.5	4.0	3.2	1.5	1.9	3.5
<b>United Kingdom</b>									
(G-T)/Y	-3.5	-2.5	-2.4	-3.4	-3.9	-2.9	-2.6	-1.0	0.4
(X-M)/Y	1.3	2.7	1.6	1.2	0.6	0.9	0.0	-0.4	-2.4
i	16.6	13.8	12.3	10.1	9.9	12.2	10.9	9.6	11.3
i-P=r	-3.2	2.3	4.7	4.8	5.6	6.3	7.3	4.8	6.1
<b>Seven Ind.</b>									
(G-T)/Y	-2.5	-2.7	-3.9	-4.1	-3.4	-3.3	-3.3	-2.4	-2.2
(X-M)/Y	-0.5	0.0	-0.1	-0.2	-0.8	-0.6	-0.2	-0.3	-0.3
i	12.9	14.7	13.2	10.8	10.5	10.0	8.4	7.8	8.3
i-P=r	3.4	6.0	6.4	6.1	6.6	6.6	5.3	5.1	5.5

Note: (G-T)/Y = budget surplus/deficit as a per cent of GNP; (X-M)/Y = current account surplus/deficit as a per cent of GNP; i = nominal interest rate; r = real interest rate defined as the nominal rate net of the CPI inflation rate, P.

Source: *International Monetary Fund 1988*: 60, 68, 74, 76, 77.

and a rising U.S. dollar. In 1982 the U.S. current account went into deficit, while the West German and Japanese accounts moved into surplus. Through this period, the Keynesian budgetary deficit stimulated U.S. aggregate demand, output growth and employment. The percentage change in real GNP in the United States switched from -2.5 per cent in 1982 to +3.6 per cent in 1983 (see Table 5-2). The boom in the United States pulled the other economies along with it as American demand for European and Japanese exports increased.

Table 5-2 shows the mismatch between the macroeconomic policies of the United States, Japan and Europe as measured by the "fiscal impulse" and "monetary impulse" of government policy in the G-7 industrialized economies. Fiscal impulse is defined as the gap between the percentage change in the fiscal budget and nominal GNP (that is, the percentage change in government expenditures net of revenues [G-T] minus the percentage change in GNP). If the gap is positive (negative), the budget deficit is growing faster (slower) than GNP and has an expansionary (contractionary) impact on the economy. Monetary impulse, similarly, is defined as the gap between the percentage change in broad money<sup>3</sup> and the percentage change in nominal GNP. If the money supply is growing faster (slower) than nominal GNP, the monetary impulse is positive (negative) and expansionary (contractionary). Therefore, negative numbers in the table are contractionary; positive ones, expansionary. The positive impact of Reaganomics on the U.S. economy, compared to the macro-impulses elsewhere in 1982 and 1983, is clear.

The developing countries, on the other hand, suffered from the high interest rates and overvalued U.S. dollar. Higher interest rates helped to create the debt crisis in 1983, as international capital markets dried up for debtor countries. To pay the interest costs on their debts, the LDCs were forced to cut back imports, thus buying less from the United States. Since most LDCs used their imports to purchase capital equipment, technology and other necessary inputs, the debt crisis had, and will continue to have, a prolonged double negative impact on LDC growth rates: first, cutting their purchasing power; and second, causing a fall in potential output levels.

The U.S. dollar rose 40 per cent in trade-weighted terms between 1980 and 1984. It continued to rise through 1984 as a result of high U.S. interest rates, political stability, low inflation and good profit opportunities due to the boom. As the dollar appreciated, U.S. exports became less competitive on world markets, while foreign imports

**Table 5-2**  
**Real Investment, Fiscal and Monetary Impulses**  
**and Growth (in percentages) in GNP, 1980-88**

	1980	1981	1982	1983	1984	1985	1986	Forecast	
								1987	1988
<b>Canada</b>									
Real GNP Growth	1.5	3.7	-3.2	3.2	6.3	4.6	3.2	4.0	4.2
Real Invest. Impulse	8.5	8.0	-7.8	-3.9	-4.2	3.6	1.8	5.6	7.8
Fiscal Impulse	0.5	-0.7	1.4	1.1	1.5	1.5	-1.0	-0.6	-0.4
Monetary Impulse	6.6	0.5	4.0	-2.4	-5.0	1.9	3.0	1.7	N.A.
<b>United States</b>									
Real GNP Growth	-0.2	1.9	-2.5	3.6	6.8	3.4	2.8	3.4	4.0
Real Invest. Impulse	-7.7	-0.8	-7.1	4.6	10.0	2.0	-2.8	-1.5	1.4
Fiscal Impulse	0.7	-0.5	0.5	0.6	0.6	0.7	0.2	-0.8	0.3
Monetary Impulse	-0.9	-2.1	5.4	5.1	-2.6	2.5	2.9	-0.2	N.A.
<b>Japan</b>									
Real GNP Growth	4.3	3.7	3.1	3.3	5.0	4.8	2.5	4.2	5.8
Real Invest. Impulse	-4.4	-0.4	-2.2	-3.5	-0.2	0.5	3.6	5.9	5.6
Fiscal Impulse	-0.4	-0.8	-0.5	-0.2	-1.2	-0.9	-0.2	-0.7	0.2
Monetary Impulse	1.1	2.0	4.1	3.4	1.6	2.0	4.4	6.4	3.8
<b>West Germany</b>									
Real GNP Growth	1.5	0.0	-1.0	1.9	3.3	1.9	2.3	1.8	2.9
Real Invest. Impulse	1.3	-4.8	-4.3	1.3	-2.5	-1.8	0.8	0.0	2.0
Fiscal Impulse	-0.2	-0.5	-1.9	-0.4	0.6	-0.9	0.2	0.2	0.6
Monetary Impulse	-1.0	2.4	3.1	1.4	-1.5	0.8	0.5	3.2	1.3
<b>United Kingdom</b>									
Real GNP Growth	-2.5	-1.1	1.5	3.2	2.6	3.7	3.2	4.4	4.0
Real Invest. Impulse	-2.9	-8.5	3.9	1.9	5.4	-0.7	-3.5	-0.5	6.5
Fiscal Impulse	-2.0	-2.7	-0.7	1.3	0.5	-0.5	0.2	-0.2	-1.5
Monetary Impulse	-2.1	6.9	2.6	2.0	2.3	4.3	12.3	11.5	11.8
<b>G-7 Countries</b>									
Real GNP Growth	-0.1	1.0	-0.3	3.3	5.7	3.4	3.7	3.7	4.2
Real Invest. Impulse	-2.1	-1.1	-4.8	0.7	3.9	1.1	-1.9	0.5	3.5
Fiscal Impulse	0.0	-0.4	-0.1	0.2	0.2	0.2	0.0	-0.6	0.1
Monetary Impulse	-1.4	-0.2	2.9	3.0	-1.3	2.0	2.7	2.1	N.A.

Note: Fiscal impulse = percentage change in (G-T) minus percentage change in nominal GNP; monetary impulse = percentage change in broad money M2 minus percentage change in nominal GNP; real investment impulse = percentage change in real investment minus percentage change in real GNP. Plus signs are expansionary; negative signs contractionary.

penetrated more deeply into the American domestic market. Traditional mass-production industries such as steel and autos began to suffer from foreign competition. The fear of lack of competitiveness led the United States to pass the Trade and Tariff Act in 1984, increasing U.S. surveillance of, and retaliation for, perceived unfair foreign trade practices. The act also moved the United States away from its professed goal of multilateralism by allowing the U.S. Executive to pursue bilateral free trade negotiations with Israel and Canada.

The protectionist pressures in the U.S. Congress, coupled with the growing agricultural war between the United States and the European Community, generated wide support for a new GATT round in 1984. The United States wanted free trade in services and reduced barriers on investment flows (non-discrimination and right of establishment) on the table; other countries were more hesitant. These talks continued through the remainder of the period.

In February 1985 the U.S. dollar peaked, reversed direction and started to fall. In the second quarter of 1985, the United States became a net international debtor as capital inflows exceeded capital outflows for the first time since 1945. The falling dollar, in conjunction with the net debtor status of the United States, induced changes in both U.S. fiscal and monetary policies. The U.S. Executive and Congress were forced to face the deficits and do something to generate foreign investor confidence. The compromise was the Gramm-Rudman Bill, which set budgetary deficit limits that would cut spending automatically when the target was exceeded. Monetary policy was also changed from targeting money-supply growth to tracking real growth rates in the economy. The easier monetary policy stance of the Federal Reserve Board helped the dollar to fall further. U.S. nominal and real interest rates fell (see Table 5-1); however, the U.S. budget deficit as a per cent of GNP continued to rise. Both monetary and fiscal policies were expansionary (see Table 5-2).

Worries about the current account deficit, which continued to rise as a per cent of GNP (see Table 5-1), generated stronger domestic pressures for orderly marketing arrangements. A protectionist trade bill passed both houses but was vetoed by President Reagan. Instead, voluntary export restraints (VERs) were extended to Japanese auto exports. The United States negotiated a market-sharing arrangement in steel and announced a more aggressive countervailing-duty policy towards foreign subsidies. Canada also negotiated VERs in autos, and the European Community in VCRs, with Japanese exporters.

## *The New Reaganomics, 1985-88*

In September 1985 the G-5 countries (the United States, West Germany, Japan, the United Kingdom and France) signed the Plaza Accord, an historic turning point in U.S. domestic policy management. For the first time, the Americans admitted that (1) the dollar was overvalued and hurting the domestic economy, (2) the U.S. budget deficit was at least partly responsible for the U.S. balance-of-payments deficit, and (3) international coordination of domestic monetary and fiscal policies would be necessary to solve the budgetary and payments imbalances. The U.S. agreed to take steps to reduce its budget deficit; Japan and West Germany agreed to stimulate their domestic economies. The G-5 countries agreed to coordinate their central bank interventions in the foreign exchange market to push the dollar down.

In the winter of 1985-86, world oil prices collapsed when OPEC could not agree on production cuts. Slower growth in oil consumption and weakening oil prices caused OPEC to drop its attempt to force up prices by restricting supply. The U.S. trade deficit widened in 1986, and world trade growth slowed from 9.5 per cent in 1984 to 3 per cent in 1985 and 1986. The slack in labour markets and low inflation rates led the International Monetary Fund (IMF) to claim in its *Annual Report 1986* that inflation had been conquered in the industrialized countries.

In January 1986 the European Community expanded to include Greece, Spain and Portugal. Lower oil prices and interest rates caused a pickup in the world economy in the second half of 1986. The G-5 countries met at the Tokyo summit and decided to expand to seven members, admitting Canada and Italy to their group. The G-7 agreed to begin international economic coordination of their economies, first by establishing a range of economic indicators and then by attempting to remain within targets. The United States began to levy a 1.4 per cent surcharge on all imports as a customs user fee. In the fall of 1986, the U.S. trade deficit started to turn around.

In February 1987 the G-7 signed the Louvre Accord, agreeing to hold their exchange rates at existing levels, by central bank intervention if necessary. The Louvre Accord effectively ended fourteen years of floating exchange rates for the industrialized economies. The G-7 agreed that countries with balance-of-payments surpluses should strengthen their domestic demand and reduce external surpluses;

countries with deficits should do the reverse. The United States moved to reduce its budget deficit and to cut interest rates; Japan announced a series of public works to stimulate domestic demand (see Tables 5-1 and 5-2 for the actual changes). The G-7 met again in June 1987 to sign the Venice Economic Declaration. Exchange rates were to be held at existing levels, and economic indicators used to increase surveillance of domestic economies. Medium-term projections would be developed to aid coordination of monetary, fiscal and exchange rate policies.

When the G-7 met in September 1987, the ministers could not agree on the appropriate level for the U.S. dollar and so did nothing. Private investors were reluctant to hold U.S. dollars as assets because they believed that the dollar was overvalued under the Louvre Accord. They began to sell. The G-7 central banks were forced to step in and spend more than \$100 billion, supporting the dollar between the February accord and the stock market crash in October 1987. Effectively, the Louvre Accord printed money to finance a U.S. balance-of-payments deficit that otherwise would have pulled the global economy into a recession. Through intervention, the G-7 expanded the stock of liquidity in the economy to prevent the crowding out that could have occurred.

Throughout 1987, investors continued to pour money into the U.S. stock market. Enormous paper gains were made, and financial advisers expected the stock market to peak and go into decline. In the autumn of 1987, U.S. interest rates began to rise and were expected to go higher at the same time as rates were falling elsewhere (see Table 5-1). The perceived widening gap between returns on U.S. equities and U.S. bonds tipped the overextended U.S. stock market into a panic in October 1987. The stock market was inflated by speculation, and to some extent the crash may have been a necessary correction. Over one trillion dollars of U.S. shareholder wealth was wiped out by the crash. Stock markets around the world also fell, although less so, and they rebounded more quickly than in the United States.

After the stock market crash, fears were widespread that a global recession would follow. However, central bank intervention to increase liquidity and prop up the dollar helped to avert a recession. The U.S. Congress also agreed to caps on discretionary expenditures and \$35 billion in cuts from the projected budget deficit. The dollar was now effectively floating and the Louvre Accord was dead.<sup>4</sup>

In June 1988 the G-7 signed the Toronto Economic Declaration, singling out three areas for attention: (1) the need to resist protectionism and strengthen the world trading system; (2) the importance of developing a strategy to alleviate the burden of debt for the LDCs; and (3) the urgency of dealing with conflict over agricultural subsidies. The G-7 members agreed to continue with supply-side deregulation: removing barriers, increasing competition, and removing disincentives to saving and investment.

The U.S. economy continued its strong growth, with unemployment rates falling to 5.3 per cent in November 1988, putting the economy at full employment and near-capacity output. World trade is forecasted to increase by 7.5 per cent in 1988, and trade imbalances to narrow significantly. Real GNP in the industrialized countries is expected to grow by 4 per cent. For the year overall, the IMF forecasts an unchanged U.S. budget deficit as a per cent of GNP, a substantial jump in U.S. interest rates and a falling current account deficit as a per cent of GNP (see Table 5-1). Overall, fiscal policy should be expansionary (see Table 5-2) — a normal expectation for this point in the political business cycle (that is, an election year).

The mid-term review of the GATT Uruguay Round was held in Montreal in December 1988. A multilateral agreement reducing tariffs on tropical fruit, along with a tentative agreement in services, was negotiated. However, the European Community and the United States remained deadlocked over subsidies in agriculture, Europe arguing for a freeze on the subsidy level, the United States for the eventual end of all agricultural subsidies. As a result of the deadlock, the developing countries refused to sign agreements on any issues until the agriculture problem was settled. The session ended without final agreement, postponing decisions until later in 1989. Unless this deadlock can be broken, the Uruguay Round may end up being the least successful GATT round, with severe repercussions on the liberal international trading system.

## The Forecast for 1989 and Beyond

It is not expected that 1989 will be a rosy year. After George Bush was elected president in November 1988 the U.S. stock market dropped 100 points and the dollar fell another 10 per cent. Bush was elected on a promise of not raising taxes ("Read my lips"), as Reagan had been in the previous two elections.

The U.S. policy-making apparatus is therefore widely perceived to be in a state of stalemate: the Republican Executive refuses to raise taxes, while the Democratic Congress refuses to cut expenditures. Fiscal policy may well be frozen by political inaction. As a result, monetary policy is expected to shoulder the burden (as it has done throughout the 1980s in the United States) of simultaneously managing the domestic goal of full employment without inflation and the external goal of a stable balance of payments. Since one tool cannot always achieve two targets, one of them must take priority.

If the full-capacity U.S. economy begins to overheat and inflation starts to rise, higher interest rates will be necessary to dampen the demand-induced inflation. If nothing significant is done to reduce the U.S. budget deficit, the economy will continue to import, implying a continuing balance-of-trade deficit. Higher rates will attract financial capital inflows, exacerbating both the capital account surplus and the current account deficit as the dollar is strengthened. Crowding out of private fixed investment, already a problem in the U.S. economy, could grow substantially worse. Higher interest rates and a weaker U.S. economy would also squeeze the Third World, slowing their exports and increasing their debts.

On the other hand, the improvement in the current account in 1988 is expected to end in 1989 as the last of the J-curve effects is felt.<sup>5</sup> If the dollar starts to fall dramatically, costs of production in the United States will rise. This could lead to higher wages and prices, starting an import-push inflation. The Federal Reserve Board would have to tighten interest rates to prop up the dollar and choke off inflation. This could push the economy into a recession, perhaps precipitating another stock market crash. Such a crash would be much more difficult to handle than the one in 1987, since the inflationary bubble has been squeezed out of stock prices. Any subsequent fall would seriously damage shareholder wealth and depress consumption and investment.

Since both higher current account deficits and higher inflation rates are probable in 1989, the most likely scenario is for tighter U.S. monetary policy, a slower-growing U.S. economy, continued short-term financial inflows and a continued budget deficit. A rapid slide into recession could raise the budget deficit substantially, making any kind of discretionary fiscal policy nigh impossible. By keeping the budget deficit high in the 1980s boom time, the government has allowed itself little flexibility to handle any domestic problems that could arise in 1989 and beyond.<sup>6</sup> In addition, by depressing private



fixed investment, the government has left a legacy of permanently slower growth, lagging productivity and reduced capacity that will persist.

The outlook for the U.S. economy in the 1990s is not good. It is saddled with high debts, aging rust-belt industries in its heartland, decaying roads and social infrastructure, and strong protectionist interest groups. The cure is not easy. The economy needs higher rates of investment and domestic saving, particularly in knowledge-intensive activities. The budget deficit must be handled if investment and saving are to increase. Too rapid a reduction of the deficit could push the global economy into a deep recession. Too slow a reduction could exacerbate inflation. The policy choice is not an easy one.

## Deficits: Do They Matter?

Throughout the 1980-85 Reagan era in the United States, while there was much hand-wringing over the budget and current account deficits, nothing was done; they were basically ignored. Tight monetary policy and easy fiscal policy kept interest rates high and foreign capital flowed into the U.S. financial markets. The combination of tax cuts and defence spending caused consumers to go on a buying spree, cutting savings and crowding business investment out of the marketplace. Not until the Plaza Accord did the U.S. government admit there could be any connection between the two deficits. Even today, little has been done to control the first; the second has been handled through dollar depreciations and U.S. neoprotectionism. The twin deficits remain a Reagan legacy for the 1990s.

Two questions have dominated discussion about the deficits in the last few years: What is the connection between them? and, Does the budget deficit matter? In this section, an answer to these two questions will be attempted.

First, the two deficits are directly connected. It is an accounting truism in introductory macroeconomics that *ex post* private consumption plus private investment plus government spending on goods and services plus net exports must equal *ex post* national output valued at market prices (GNP). Since consumption, investment and government spending total domestic demand, if domestic demand exceeds (is less than) GNP, the current account must be in deficit (surplus). This relationship is a truism in an *ex post* sense, regardless of the exchange rate. It is also true in an *ex ante* sense when markets are in equilibrium,

that is, when the intended plans of consumers, producers and investors are actually realized.

Another way of writing the same statement is to say that *ex post* withdrawals out of the system and *ex post* injections into the system must balance. The withdrawals are saving, taxes and imports; the injections are government spending, investment and exports. Again, it must always be true, *ex post*, that the current account is in deficit (surplus) if domestic private saving exceeds (is less than) the sum of private investment and the budget deficit. Therefore, the current account will be in deficit whenever output falls short of domestic demand or, alternatively, whenever domestic saving is insufficient to finance private investment and the government budget deficit.

Since the balance of payments is also an accounting balance for the year, if the current account is in deficit (surplus) there must be an equal and offsetting surplus (deficit) on the capital account (including both private and official compensating monetary movements). A current account deficit (surplus) is matched with foreign capital inflows (outflows).

Economists theorize about the lines of causation from the budget deficit to the current account deficit in the following manner. Suppose the economy is in equilibrium, with planned expenditures equal to planned output, and assume initially (for simplicity) that the current account is balanced. If the government now increases its expenditure without raising taxes (that is, running a budget deficit), aggregate demand increases in the system, pulling up the equilibrium level of output. The rise in GNP increases imports, which are assumed to be positively related to GNP. If exports are determined by levels of national income abroad (and the foreign repercussion effects of domestic policies on foreign incomes are small), a current account deficit will open up. The budget deficit also tends to push up domestic interest rates (unless the economy is very small in the world capital markets, in which case interest rates are fixed internationally). This crowds out private investment spending and attracts an inflow of foreign capital. Thus, the budget deficit tends to create a current account deficit and an offsetting capital account surplus.

Reagan's supply-side economic policies appear to have done just this. Since the Congress and U.S. Executive have been deadlocked over reducing the budget deficit, attention has been focused on the current account deficit, with depreciation of the dollar used as the policy tool. The reasoning is straightforward. Depreciation of the dollar should

eventually cause U.S. exports to become more competitive and imports less competitive on world markets, after the initial negative impact on the balance of payments due to lags wears off (the so-called J-curve). The rise in net exports stimulates aggregate demand, causing the equilibrium level of GNP to rise. As long as inflation does not heat up, the net impact of depreciation should be positive.

However, this reasoning ignores the domestic demand/domestic output equality discussed above. As long as domestic demand exceeds GNP, the current account deficit must persist. Hence, depreciation of the U.S. dollar is unlikely to work unless (1) the government reduces the budget deficit and (2) domestic saving is increased. The alternative is more crowding out of private investment, higher interest rates and a persistent current account deficit (*Economist* 1988).

The second question is, Does the budget deficit matter? The answer appears to be, sometimes, and in the U.S. case, definitely. As we have seen, the budget deficit generates an excess of domestic demand over domestic output. This excess demand, showing up as a current account deficit, requires a capital inflow to finance intended expenditures. In the long run, such borrowing must be repaid. If the borrowing is foreign portfolio investment, both the interest payments and the principal must be repaid. If it is foreign direct investment, dividends and other earnings will be repatriated. Eventually, a debtor country must generate enough output growth to finance the necessary pay-back to its foreign lenders. In the U.S. case, in the long run, either consumption must be curtailed, output expanded, or both, until output exceeds domestic demand by the amount needed to pay back the Japanese financiers.

The productive use of the borrowed funds is the crucial variable in the analysis. In the U.S. case, the share of business fixed investment in GNP dropped dramatically over the 1980s as the budget deficit crowded out private investment. Table 5-2 calculates a real investment impulse measure: the percentage change in real gross private fixed investment (that is, depreciation is included) minus the percentage change in real GNP. The crowding out of U.S. private investment, particularly from 1985 on, is clear. To the extent that the government spending which replaced it focused on building productive infrastructure, one may have offset the other. The long-run productivity of defence expenditures versus private investment expenditures is, however, a topic of intense debate (Bellon and Niosi 1988: 126-48). If the

deficit is being used to pay for previous government debts, these funds are, by definition, not available to finance economic growth.

If Gilpin's (1987a) "overconsumption/undersaving" thesis is correct, the decline in private investment in the United States throughout the 1980s will lead to lower growth and productivity rates in the years ahead. This will leave the American economy poorly positioned to deal with the Japanese economy of the 1990s. The legacy of the Reagan era may therefore be the widening gap between the U.S. and Japanese economies. Changes in the international division of labour will exacerbate this gap.

## Choices in the Changing International Division of Labour

The legacy of heavy budget deficits in the United States, and in Canada as well (see chapter 6), must clearly constrain future policy choices. Given that the global economy is changing much more rapidly than in the past, this fiscal inflexibility will hamper attempts by the state to anticipate and adjust to change. The third technological revolution has started; managing change is an essential strategy for the 1990s, and one for which we are ill-equipped.

The first technological revolution occurred two hundred years ago with the application of steam power to transportation and capital-goods production in factories (Mytelka 1987; Bell 1987). What we now call the "old international division of labour" was created whereby a group of core manufacturing countries centred in Western Europe bought raw materials and primary products from a periphery of colonies and less-developed economies.

The second technological revolution began one hundred years ago with the spread of electricity, synthetics and plastics. In the early 1900s in the United States, manufacturing firms began to mass produce consumer durables for their domestic markets. Lipietz (1987) has referred to this as Fordism (after Henry Ford and the Model T car). The old international division of labour began to show cracks in the late 1960s with the rise of Japan. Mytelka (1987) has argued that Western firms responded with two strategies. The first consisted of firm mergers, forming conglomerates to control forward and backward linkages, reduce risk and cartelize local markets. The second strategy was delocalization, designed to lower costs by shifting production to countries with lower unit labour costs. Multinational enterprises (par-

ticularly U.S. ones) began to move production offshore, and intra-firm trade in intermediate products between affiliates of vertically integrated multinationals became a major part of world trade flows (Casson 1986).

The energy squeeze, the productivity lag and the rise of the newly industrializing countries in the 1970s accentuated these pressures. Two kinds of manufacturing production were pulled offshore, particularly to the NICs. The first consisted of light, labour-intensive assembly operations, primarily in the textiles and electronics industries. The second consisted of basic industrial manufacturing of standardized mass-production products, such as stages in the automotive and steel manufacturing industries. (Lipietz [1987] referred to the first as Peripheral Taylorism and the second as Peripheral Fordism.) These two moves in the 1970s introduced the "new international division of labour" (NIDL).

The third technological revolution is different from the previous two in that it appears to be knowledge based rather than capital intensive. Bell (1987) argued that the third revolution is the joining of computers and telecommunications to produce new technologies, offering services as varied as interlinked computers and electronic mail to information storage and retrieval. New information-based industries are being created: computers, robotics, biochemical engineering, scientific instruments. The linking of buyers and sellers through computer hookups is changing the concept of a market from a geographic location to a network of computers linked by telephone lines.

This third revolution is a "transforming" one where new technologies replace previous methods, creating large structural changes in industries. Change is already occurring in the DMEs where, according to Bell, production is splitting into three distinct types:

- materials-based, standardized, mass-production, low value added operations where cost minimization is important;
- flexible batch production operations that are specialized, customized and high value added; and
- the new information-based, high value added industries such as engineering consulting, data processing, advertising and financial services.

If knowledge is displacing labour and capital as the underlying factor determining the global allocation of production, new strategies are

needed to cope with this change. Mytelka (1987) argued that new growth strategies for firms wishing to position themselves at the forefront of this revolution involve decentralizing research and development (R & D) operations, engaging in joint ventures to share R & D costs, and sharing knowledge production with universities and institutes. Government strategies must pay close attention to the local production of knowledge inputs. Such industries may be strategic, generating interindustry linkage externalities that foster growth (Krugman 1987).

Junne (1987) argued that a second effect of the revolution is changes in the NIDL. The manufacturing pattern of the 1970s and 1980s may not persist into the 1990s as flexible automation accelerates. Manufacturing processes can be transferred back from the NICs to the developed market economies, hastened by neoprotectionism. Exported strategies may therefore be less appropriate for LDCs; there may be no more NICs (see Broad and Cavanagh 1988).

The nation now at the forefront of the technological revolution is Japan. However, the United States also has an educated labour force, a large and wealthy market economy and dynamic information-based industries. By maintaining trade, investment and knowledge links with Japan, U.S. firms can learn from Japanese technology and remain competitive; consumers can benefit from greater choice and lower prices. The inflow of global resources can keep the U.S. economy dynamic and growing. The openness and decentralization of the U.S. economy is a major part of its attraction for labour and capital immigrants.

Change benefits newcomers at the expense of old groups in the economy. Inward-looking policies give power to current vested interest groups, which can gain by vetoing change to protect their privileged position. Thus, newer groups without a voice can be blocked from growth by protectionist policies favouring established industries. Olson (1988) argued that such policies create an aging and less-dynamic society in danger of domestic sclerosis. Erecting barriers and turning inward calcifies the economy, positioning it further behind countries that adapt to and anticipate change.

## Implications for Canada

Canada is a small player on the international stage. It is also one of the most open countries, and therefore particularly vulnerable to changes

in the international economic environment. It has a strong interest in seeing that the international trading regime remains open and multi-lateral. However, with close to 80 per cent of Canadian trade and investment flows now tied to the United States, U.S. economic policies and successes/failures have their first and major impact on Canada. The bilateral relationship therefore dominates, and has dominated, Canadian economic policy making.

Throughout the postwar period, Canadian macroeconomic policy has followed that of the United States; the 1980s have been no different. In the 1980s, Canada's budget deficit has been significantly higher than the American as a per cent of GNP. Canadian nominal and real interest rates also remained above the American rates, as the Bank of Canada used interest rates to prop up the Canadian exchange rate. Thus, the combination of an easy fiscal policy plus a tight monetary policy characterizes Canada even more so than Reaganomics does the United States.

Canada's budget deficit as a per cent of GNP has shrunk substantially from its high of 7 per cent in 1985 to a forecast 2.2 per cent in 1988, due mostly to growth in the economy rather than shrinkage of the deficit. Interest rates continue to rise (see Table 5-1). The rapid growth in real GNP, peaking in 1984 at 6.3 per cent, and expected to be 4.2 per cent in 1988 (see Table 5-2), is, however, unevenly spread across the country. Ontario is running close to full-capacity output; the eastern provinces substantially below that (see chapter 6).

Canada may be particularly vulnerable if there is a downturn in the international economy in 1989-90. If there is a worldwide recession, higher interest rates will raise debt-service costs for the government deficit, reduce tax revenues and exacerbate interregional growth differentials. On the other hand, through the Canada-U.S. Free Trade Agreement, Canada will be somewhat protected from U.S. policy initiatives if the United States responds by turning inward, adopting managed trade and strategic trade policies.

Under the Free Trade Agreement, Canada becomes part of the larger North American trading bloc, trading some loss of sovereignty against a more secure economic future. Intra-industry commodity, capital and service flows between the two economies should increase, partly at the expense of reduced trade with the rest of the world. Economic theory tells us that Canada, as the smaller of the two partners, should reap most of the gains; however, Canada must also shoulder most of the adjustment costs. A recession with high interest rates would exacerbate

these adjustment costs, reduce the potential gains expected from the agreement, and further increase interregional conflicts. It is therefore in Canada's interest to see that the macroeconomic imbalances in the world economy do not lead to such a downturn. The wise domestic policy choice for Canada in 1989-90 would be to increase its fiscal flexibility and be prepared to cushion the effects of global change for particular groups.

## Conclusion

As the major, but reduced, player in the global economy, the United States through Reaganomics has generated economic growth, pulling the other economies along with it. At the same time, the Americans have become more protectionist, negotiating managed commodity agreements with Japan, Western Europe and the NICs, and holding up negotiations in the current GATT round. The European Community is preoccupied with structural adjustment to global technological change and with 1992 as a potential solution. Japan is awash with liquidity and, at least currently, willing to finance the enormous U.S. budget deficit.

The need to reduce macroeconomic imbalances in the global economy is, however, not a call for more coordination in international macroeconomic policy. As the Louvre Accord showed, such coordination reflects a combination of economic theory and political realities. Managed stabilization policy accords are no more likely to be successful than managed commodity trade accords. Such pacts may actually be more destabilizing, since they inhibit, but do not eliminate, the underlying causes of discord and they may actually magnify errors. As in international commodity markets, rule rather than negotiations may more successfully handle change.

This chapter, therefore, echoes Nye's conclusion that looking outward remains the best strategy for the 1990s. While large nations may gain from breaking the rules, engaging in strategic trade policies and encouraging managed trade, it is a zero-sum game that imposes losses on the smaller players. In addition, rigidifying the market with inward-looking policies is to lose the ability to cope with change. It is to the long-run advantage of all players to participate in the changing global market.