

# The Reagan Years and Beyond

How has the U.S. economy fared under President Ronald Reagan? What has this meant for the Japan-U.S. relationship? What are the most urgent tasks facing the next president? These are among the issues covered in the discussion set out below between Harvard professor of international economics Richard N. Cooper and *Journal of Japanese Trade & Industry* publisher Naohiro Amaya.

**AMAYA:** Now that President Reagan is on the 18th-hole fairway, this seems an opportune time to assess his administration's achievements.

When Reagan was inaugurated in 1981, his biggest task was to make America strong again. Economically, he has been very successful in many ways. Inflation has subsided, employment is close to full, and the economy has been growing for five-and-a-half years.

However, there is no sign of any substantial reduction in the giant twin deficits, and exchange rate volatility is uncured. It is thus still too early to say whether the American economy is standing tall or not.

On trade, Reagan is committed to free trade and has made admirable efforts to curb protectionism on Capitol Hill.

The biggest issue in U.S.-Japan relations has been the abrupt emergence of a tremendous trade imbalance, which has in turn caused many specific trade problems between the U.S. and Japan. Generally, however, the friction has been fairly well managed, and U.S.-Japan relations have been good.

Politically, the Reagan administration's biggest achievement has been in improving U.S.-Soviet relations. Many problems still exist between East and West, but great progress has been made.

**COOPER:** I suspect you have been too generous. From the historical perspective of, say, 20 years from now, I see two, possibly three, enduring legacies of this administration—two aircraft carriers and a trillion dollars more debt than we would have had otherwise. Much of that debt





will be held abroad. To those two, I would add the signing of the INF (Intermediate Nuclear Forces) Treaty, which I suspect will be seen as a historical achievement, although my guess is that functional substitutes will be found for those weapons.

I attribute the sharp reduction in inflation more to the Federal Reserve Board than to the administration, since it was, after all, President Carter who appointed Paul Volcker and most of the FRB members who took the very tight monetary measures that pushed back inflation.

The exceptionally long period of economic expansion has to be qualified by the realization that it is a recovery from the deepest postwar recession we have ever had—in 1982, the second year of the first Reagan administration.

Still, the Reagan administration deserves credit for the fact that the recovery has not gotten out of hand.

On trade policy, I would give the Reagan administration rather poor marks on balance. Reagan has been the only American president who has actually been committed to free trade. At the same time, however, he has taken no interest in the details of government. Therefore, we have this paradox of a president who is a genuine free trader, and an administration that has taken more protectionist actions than any other administration since World War II. Its rhetoric has been free trade and its actions protectionist.

Two problems have already come home to roost. One is the semiconductor agreement, which has driven memory chip prices way up due to inadequate capacity. The other is steel, where the continued expansion has created demand for more steel than U.S. domestic production can supply; yet steel users encounter difficulties importing steel because of the import restrictions.

On the whole, the administration's record is not good. At the same time, Reagan remains an extraordinarily popular president. He is by nature optimistic, and he conveys an intrinsic optimism that American voters find very appealing. Most people, after all, are not concerned with the details of government. They are drawn by personalities and by general images.

On bilateral Japan-U.S. relations, I agree that the trade imbalance has created an environment in which many specific trade issues came to the fore. Neither side handled these issues well. The task in both Japan and America during the next several years will be to bring public attitudes more in line with what is fundamentally not only a very important but also a very sound bilateral relationship.

**AMAYA:** Do you think that America is strong again, or is America weakening?

**COOPER:** This notion of strength is very complex, and the answer has to be complex. In military terms, the U.S. is clearly stronger than it was eight years ago. In diplomatic finesse, it is probably somewhat weaker, but not much. I believe the American economy is fundamentally sound. It is very flexible and innovative. I did not take the early 1980s talk of long-term disindustrialization seriously because I saw that the pressures arose largely from an unsustainably strong dollar.

The American economy's debt structure is much worse now than it was eight years ago. External debt and public debt are both much higher because Americans have been consuming too much both privately and publicly.

Perhaps more important than these tangible dimensions are the intangible ones of attitude, self-confidence and so forth. There is no doubt that Reagan conveyed a much greater sense of confidence than Carter did, and the public warmed to that. In that sense, there has been an improvement, although that improvement has been shaken in the last year. Again, we have something of a mixed picture.

**AMAYA:** Looking to the future, who will the next president be?

**COOPER:** American election campaigns are a bit of a crap shoot. The polls show Dukakis with a strong lead. But that has to be qualified by two things. We know from past experience that external events can have a strong influence on public sentiment between now and election time.

Secondly, the Democratic Party has a history of shooting itself in the foot, and it is quite possible that the Democrats

could cut themselves up between now and election day.

**AMAYA:** The perception in Japan is that the Democrats are more protectionist than the Republicans. Do you think Dukakis is more protectionist than Bush?

**COOPER:** Insofar as I understand their positions, both Bush and Dukakis are committed to an open economy and against serious protectionism. I do not think there is much difference between them in this area.

**AMAYA:** Whether it is Dukakis or Bush, what will the new administration's biggest tasks be? On the economic side, Reagan has not finished making America strong, and the new administration will probably have to cut spending and perhaps raise taxes. Will the new administration dare do that?

**COOPER:** The first priority of any new president is going to be reducing the budget deficit. The question is how. My own view is that we should not have major cuts in defense spending—at least not without corresponding reductions by the Soviet Union. Nondefense spending has been cut too severely for the most part already. Given this, I am drawn to the conclusion that we need a tax increase of one kind or another. We are not an overtaxed country. Japan and the United States both stand at or near the bottom among the industrialized countries in terms of taxation relative to GNP.

One tax that I support is a tax on oil products, especially gasoline. The United States has the lowest gasoline taxes, and the lowest gasoline prices, of any non-oil-exporting country. There is also some fiddling that could be done to raise additional income tax revenues. I suspect with those two alone one could do the job, but it is important to move quickly.

These measures involve compromise all around, but they are possible. There is widespread agreement that the budget deficit is too large, and a tax increase can be phased in over four years.

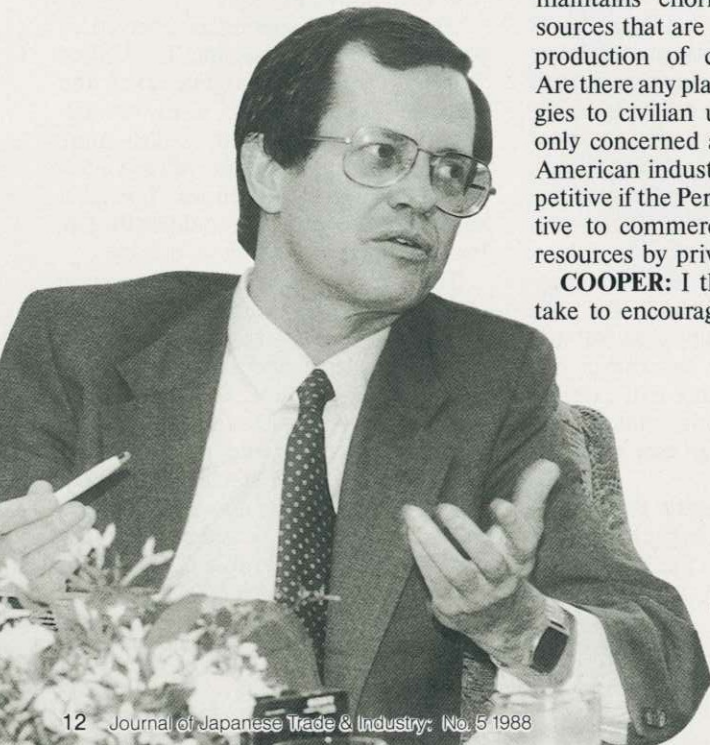
**AMAYA:** If people are optimistic on that, the foreign exchange and stock markets should be more stable. What about the American trade account? Do you think the deficit will be reduced? American exports are up because of the dollar's



devaluation, but industry is working at close to full capacity and needs more capital investment if it wants to expand exports.

**COOPER:** American manufacturers are cautious about making major new investments because they fear that exchange rate movements will make them unprofitable again in five years. Nonetheless, investment is strengthening and considerable improvement in the U.S. trade position is possible at current exchange rates—probably not enough to eliminate the trade deficit, but enough to work substantial reductions. That is what is important for the next several years: steady improvement.

Unlike some economists who want to see further depreciation to eliminate the trade deficit, I do not think it is possible to eliminate the deficit over the next five years or so—not because the American economy is incapable of it but because the rest of the world will not allow it. Reducing the American deficit means reducing other countries' surpluses. Embarrassed by their surpluses, Japan and Germany would each welcome the first \$25 billion. The second \$25 billion each would be much less welcome, and the third \$25 billion would be impossible. Yet that would be required to eliminate the U.S. deficit.



The American trade deficit cannot be eliminated without a solution to the Third World debt problem. Until we get stronger growth and improved import capacity in the developing countries, it will be impossible to eliminate the U.S. deficit.

**AMAYA:** If investors could see sustained improvement in the American trade balance, perhaps confidence in the dollar—which is fundamental for exchange market stability—could be maintained.

In seeking to make American industry more competitive, a number of people have raised the industrial policy question again.

**COOPER:** I share the economics profession's general bias against industrial policy. Government, particularly democratic government, is very poorly placed to decide which industries represent the promise of the future. Japan has had limited—but only limited—success. The United States has had none.

Fortunately, the term “industrial policy” is sufficiently undefined that I can find some things that I like: heavy support for education and research, facilitation of information flow and so forth; but it would be a mistake to embrace industrial policy if that means government emphasis on some sectors of the economy and de-emphasis on others.

**AMAYA:** The Defense Department maintains enormous technological resources that are not fully utilized for the production of consumer-sector goods. Are there any plans to put those technologies to civilian use, or is the Pentagon only concerned about the military side? American industry might be more competitive if the Pentagon were more receptive to commercial utilization of those resources by private industry.

**COOPER:** I think it would be a mistake to encourage the Defense Depart-

ment to try to influence the general industrial structure in any major way, except of course through its own procurement needs. There are some things, however, that the Defense Department could do that would be helpful—mostly in research and development. For the last 15 years or more, most Defense Department R&D contracts have been highly focused on specific military applications. It would be useful to go back to the old way and give general research grants for areas of potential military application.

It should also be less negative on high-technology exports to friendly nations. The Defense Department should take a more balanced view of total American interests, rather than addressing only the narrow question of transferring militarily relevant technology abroad.

**AMAYA:** Is more cooperation between Defense and Commerce feasible? Better communication there would certainly be very beneficial for the American industrial structure and competitiveness.

**COOPER:** Export controls are the test case there. If they can cooperate in the area of export controls, we might think of other areas. If they cannot succeed there, I would not encourage them to try other areas.

**AMAYA:** On the openness of the Japanese market, many Japanese argue it is open and many Americans claim it is closed. This is a very contentious issue, and specific trade friction takes place against this background. What are we to do?

**COOPER:** It is a question of continuing to manage specific problems skillfully. On whether the Japanese market is open or closed, with the well-known exceptions in agriculture and a few other products, Japanese policy is not protectionist. Tariffs are low, and there are few quotas.

At the same time, foreigners have exceptional difficulties selling in the Japanese market. When those difficulties are the usual ones of language and culture, there is nothing Japan can do about them. The complex, and somewhat cozy, distribution system will change over time, but is not going to change radically.

Yet when those difficulties include actions by middle-level bureaucrats, the

Cooper: Paradox between a free-trade president and the most protectionist administration since the war.



distinction between policy and culture becomes blurred. Practices that seem natural in the Japanese context are perceived as protectionist overseas. And prices in the marketplace certainly do not convey an impression of openness. I can buy a grapefruit in Tokyo for ¥500. In the United States, I can get seven grapefruits for that price. Transport costs are not that high. Similarly, the prices of foreign books are outrageously high.

I recently did a study of how rapidly the 1986 fall in world oil prices was reflected in consumer prices. In the United States, gasoline and fuel oil prices came down very quickly after crude oil prices fell—with about a one-month lag. In Japan, heavy industrial fuel oil prices came down quite quickly, although there was a two-to-three-month lag. Gasoline and kerosene prices came down hardly at all. If Japan were open to trade, some sharp dealer would buy gasoline in Singapore and import it. But actually, oil products are all subject to MITI guidance, so the market is not working here. And my guess is that there are many areas where the market is not working the way Western economists think it should.

The only way to deal with this is piecemeal, going after the impediments foreign exporters find and removing them one by one. It is a frustrating, but necessary, process.

**AMAYA:** This is useful not only for foreigners but also for the Japanese economy, yet it is difficult to implement because of the many, many, small obstacles.

Speaking of free trade, what do you think of the U.S.-Canada free trade agreement and the European drive for market integration by 1992? Do they promote free trade or are they obstructive?

**COOPER:** It can go either way depending on the details. I am satisfied that the U.S.-Canada free trade agreement is consistent with GATT and is a step for free trade.

Much merchandise trade between Canada and the U.S. is already free anyway. The real novelty of the agreement concerns services and investments. There is no doubt that, if it works, it will widen the market and reduce protection in those areas.

The Europeans say that their 1992 EC goal will not be protectionist, and I am prepared to believe them. Even so, countries such as the United States and Japan will have to watch the details very closely to make sure that the widening of the European market is not at the expense of outsiders.

**AMAYA:** In light of these moves, Ambassador Mansfield has been advocating a U.S.-Japan free trade agreement. What do you think?

**COOPER:** There is some interest in Japan, but virtually no discussion in the U.S. Some of the Japanese who have talked about this claim agriculture is too difficult and want to restrict it to industrial free trade. But without agriculture, it will not be attractive to Americans; with agriculture, it will not be attractive to Japanese. So I do not see this as a realistic possibility for the near future.

**AMAYA:** With even broader horizons, there is fairly strong enthusiasm in Japan for a Pacific Rim economic community—not firmly institutionalized like the EC but rather a loose framework for communication and cooperation among the fast-growing Pacific Rim countries, including the United States.

However, there are serious questions on how to sustain economic development in this region. We all agree that economic development in this area will ultimately contribute to global economic growth and health, but the question is how to power Pacific economic development. Cooperative U.S.-Japan contributions are very important in this area.

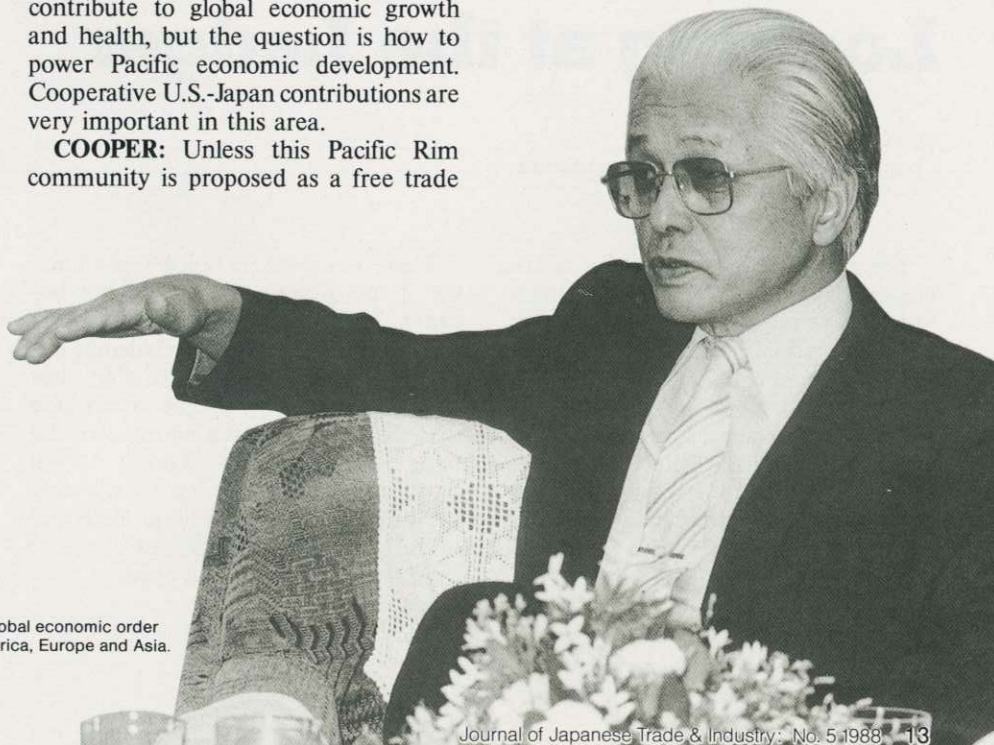
**COOPER:** Unless this Pacific Rim community is proposed as a free trade

area, I do not see any need for further institutional development. We already have two intergovernmental institutions that can collect statistics and sponsor conferences—the ADB and the ESCAP. At the same time, there are a number of private conferences—both academic and business—that are useful for exchanging information, opinions and ideas. What more is needed at this time?

Then there is the difficult question of exact membership. Which countries do you include? I don't have answers, and I doubt if anyone else does.

**AMAYA:** I suspect the purpose is not so much to create a rigid structure but to ensure better balance in the world economy. Unless there is relative balance among America, Europe and Asia (meaning Japan plus the Asian NIEs), it will be very difficult to maintain a stable global economic order.

It is thus most important that the United States, Asia and Europe keep their economies healthy. Just one is not enough. Just two is not enough. It has to be all three legs. We all share a common interest in maintaining global prosperity. That is the underlying issue for the future.



Amaya: Difficult to maintain global economic order without balance between America, Europe and Asia.