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ecovery and the Free Market Economy

Mr. AMAYA: I recently met a number of businessmen, Congressmen, and journalists, and the impression I got from these meetings is that the U.S. economy is clearly picking up. The question now is how far and how fast the recovery will be. We can see signs of recovery in housing construction and auto sales, but the increase is not consistent. During January and February car sales picked up, only to slow again in March. Ups and downs are inevitable, of course. I should like to ask, however, what you think about the current economic situation in the United States.

Dr. CAMPBELL: First, I must say for the record that the views I express in this interview are personal views and do not represent my official positions in any of the advisory posts I hold with the Reagan Administration or as chairman designate of the Japan-U.S. Friendship Commission.

AMAYA: Let me add that I too am only expressing my personal views.

CAMPBELL: Getting back to your question, I think the recovery is clearly under way and has been under way for some time. Even the New York financial people, whose predictions have been consistently wrong during the past two years with respect to President Reagan's policies, are now recognizing that the recovery is under way. There was never any question in my mind

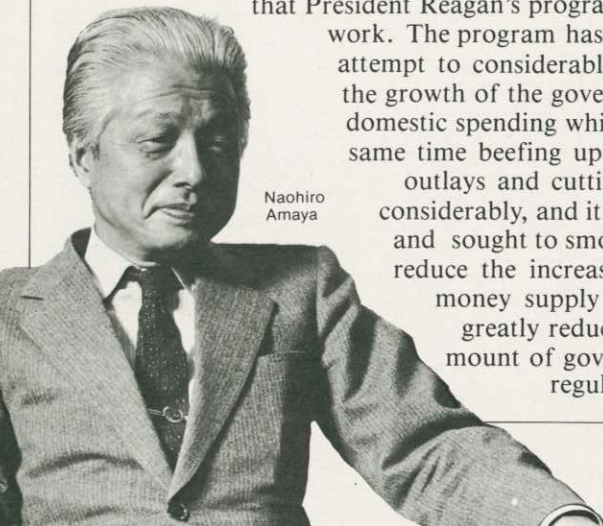
that President Reagan's program would work. The program has been an attempt to considerably reduce the growth of the government's domestic spending while at the same time beefing up defense outlays and cutting taxes considerably, and it has also and sought to smooth out reduce the increase in the money supply and to greatly reduce the amount of government regulation of

business. Now, like all comprehensive programs, some parts work better than others. But as far as I am concerned, on the part that really mattered most to the American people in 1980, namely the plan to reduce the rate of inflation, the Reagan Administration has brought that well under control. We now have 3% inflation, compared to the previous rate of 15%. That's a real achievement. And now the stage is set for a sustained recovery in the U.S. including, finally, a considerable increase in productivity.

AMAYA: The decline in the rate of inflation is quite a remarkable achievement. Yet in spite of this remarkable decline in the rate of inflation, interest rates are still very high, with the long-term prime rate 10.5%, which has a very serious effect upon the dollar-yen exchange rate. Moreover, this high interest rate will also affect investment by companies. How are interest rates to be stabilized and then reduced? And how far can we expect interest rates to decline?

CAMPBELL: First, I am sure you are aware of the fact that the interest rate during the past year has declined a larger percentage amount than in any post-World War II recession and recovery to date. Part of the problem was that it was starting from such a high level with all the inflationary expectations that were built up.

Another reason for the lower interest rates, and one that you must have noticed during your many visits to the U.S., is that President Reagan is a different type of president than what the American people have been used to for many years. The American people have been used to presidents who have had a tendency to say one thing for public consumption and then do another thing. President Reagan has had to make political compromises too, but as much as possible he tends to act the same way as he talks. I think he has had a terrible problem convincing the New York financial community that the government is going to be able to hold the rate of inflation down and that therefore interest rates will come down further. For a while, I believe, he even convinced Mr. Henry Kaufman—who had a remarkably



Naohiro
Amaya

In this wide-ranging tour d'horizon, Dr. W.G. Campbell and Mr. Naohiro Amaya discuss the economic outlook with special attention to the current tide of protectionism and what can be done to quell it in the interests of world trade.

Dr. Campbell received his Ph.D. in economics from Harvard University in 1948, where he taught for three years before becoming a research economist for the U.S. Chamber of Commerce and later for the American Enterprise Institute for Public Policy Research. Since 1960, Dr. Campbell has been the director of the Hoover Institution on War, Revolution, and Peace at Stanford University. In addition, Dr. Campbell is a close confidant and foreign policy adviser to President Reagan.

A graduate of the Law Faculty of Tokyo University, Mr. Amaya had a long and distinguished government career culminating in his appointment to the position of MITI Vice Minister for International Affairs from 1979 to 1981. He is currently a senior adviser to MITI.

wrong record during most of 1982. From the end of 1982 until the first part of this year, Mr. Kaufman has been predicting further interest rate declines. But recently, although I have not kept in touch with this as closely as I should, I understand he has hedged somewhat. In view of his past record, I find that encouraging since it probably means that there will be a further decline in interest rates.

AMAYA: The future of U.S. interest rates may be quite closely associated with how well the government deficit can be controlled and contained. I understand that tough budget negotiations are under way between the president and the Congress, and that many very difficult points and problems are involved. They say that the deficit for 1983 will be in the vicinity of \$200 billion. Do you think that that is a correct assessment of the upcoming deficit?

CAMPBELL: Well, the House of Representatives just passed their budget proposal, which is different from the president's. In comparison, the president's calls for a higher increase in defense expenditures, a much lower rate of increase in social expenditures, and no tax increases. The one that passed the House of Representatives calls for a much lower rate of increase in defense expenditures but a much higher rate of increase in social welfare expenditures, coupled with an unspecified tax increase. Actually I think the House budget comes out with a slightly smaller deficit, but the difference is so small that I don't really think it's significant. In terms of deficit, the more important thing is that if we have a general recovery in the U.S., the rate of unemployment, for example, will come down. At its peak, this was about 10.5%. If it is reduced to 6.5%, which, given the amount of structural unemployment we have, would be an enormous achievement, that \$200 billion deficit would be cut in half. So you can say that at least 50% of the deficit is caused by the recession. Now, the remainder of the deficit in respect to President Reagan's program, which in general thrust I support very strongly, is because the rate of increase in social

expenditures (as opposed to actual dollar figures, since none of these figures has declined) has not been slowed up to the desired extent. On the other hand, in defense expenditures, as a result of the huge decline in the rate of inflation, the original increase in the defense expenditures that were projected (I think they were originally a 7% real increase) are now promoted as a 10% real increase, which the military, Secretary of Defense Weinberger, and President Reagan insist is absolutely necessary. Frankly, I really don't know enough about the subject to pass a worthwhile opinion except to say that I would assume that the final figure will probably be around 7% when a compromise is reached between the 4% real increase the House of Representatives approved and the 10% real increase the Administration has been proposing. That compromise would also bring the size of the deficit down. Now once you take these three factors into account, the U.S. deficit is not really that large or that significant.

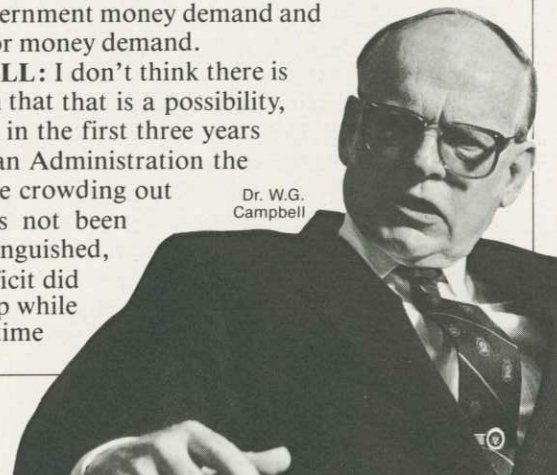
AMAYA: I feel that the higher the economic growth rate climbs the less the government deficit will be. Is that right?

CAMPBELL: Yes, I think so.

AMAYA: But the problem is that when the economic growth rate is accelerated, there is greater money demand in the private sector. Therefore there is a possibility that the so-called "crowding out" phenomenon will occur unless reconciliation is achieved between government money demand and private-sector money demand.

CAMPBELL: I don't think there is any question that that is a possibility, even though in the first three years of the Reagan Administration the record of the crowding out theorists has not been exactly distinguished, since the deficit did shoot way up while at the same time

Dr. W.G. Campbell



interest rates declined significantly. But I think there is always a danger of crowding out. That's why I think it's absolutely vital that there be a further decrease in social welfare expenditures, and also why I personally wouldn't be particularly upset if defense expenditures only increased by about 7 to 8% in real terms.

AMAYA: I think economically, it is the correct remedy for the disease, but politically it's a terribly difficult task.

CAMPBELL: I agree. And that's why there is so much worry that the recovery is not going to be as sustained or as robust as a lot of people would like it to be. But there is one other factor that I've neglected to mention, one that I think is a fairly direct consequence of the Reagan Administration's successes in getting the rate of inflation down so drastically. The rate of savings in the U.S. is finally increasing significantly. We used to have just about the lowest rate of savings of any industrialized non-communist nation. I haven't looked at the figures lately, but I suspect we are moving back toward the average. I'm sure our record will not be nearly as good as Japan's, but it won't be as relatively bad as it has been.

AMAYA: Changing the subject, recently we have seen a substantial oil price decline. Do you think that this is very good news for the U.S. economy as well as the world economy?

CAMPBELL: As in all things, there are pros and cons. Basically, I come down on the side that it's good news. It's good news, in my opinion, on net balance for the United States. I assume it's certainly considered good news in Japan.

AMAYA: Yes, certainly.

CAMPBELL: And it's good news for a lot of West European countries.

AMAYA: And for Brazil and Argentina.

CAMPBELL: However, I guess it is mixed news for Canada, since they are both an exporter and an importer of oil.

AMAYA: It's also bad news for Mexico and Venezuela.

CAMPBELL: And the Arab and other Middle East oil producers. But overall, if we are referring more specifically to the so-called international banking problems, I doubt that it's either worsening or improving them that much on net balance.

AMAYA: There is some scepticism on whether this \$29 price level will be maintained or whether it will continue to decline, and if so how far.

CAMPBELL: Well, like my colleague Milton Friedman, I'm a free-market economist, so my answer would be that the price will decline as far as necessary to clear the market. Now it's always dangerous to get into forecasting, but I personally wouldn't be surprised to see the price of oil decline to \$25 a barrel. I know there are some reputable U.S. forecasters who talk about \$20 a barrel. I believe the former chairman of the Council of Economic Advisers under President Ford, Alan Greenspan, has just recently been saying it may go to \$20. History teaches that cartels invariably break up sooner or later. This one (OPEC) has probably had a longer and more successful career than most, but I'm sure its days are numbered. I'm sorry to answer your question

so indirectly, but you have to be much more confident at forecasting techniques than I am to answer the question directly.

AMAYA: I know that it is almost impossible to make a forecast for the price of oil or exchange rates or that sort of thing. Looking back at history, in the 1950s and 60s oil prices were stable, exchange rates were stable, and interest rates were pretty stable. So the entrepreneurs had much less uncertainty than they do today. Nowadays the exchange rates are quite volatile, oil prices are fluctuating, and interest rates are also quite volatile, all of which increases the uncertainties substantially and is detrimental to investment by the private sector. I don't know very much about economic theory, but from the pragmatic point of view, we feel that it is quite desirable, if possible, to stabilize the price of oil, interest rates, and exchange rates. However, when it comes to the question of how to do this, nobody has a clear-cut answer.

CAMPBELL: Let me make two or three random comments on this. First I would say the destabilization of the price of oil came as a result of governmental actions, so that really can't be blamed on the private market place.

Now, as for stable exchange rates, those were held steady basically during the period when the U.S. was the only economic superpower in the world. It's true there were a lot of countries, Japan, West Germany, France, and others who were growing much more rapidly to reach economic superpower status, but in my opinion no single country has the economic power and influence to stabilize exchange rates now. This immediately brings us to the issue of the gold standard, which many of my fellow advisers to President Reagan favor very strongly. My position on the gold standard is somewhat like that of my colleague, Professor Friedman. If I thought the countries of the world were ready to obey the rules of the game, I would favor the gold standard. But as far as I'm concerned, it's perfectly obvious that many countries would go off the gold standard as soon as it started for internal political reasons, and so you would still have this exchange instability. Frankly, I don't have that much confidence in international organizations for maintaining exchange stability.

AMAYA: You believe in the market?

CAMPBELL: I would just point out that during the whole period in which the International Monetary Fund has been operating, I don't believe there is any proof on the record that increasing the reserves of the IMF will necessarily improve exchange rate stability. However, there are other reasons for wanting to increase the reserves of the IMF than exchange rate stability. So I guess my answer is that I am quite confident that these uncertainties are going to diminish in the 1980s, although we are never going to go back to the system of the more or less full stability that we had in the 1950s. I don't know. What's your view on that?

AMAYA: My view is that the 1950s and 60s might be compared to one giant Gulliver (America) and many Lilliputians of other countries, and that that structure has disappeared forever. We cannot go back in time to Lilliput.

CAMPBELL: Right. So you are basically agreeing with me that we can't really see a firm structure, at least at the present time.

AMAYA: One reason we are rather worried about this exchange rate problem is that the exchange rates, especially the depreciated yen exchange rate, is related to the rising tide of protectionism. And we are really worried about this rising protectionism in the U.S. and in Europe. Protectionism is quite detrimental to the world economy. But on the other hand, we can understand the terrible problems which U.S. steelmakers, automakers, and other industries are facing. It is not so easy for them to change their industrial structure quickly. So I think they have to have some sort of transitional breathing space. I am a believer in scratch rule competition, that is without any handicap. Although that is ideal, in reality I think sometimes a handicap needs to be introduced in cases where nobody would want to play otherwise. The American steel and auto industries, and some European industries, are asking for handicaps when they play against Japan. The question is what handicap is fair, and we don't have the answer to that difficult question. Do you also believe in the scratch rule, in perfectly free trade?

CAMPBELL: As close to free trade as possible, yes.

AMAYA: It's an ideal and I believe in it. But is it practical? That's the question.

CAMPBELL: I think it's better than the alternatives. I might make one comment with respect to automobiles and steel in the United States. Without going as far as to say that Japan is blameless, the first comment I would make is that you can't correct the mistakes of 20 years in a few months or even in a year or two. There is simply no question that as a result of the excessive wage scales, the somewhat deficient management controls and techniques, and the insufficient modernization, these industries are not that competitive any more. I'm hopeful that there is going to be an improvement, and I understand there has been a great improvement in the quality of American cars to make them competitive with the Japanese cars that are coming in, but there is still the problem of the sizable price differential resulting from the much higher, union-induced labor costs in the United States. So I think there is a terrible problem of perception in the U.S. now. It's always very easy, particularly if you are politician who wants to be reelected, to blame your constituents' problems on a foreign country.

Too many Americans go abroad these days and immediately start advising foreign countries and foreign officials on what they should do. I do think, however, that there is a serious problem of perception in the U.S. regarding Japanese import quotas on certain goods, and, probably even more important, the various administrative regulations. There are also the high tariffs on certain products such as tobacco, biscuits, and chocolates. I'm delighted to see that Prime Minister Nakasone has already taken action in respect to reducing tariff rates, and I understand he has announced that there is going to be a whole series of administrative proposals put before the Diet.

To illustrate the problem that the Americans have in this segment, let's consider automobiles. Rightly or

wrongly, Americans couldn't understand why it should take 7 months to get an American car into Japan. I understand under the new proposal it is going to be reduced to 2-1/2 months. I realize it is very complicated because there are other quality standards that you have to meet, but the attitude of most Americans is that since we allow the Japanese authorities to certify that their cars meet U.S. standards, the Japanese government should be willing to do the same in respect to American cars. I suspect that's a change that wouldn't cost Japan much, because I doubt that American cars are very competitive with Japanese cars anyway. But at the same time, I think there is recognition in the U.S. that Japanese manufacturers are trying to meet the problem halfway, particularly by building plants in Tennessee and Ohio, and by the proposed joint production agreement between Toyota and General Motors in Fremont, California.

AMAYA: Japan is very heavily dependent upon the international free trade system. Therefore I think that we must contribute to the maintenance of this system. I think it's in Japan's interest to continue its efforts to further open up its market and further reorganize its systems. So the government is now continuing these efforts even though we face political difficulties. We can't go very quickly, because of the practical and political difficulties. But we certainly will not go in reverse. Japan has never sought to set up or strengthen import barriers. To the contrary, we have been trying to dismantle such barriers for the past 20 or 30 years. We have no intention at all of introducing new protectionist measures in Japan.

I think it would be ideal for us to have just one world government for a universal inspection system and customs clearance procedures. But the reality is that we have different governments, different systems, and different traditions. I think it is necessary for us to make every effort to simplify and unify those different procedures as much as possible.

CAMPBELL: Yes, and I would emphasize, that in the U.S. these different Japanese procedures are blamed as being a much bigger factor in the U.S. balance of payments deficit with Japan than they actually are.

AMAYA: We can understand why that kind of perception exists. But on our side it's very difficult for us to make our system the same as the American system, since the Japanese system and institutions have deep historic roots.

CAMPBELL: The other very touchy issue in the U.S. is the quite strict quotas on citrus fruit and on beef. But I think at least part of this trade friction will disappear if recovery takes place in the U.S.

AMAYA: As for citrus and beef, in my personal opinion, Japan has to try to increase the quotas for these products gradually. In the end, I hope Japan could abolish these import barriers altogether. But because of political realities, I can't say how quickly this can be done. The direction is quite clear, however.

CAMPBELL: Yes, and I think you will find that the Reagan Administration is quite sympathetic with all the efforts that Japan is making. I hope the Administration will be able to prevent the Congressmen and Senators

from the so-called smokestack industry states from putting together coalitions of their constituents with the beef, citrus, and tobacco producers in order to get domestic content legislation passed. Now you and I know that even if the quotas on citrus fruit and beef were completely removed tomorrow, it wouldn't make that much difference in the overall deficit in the U.S. balance of payments with Japan. If we really wanted to reduce our deficit, of course, we would have to change our law about the export of Alaskan oil and natural gas to Japan, which Japan has wanted us to do for some time. But now that oil prices have dropped, you may not be as interested as you used to be.

AMAYA: By the way, we are rather perplexed at the rising criticism in the U.S. against what is called the Japanese government's industrial policy. For example, Under Secretary of Commerce Olmer and U.S. Trade Representative Brock said publicly that there was concern about the trade distortion effect which Japan's industry policy might have. They said they would investigate the situation, and would perhaps take the problems up at the GATT forum. I think we are quite prepared to explain what industrial policy is and what kind of effect this industrial policy has on international trade, but I don't understand this sudden outburst.

CAMPBELL: What sort of criticism is that? Is it the so-called targeting?

AMAYA: Yes. Some U.S. businessmen charge that the Japanese government has selected some industries to be protected and assisted by the government, and that these so-called target industries have been given the protection of special tax credits, special financing, and at times, subsidies. They say that the Japanese industrial development in some sectors has been quite successful in making very quick development and has become excessively competitive in the international market because this competitiveness has been supported by the Japanese government, and thus some American industries have been seriously affected. Therefore they argue for measures to insulate American industries from the competitiveness of Japanese industries, such as measures for import restrictions or governmental assistance to U.S. industries.

CAMPBELL: Well, this is an argument that I personally have a great deal of difficulty with because, historically of course, there is no question that such targeting really took place 30 years ago, and it took place with American encouragement, when for reasons of economic recovery, national security, and so on, the U.S. was very anxious to see Japanese exports expand. I would turn the argument around and say that if you consider automobiles, Japanese car companies have been in such a strong position for at least the last 10 years that there hasn't been any need for any government encouragement or special favors. As a matter of fact, in your trade relations, at least with the U.S., I would say the mistake has been that Japan's nontariff trade irritants haven't been addressed much earlier. I think that if you believe in free trade and you believe in the international trading system, you can only argue up to a certain point that such irritants are necessary because of your country's customs and culture. I guess

high technology is the sector most recently alleged as targeted. Every major economic bloc and every major country in the world is targeting high technology. They are certainly trying to do it in Europe. Japan is trying to do it. We are certainly trying to do it in the U.S., at least for defense purposes. I believe Defense Secretary Weinberger made a statement about that the other day in relation to computers, that we intended to do our best to always be ahead technically for the sake of national security.

AMAYA: I think this targeting is human instinct. For example, game hunters, business managers, politicians, and everyone else has some object to pursue. Everybody has a target. I think it's inevitable for government or for an industry to have targets.

I think there are three categories of relationships between government and the market. One is the typical Adam Smith-Ricardo type, where market mechanisms are all and the government does nothing. The second type is the Stalinist type where the government is all and the market counts for nothing. But these two are extreme cases and the third, in-between type is common.

CAMPBELL: Well, I would certainly say the second one is an extreme.

AMAYA: It's true that in the 19th century, the U.K. had the first type of market mechanism, or very close to that. And in the United States at the time of Presidents Harding and Coolidge, your system was very close to the first category as far as your domestic economy was concerned. But even at that time, American industries were protected by high tariffs.

CAMPBELL: I'm not sure the high tariffs were that important, actually. That was a convenient excuse in the U.S. but it's not necessary for your argument.

AMAYA: With Franklin Roosevelt, governmental intervention increased, and in Japan during and just after the war the economic and political situation of the time made it inevitable that allocation systems be introduced. We were on the verge of starvation and were forced to introduce rationing for food, materials, and foreign exchange. But as time went by and as the Japanese economy recovered, we gradually reduced this governmental intervention, and I think we are still going in the direction of further reducing governmental intervention. But it depends upon the historic conditions, and I don't think we shall be able to have an almost 100% market economy. While I think the direction is towards less governmental intervention, I also think that governmental intervention is required under some historical circumstances. It depends upon the specific circumstances, yet the ideal direction is quite clear—the less intervention the better.

CAMPBELL: I agree. I think you have given an excellent summation of the arguments for and against the free market economy, and I guess all that I would add from the viewpoint of the U.S. is that although there are a lot of very powerful forces that want us to turn back toward a controlled economy, as evidenced by the call for domestic content legislation, I would say that as of now we are still somewhat closer to the Adam Smith-Ricardo model, and we hope that Japan will move a little faster toward this model than it has been. ●