

Looking at the Options

By C. Michael Aho

Professor Toshio Watanabe is correct in saying the world's most dynamic economies are located along the Pacific Rim. But given the appreciation of the yen, the rapid expansion of the NICs, China's economic reforms, and the need for the U.S. to run a trade surplus to service its debt, the region will undergo significant changes in the structure and direction of trade and the location of economic activity. The outcome for patterns of production and employment is uncertain, depending on foreign investment activity, the degree to which alternative suppliers are complementary, and national policy actions.

The critical dimension will be national policy actions. Whether the Pacific Rim can become the world's next growth frontier depends fundamentally on national policy choices. With such significant and rapid changes occurring, trade frictions are likely to heighten. All countries in the region will have to work together to minimize those frictions.

The most important policy questions concern (a) the adjustment process: 1) Which countries will have reduced surpluses and how will the surpluses be reduced? 2) Will the internal adjustment process be smooth or fraught with political frictions? and (b) governance at the end of the process: 1) If the United States is no longer willing or able to continue to bear the burden of leadership, how can Japan assume more of the burden? 2) Is a new international institution needed to organize economic affairs in the region, and what role would the newly industrialized countries play in it?

The world economy is different today because the United States has become a "diminished giant." To move ahead, joint leadership will be needed, but it is less stable and more subject to delay than unilateral leadership. Time will be needed to adjust to this new situation, but in the meantime the world will not stand still. The pace of change has quickened. Heightened international competition

and technological changes are transforming the industrial landscape, causing dramatic shifts in the composition of the labor force and creating adjustment problems that spill over into domestic politics.

But we should not forget that all countries are in this together, with shared interests and shared responsibilities. Those interests include raising economic growth and reducing frictions and uncertainty. Each country has contributions to make, but each also has domestic political imperatives.

The United States

The coincidence of widespread layoffs and slow income growth coupled with record trade deficits and burgeoning foreign debt has led many Americans to question whether the United States will enjoy a more prosperous future. Concerns are being expressed about the ability of the United States to control its own destiny. Some ask whether it is the beginning of the end of the American dream. Real wages are below their mid-1970s level. Productivity growth has slowed to a crawl. Many Americans today worry that the increasing competition facing U.S. firms is hurting their standard of living. The nation's support for free trade is wavering, and foreign economic development is seen increasingly as a threat to U.S. welfare rather than a help.

What contributions should the United States make to facilitating adjustment? First, it should not attempt to avoid adjustment by erecting trade barriers, because that would damage living standards, not protect them. Granted, the temptation to resist change will be very great. But change is inevitable, and it is the key to growth and a better future. America must meet head-on the challenge of its changing global role by adapting to the increased competition in the global economy. America should welcome the competition. Competition is what prods us all to do better.

Next, it should stop living beyond its means. Just like a household that spends more than it earns, sooner or later the United States must service that debt and spend less than it earns. The primary culprit is the government budget deficits. These hemorrhaging deficits must stop. Cutting them must be the first priority of the next administration.

Some time well before the year 2000 the United States will be forced to pay its way in the world community. By then it will have to produce enough to cover domestic consumption and investment, as well as to pay interest on its rapidly accumulating foreign debt. This means that the current trade deficit will have to turn into a surplus. While trade includes services and agriculture as well as manufactures, only manufactures have a realistic chance to produce the required massive swing in trade.

But U.S. manufacturing has performed poorly when compared with the major foreign competition. Its productivity growth has lagged, its technological edge has eroded, and its product quality has not kept pace with that of foreign manufacturers. Poor performance, however, will not prevent the United States from selling its products if the price is right. To generate the required surplus, U.S. products may have to carry a lower price tag, which means a lower dollar—and that would lower the U.S. standard of living.

One way to close the gap between spending and output is to produce more—to raise productivity. Raising U.S. productivity growth will not be easy and it will not happen overnight. By building on its strengths in people, capital and technology and by expanding investment in people and in plants, U.S. productivity can be raised.

Although both government and business have a role to play, the bulk of the responsibility will fall on business and private initiative. American business must take steps to improve the quality and performance of American products



The NICs are taking more responsibility for avoiding trade disputes and cooperating within such worldwide trading systems as GATT.

sold on world markets. If U.S. products become more attractive, future declines in the dollar can be minimized or avoided altogether. Furthermore, efforts must be redoubled at the grass-roots level to improve education and to emphasize excellence at work. All Americans should be urged to strive to make a difference in a united quest for excellence.

The problem is that all of this is akin to an overweight, middle-aged person embarking on a good health program. If they can pinch an inch of fat, their doctor tells them to cut down on calories and increase exercise. But that's boring and it takes a long time to produce results.

Politicians are short on patience. They want quick fixes. Will the United States do the right thing—improve education, expand R&D, stimulate savings and investment, and rebuild infrastructure—or the wrong thing and blame foreigners? If pocketbooks are suffering, and if it is perceived that the United States is losing the economic race, mass psychology and politics could produce a demagogue, and that could result in disaster.

Presidential attention and leadership will be needed to convince the Congress to do the right things. Rather than mind-numbing changes in trade remedy laws, Congress should be urged to write laws that lay the basis for higher productivity growth in the future and should also adopt new measures that improve the skills and mobility of the workers who bear the brunt of adjustment burden from rapid change.

The United States should be doing these things in its own self-interest. Raising productivity will not only raise the overall standard of living, it will also make it easier to help the less fortunate of society. As Nobel Laureate Robert Solow put it, "redistribution is not something Americans are good at." Redistribution out of an expanding pie is much easier to accomplish. As a by-product, U.S. firms would be better-positioned to meet the challenge of foreign competition.

The sooner these steps are taken, the sooner the American people will again enjoy uninterrupted increases in living standards, and the sooner America's confidence in itself will be restored.

Japan

The decline in U.S. dominance is the mirror image of Japan's ascendancy in the world economy. Given its size and wealth, Japan will have to play a greater role in preserving and sustaining the economic growth and development of the region and the world at large.

On its way to record trade deficits in excess of \$150 billion, the United States pulled in the lion's share—about two-thirds—of the developing countries' exports of manufactures. With the decline of the dollar and eventually the reduction of the U.S. budget deficit, the onus will be on Japan to take up the slack. In particular, as Professor Watanabe stresses, Japan will have to import more from the NICs and from other developing countries.

Japan has benefited most from the trading system and now it must bear a commensurate share of the burden for making it work. With a high growth rate and a low unemployment rate, Japan is in the best position to liberalize its markets. At the GATT talks, multilateral pressure will likely be brought to bear on Japan to do more to liberalize. Other countries should not forget that liberalization benefits most those that practice it.

But further liberalization will not be painless, and domestic adjustment problems in Japan could slow the adjustment process. Will the combination of a rising currency, rapid technological change, modernization of the distribution system and the widespread offshore movement of Japanese firms result in political labor adjustment problems within Japan as similar changes did in the United States? Will Japanese harmony and consensus be strained by the combination of these events? If the unemployment level should continue to rise, this would further exacerbate adjustment problems. Will this make Japan less likely to accede to others' demands?

Despite the decline of the dollar, the United States will continue to press Japan on trade problems. Trade policy in the United States is "loser driven"—the least successful firms call the shots. And there is always the chance for the "coalition of the frustrated." Legislators representing beef, citrus, rice and automobiles among other products may one day band together to legislate unilateral action against Japan. Those legislators are anxiously waiting for results that have come slowly and grudgingly, if at all. The Toshiba case represented the potential for disagreements over defense-related issues. With frictions escalating, both countries will have increased responsibility to communicate, cooperate and avoid conflicts.

What should Japan do? Many steps in the right direction have already been taken, and they must continue. They include: promote domestic expansion and deregulation; liberalize trade further and set out a bold plan ("a vision") to bring in more LDC imports; expand aid and development assistance; build domestic



Down to business—delegates meet at GATT.

coalitions of stakeholders in open trade to overcome entrenched protected sectors like agriculture; and work actively in coalition formation to move the multilateral process forward. In short, bear more of the responsibility for the international economic system's functioning.

Newly industrialized countries (NICs)

The Asian NICs have clearly demonstrated their increasing importance in the trading system. Taiwan, Hong Kong, South Korea and Singapore now account for over 50% of developing countries' exports of manufactures. In the past 15 years each of these countries has ascended to be among the top 20 exporting and top 20 importing countries.

With rank comes responsibility, and each of these countries needs to take steps to realign its exchange rates, at present largely tied to the dollar, and to liberalize its markets. In 1987 their current account surplus with the United States amounted to over 20% of the U.S. current account deficit. Although bilateral comparisons are fraught with problems, further appreciation of the NIC currencies vis-à-vis the dollar is necessary.

The NICs also have a responsibility to open their markets to the exports of other developing countries in the region. As they move into the production of more sophisticated manufactured products, they should phase out less sophisticated manufactures to give other developing countries an opportunity to grow. This will require overcoming entrenched domestic interests that have profited from the web of restrictions, particularly in textiles and apparel.

The NICs also have a responsibility to avoid trade disputes and to work actively within GATT to strengthen the trading system. After all, a stronger system is the best protection for the weak against the powerful. Achievement of a stronger system will depend on the NICs' willingness to give up their special status as developing countries in GATT and to implement domestic reforms on such issues as intellectual property and investment. The NICs could be the key players in the establishment of coalitions for strengthening the trading system. The challenge will be to bring them back into the bargaining framework of GATT. To get them to bargain seriously, the industrial countries will have to grant more enhanced and assured access to their markets.

China

China has embarked on an ambitious program of economic modernization aiming to quadruple its total output from 1980 levels by the year 2000, a goal that will require an average annual growth rate in excess of 7%. The primary obstacle to achieving its ambitious goals will be the pace of domestic political reform. Managers need to be motivated, prices decontrolled, investment better allocated, regulations reduced and mobility improved.

Economic efficiency is low in China and to succeed in their goals, the Chinese will have to increase efficiency. This boils down to how the economy will be organized and the nature of the incentive structure. If changes in ownership and managerial patterns are required in order to spur industrial productivity, political reforms are the key to the success of economic reforms. With improvements in

efficiency, a quadrupling of output may be attainable; without such improvements, that goal is beyond reach.

China's current trade regime, including its regulatory and foreign exchange policies, is not compatible with its modernization needs. Quantitative restrictions, licensing and other regulatory measures hamper the pace of economic development. If greater reliance on market forces were adopted, China could specialize production according to its comparative advantage and that would encourage inflows of foreign direct investment, thereby enhancing efficiency and productivity. China will also need foreign help in the form of capital, raw materials, technology and expertise.

Few other countries have been able to sustain economic growth at rates in excess of 7% per year over an extended period. Those that have—Japan, South Korea, Hong Kong, Singapore and Taiwan—have been outward-oriented countries that relied considerably on market decisions, and they also had the benefit of a relatively open international economic environment. The danger today is that markets are not opening up but instead are closing down. If China were to double its exports, who would buy them?

Whether the dynamism of the Pacific Rim can be sustained depends fundamentally on domestic policies in each country. If national policies are adopted that are supportive of and facilitate change, the dynamism can continue. Countries that resist change condemn themselves to falling behind, and in this highly interdependent world if one of the major economic powers resists change, all countries will suffer the consequences.

The two critical countries are Japan and the United States. They are the two largest free world economies and are the greatest sources of technological breakthrough, but they are also each other's main rival. Cooperation and joint decision-making will be necessary in the future.

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