CHAPTER 7

Growth and Market Reform in the Global Economy

THROUGHOUT THE WORLD, there are welcome signs that barriers to free markets and to an open trading system are coming down. Indeed, the movement toward free markets accelerated dramatically in 1989. Revolutionary transformations from centrally planned to market-oriented economic systems are being attempted in Poland, Hungary, and other countries in Eastern Europe. Economic reforms have improved performance in some of the heavily indebted developing countries, such as Costa Rica, Mexico, and the Philippines, and recent steps to reduce debt burdens promise to further this goal. Market-oriented development in the Asian Pacific Rim economies is proving a dramatic success, and efforts are under way to translate the export orientation of these nations into higher domestic living standards. Barriers to the free movement of goods, services, labor, and capital are being removed to establish a single, unified market in Western Europe. The United States and its trading partners are continuing to work for a significantly freer world trading system by developing or extending rules for trade in agriculture, services, intellectual property, and other areas through the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), which is to be completed this year.

What has been called the revolution of 1989 in Eastern Europe highlights the intimate interaction between political and economic freedoms. U.S. support for democracy and free markets, as well as the recent success of the U.S. economy and its market-based system, have been a key impetus to these transformations. During his first year in office, the President took significant actions to further the development of market reform. He submitted legislation for financial and technical support to Poland and Hungary, which was enacted by the Congress last November. More recently, he has proposed a program of technical assistance and a trade agreement with the Soviet Union.

The United States has also been a leader throughout the postwar period in working with other countries toward a more open international trading system. However, many steps have yet to be taken. Thus, the successful completion of the Uruguay Round of GATT negotiations and the strengthening of this rules-based insti-

tution for liberalizing international trade is the highest priority of the President's trade policy. The United States and all developed and developing economies can benefit greatly from a healthy global economy and full participation in an open international trading system.

MARKET-ORIENTED REFORM IN CENTRALLY PLANNED ECONOMIES

In recent months, the world has witnessed unprecedented developments in Eastern Europe as many countries moved toward democracy and economic reform. These countries have set out on a road that, while difficult, is the only hope for sustained improvement in the future economic well-being of their citizens. The new Polish government has already begun to implement a major economic restructuring and stabilization program. In October 1989, Hungary declared itself a republic. While economic reform has been under way for many years, Hungary is to launch a new reform initiative in 1990. Since the opening of the Berlin Wall in November, economic contacts between East and West Germany, including plans for continued assistance, have multiplied. There have been leadership changes in Czechoslovakia, Bulgaria, and Romania. These countries have indicated some desire to undertake market-oriented reforms and are in the process of redesigning economic policies. As part of continuing reform efforts, new economic policies were recently announced in Yugoslavia.

Economic reform has also been under way in other parts of the world. The People's Republic of China has moved to reshape its economy, and began in 1978 to rely increasingly on markets. However, political actions associated with the Tiananmen Square repression set back these reforms. Through 'glasnost' (openness) and 'perestroika' (restructuring), the Soviet Union began to initiate political, legal, and economic reforms in 1985. Since 1985, the Lao People's Democratic Republic has significantly increased reliance on market forces.

These changes in Eastern Europe, the Soviet Union, China, and Indochina are of tremendous global significance. One-fifth of the world's population lives in China, and nearly 8 percent live in the Soviet Union and countries of Eastern Europe.

These countries are all addressing the fundamental question of how some form of market economy can revive growth rates and raise living standards after years of disappointing economic performance. The World Bank estimates per capita income for 1988 at $1,850 in Poland and $2,460 in Hungary. In contrast, it was $19,780 in the United States. (Other estimates suggest that these figures may understate living standards in Poland and Hungary somewhat.) Even

if the economic reforms are successful, it will take many years to close these gaps. However, market-oriented economic reforms can generate noticeable improvements in the short run by reducing shortages of key goods and services, by improving quality, and by producing goods that people actually want, rather than what central planners want them to have. Furthermore, the freedom to choose is an important addition to human welfare that is not measurable by per capita income levels.

Bold and comprehensive plans for economic reform have been put forth by some of the centrally planned economies. These reforms will eventually improve living standards for citizens of these countries. If successful, they promise future growth and prosperity. However, the difficulties of economic transition should not be underestimated. Transformation from one economic system to another will be extremely complex and the adjustment may be painful, involving widespread unemployment with limited unemployment insurance or other social support systems currently in place. No single set of policies will work for all countries, and the appropriate mix and timing of economic policies must be designed on a case-by-case basis. Any policy package necessarily involves the risk of failure and a host of uncertainties. However, external support will raise the likelihood of success. The President has taken a deep interest in the progress of political and economic reform and remains committed to providing assistance.

CENTRALLY PLANNED VERSUS MARKET ECONOMIES

Between World War II and the early 1950s, most countries in Eastern Europe adopted the Soviet economic model of central planning and became members of the Council for Mutual Economic Assistance (CMEA). Each centrally planned economy is unique, just as the United States, West Germany, and Japan are each examples of market economies but with distinct characteristics. A fundamental distinguishing feature of centrally planned economies is that state authorities, not private citizens, own and control most of the means of production. Instead of allocating resources through markets that establish prices based on supplies and demands, the state authorities generally formulate detailed plans for inputs and outputs. Coordinating this process properly requires an immense amount of information, making it exceedingly difficult for a centralized system of managers to allocate scarce resources according to what people want, or to respond to changes in demands, supplies and technologies. The lack of private ownership implies that individuals have little stake in improving resource allocation. Of course, the population as a whole would gain if resources were used to produce goods and services they valued more highly.

Although the operation of centrally planned systems is very complex, a simple polar example illustrates key issues. Consider an enterprise producing shirts. In a centrally planned economy, planners would typically determine the amounts of cloth, dye, thread, and other inputs the enterprise would receive and the source and price of each input. Workers would be assigned to the enterprise, and often allocated to particular tasks. The plan would also set targets for output of each type of shirt and determine the final prices to households.

The contrast with a market economy is striking. In a centrally planned economy, prices of labor, goods, and services do not adjust to reflect supplies and demands, and production decisions are not motivated by profitability. Unlike a market system, producers typically have no leeway to reduce prices or production when inventories accumulate or to raise prices or production as inventories decline—even if consumers form long queues. The enterprise does not base hiring decisions on its assessment of needs and worker quality, nor does it choose where to purchase inputs so as to minimize production costs. Furthermore, state-owned enterprises are allocated the credit needed to finance operations through a centralized banking system. Most centrally planned economies have never developed laws to deal with bankruptcies, because enterprises are typically bailed out if costs exceed revenues. Consider the implications for U.S. firm behavior if the Federal Government promised to mail a check to cover the losses of every business that lost money. Such a system severely weakens the incentives for producers to use resources efficiently.

Because individuals in centrally planned economies own few of the factories or other productive assets, individuals have little incentive to respond to market signals about resource scarcity, even if such signals exist. Instead, the central planning system puts a premium on meeting output targets. The lack of private ownership also provides little incentive for innovation or quality control. New firms cannot simply enter the market to take advantage of better management or new ideas.

Centrally planned economies have persistent problems with demand exceeding supply at officially set prices. As shortages of consumer goods and of inputs required for production develop, the scarce supplies must be rationed to households and to firms, often resulting in long queues and disruptions to production. At the same time, other products may be overproduced and go to waste. The shortages often lead to black markets in which goods sell for far more than their official prices. If shortages get worse over time, hidden inflation may develop. As official prices are decontrolled, measured inflation soars. For example, the removal of controls on

food prices in Poland resulted in the acceleration of inflation in Poland last August (Box 7-1).

Severe housing shortages in Poland provide another example of chronic excess demand. The wait for an apartment has been reported to be as high as 15 years in large urban areas. Largely because of high government subsidies, housing has been very inexpensive for households lucky enough to get it. One survey estimated expenditures on rent or cooperative housing at just 3 percent of total household expenditure in the mid-1980s, compared with more than 14 percent in the United States. Unlike the United States, however, rationing constrains many Polish families from choosing housing of a different size, or in a different area, or from moving to their own residences. Although recent studies have found high returns to producers of new housing, new building is inadequate. Private construction has failed to provide a remedy because of lack of materials, undeveloped financial markets, and counterproductive laws and regulations governing ownership and property transfer.

Centrally planned economies are often also faced with an inadequate tax base, large budget deficits, and a tendency to print money to finance this deficit, fueling inflation. Inflation, which has been estimated recently at 50 percent *per month* in Poland, and at an even higher rate in Yugoslavia, has become the overriding problem. Reducing inflation is a priority of both governments. These difficulties worsen the problems arising from misallocation of scarce resources. Government pricing, credit allocation policies, and subsidies to state-owned enterprises can raise expenditures and increase the budget deficit. With few exceptions, there is no domestic market to finance the deficit through bond sales, so that the central bank cannot make independent decisions about money growth.

ECONOMIC PERFORMANCE OF CENTRALLY PLANNED ECONOMIES

Poor economic performance has been a major impetus for transforming centrally planned economies toward market economies. Even economies such as Hungary that have been gradually undertaking reforms have experienced long-term declines in productivity, product quality, and economic efficiency. Planners have also been concerned about slow progress in developing and adopting new technologies.

Without meaningful price indices, measures of aggregate output are unreliable. Official CMEA statistics use net material product, which is a measure of national output like gross domestic product, except that it excludes the value of depreciation and of nonmaterial services, such as health, education, and public administration. These data show that average annual growth of net material product has declined consistently over the past four decades. Real net material product growth averaged 9.6 percent during the recovery

Box 7-1.—Difficulties in the Transition from Central Planning: Food and Food Aid in Poland

Developments in food supplies and food prices have been a focal point of Poland's economic difficulties. These developments illustrate both the difficulties of implementing market-oriented reforms and the potential short-term hardships of a transition from central planning.

Long lines at food stores were an early, visible sign of problems. Three main factors accounted for the queues. First, political and economic uncertainties contributed to widespread panic buying and food hoarding by consumers. This response was related in part to memories of severe food scarcities and sudden price hikes. Second, very rapid inflation meant that commodities, such as food, have been a better store of value than currency. Thus, farmers withheld products from the market. Finally, the distribution system had been disrupted. State enterprises had difficulty procuring output from farmers as state-set prices had not kept pace with rising input prices. Private distribution systems will take time to develop.

Removal of price controls on food in August introduced some market signals, and the lines now seem to have abated. Food prices have risen substantially, reducing demand and alleviating the shortages. Food supplies have not increased markedly, however, largely because higher prices have not generally been passed on to farmers.

Food is now relatively more expensive, however, and the price increases have been especially hard on low-income groups and people with fixed incomes. The United States and other countries have contributed substantial amounts of food aid. In addition to its nutritional value, increasing the availability of food may bolster public confidence in the new government, and help to ease the difficulty of implementing economic reforms.

Food aid must be managed so as to ease the difficult adjustment period without impeding longer run development of agricultural markets. Large amounts of food aid may disrupt Poland's newly emerging market system. Greatly increased food supplies from external sources could seriously lower current prices, which would discourage domestic production and lead to even more severe problems next year. Providing pesticides, machinery, and technical assistance that would help increase agricultural production may yield greater benefits than direct food aid.

from World War II in the 1950s, but fell to 3.2 percent during 1981–87. However, official net material product statistics are widely believed to understate inflation substantially, which implies that they greatly overstate real growth. Furthermore, because the central planning system does not typically produce the goods that people actually want, growth in physical production overstates the value of increased output.

Some centrally planned economies have also had mounting balance of payments difficulties with countries outside the CMEA. Trade and current account deficits have grown, especially since high public investment after 1985 led to a surge in imports from the West. These deficits have been financed primarily through foreign borrowing. Since 1986, both Poland and Hungary have had difficulties in servicing their external debts. Debt levels have risen recently in Bulgaria and in the Soviet Union, and to a lesser extent in Czechoslovakia, although these countries have not had debt-servicing difficulties.

ELEMENTS OF A REFORM PACKAGE

Economic difficulties faced by centrally planned economies are extremely complex. There is no established policy package for reform, nor is there a single prototype market economy that all reformers seek to emulate. However, a growing consensus has emerged on many aspects of the reforms required. In addition to improved long-term growth as resources are more efficiently reallocated, increased reliance on markets is likely to generate some quick payoffs through relieving shortages of food or other goods.

Price and Structural Reform

Perhaps the most important reform is to establish prices that adjust to reflect relative scarcities of goods, labor, and capital. Such prices provide information that can be used to allocate resources effectively through decentralized markets, without the need for an elaborate system of central planning. Institutions need to be put in place to facilitate a market system. These include banks and financial institutions that can help allocate savings to productive investments. Also important is a legal system that defines property rights, provides for bankruptcy, and deals with a host of other issues. Firms need useful and reliable accounting systems. Workers and managers also need to learn, through training and apprenticeship programs, how a market economy works. After 40 or more years of central planning, few residents will have developed entrepreneurial skills. Foreign direct investment and joint ventures can play an important dual role in raising economic growth while providing experience for domestic workers. In addition, unemployment insurance and other support programs for low-income households can provide an important social safety net.

Stabilization Measures

It is exceedingly difficult to reform prices and to provide incentives for private-sector investment and growth in the midst of very high inflation. Thus, in some cases such as Poland, the overall economy must be stabilized before the more fundamental economic restructuring can take place. The difficulties are compounded by the likelihood of large initial consumer price increases as prices that have been kept artificially low for years are decontrolled. The basic elements of a stabilization package are reductions in budget deficits, measures to control money growth, and the establishment of a competitive exchange rate.

History offers some useful examples of reforms. Israel and Bolivia brought down very high rates of inflation in the 1980s. The 1948 Erhard reforms in West Germany eliminated price controls and reestablished a vibrant private sector after several years of administered price controls. These reforms also stabilized the value of West German currency and revived its usage in international markets. But there are no examples where, after four decades of central planning, an economy has successfully accomplished all of these at once. The centrally planned economies face a unique challenge.

RECENT DEVELOPMENTS

Each of the centrally planned economies has its own economic and political situation, calling for somewhat different policy responses. Similarly, the appropriate response from the United States and other developed countries to support these reform efforts differs across cases.

Soviet Union

The Soviet economy has many difficulties in addition to the inefficiencies inherent in central planning. For example, military expenditures of more than 15 percent of gross national product (GNP), compared with 6 percent in the United States, consume large amounts of scarce resources. Also, many Soviet households have stored up massive amounts of rubles (Soviet currency) during years of waiting for scarce goods to become available. Distrust of the undeveloped financial system means that much of this wealth is simply hidden by domestic residents. The stored rubles are a problem because economic reforms that free prices and put appliances and other desired consumer goods on store shelves may trigger a buying spree that would fuel inflation. The inflationary impact of price decontrol will be mitigated if higher prices are fed through to producers, thus raising incentives for increased productivity and output.

In 1985, the Soviet Union initiated a program to restructure its economy. Especially those measures taken since 1987 were intend-

ed to increase reliance on independent decisions of enterprises. This goal has proven difficult to achieve while prices as well as credit and production inputs remained controlled. The Soviet economy continues to rely on output targets set by a central plan. Many fundamental steps toward market orientation of the economy have yet to be taken, and the government's commitment to genuine economic reform therefore remains questionable.

Following the Malta meeting between the Presidents of the United States and the Soviet Union in December, the United States renewed efforts to increase its economic ties with the Soviet Union. These efforts may involve negotiation of a trade agreement and an investment treaty. In addition, the United States has offered technical cooperation, for example, to help the Soviets improve their system of economic statistics. To help further integrate the Soviet Union into world markets, the President of the United States has supported Soviet observership status in GATT, once the Uruguay Round has been completed.

Hungary

Hungary was the first centrally planned economy to introduce major market reforms, initiating a market-oriented reform program in 1968. It has gradually reduced direct control by central planners and has actively encouraged private-sector development. It also has taken steps to reform the price system. Nonetheless, most analysts agree that, while prices in Hungary reflect relative scarcities better than in most other centrally planned economies, mispricing has nonetheless slowed growth. Hungarian authorities continue to control prices of more than one-third of domestic products and to monitor other prices.

Hungary has fewer pervasive problems than other centrally planned economies—such as inflation, shortages, low product quality, and black markets (although they exist, for example, for foreign exchange). But the overall success of the reforms in stimulating the economy has been mixed. Hungary has developed a small but vibrant and growing private sector. Between 1981 and 1987, gross value added in the private sector as a percentage of GNP doubled to 14.5 percent. In contrast, employment and average incomes in the socialized sector declined. However, more than 90 percent of industrial production was still produced in the socialized sector. Although direct controls are no longer pervasive, widespread indirect controls persist, for example, on the entry and exit of firms.

The Hungarian experience illustrates the difficulties in reforming a centrally planned economy gradually. With the basic institutional structure of a centrally planned economy still intact, authorities remain involved in a wide range of decisions, while managers take only limited responsibility for the operations of enter-

prises. Not surprisingly, the early reforms were only partially effective. Hungarian authorities continue to introduce measures to improve economic performance, including steps to privatize some state enterprises and to encourage further foreign investment.

The United States has offered both technical and financial assistance to support the next phase of Hungarian reforms. U.S. aid includes an enterprise fund that will facilitate private-sector development, including joint ventures.

Poland

Poland has made repeated attempts to decentralize economic decisionmaking. Although reforms implemented during the 1980s reduced the central allocation of inputs and liberalized the agricultural sector, severe problems remain. Reforming the Polish economy is especially complex because reforms must be implemented in the midst of an economic crisis. In addition to extremely high inflation, Poland has accumulated a large external debt and is unable to meet its debt-payment obligations.

The new Polish government has launched a comprehensive and radical program of structural reform and macroeconomic stabilization. In contrast to the recent Soviet approaches, the government plan calls for rapid removal of many price controls and subsidies and the reform of the budget process to eliminate the need for inflation-inducing money finance. It also lays out a sensible plan for gradual privatization of state enterprises and reform in banking and finance. Although the Polish plan is well formulated, the adjustment period may bring high levels of unemployment and temporary reductions in living standards, making the plan difficult to implement.

External assistance can play an important role in increasing the likelihood of success. The United States is actively exploring means to support Poland's ambitious effort. In addition to technical assistance, the United States has allocated an aid package that includes $125 million in food aid, $240 million for an enterprise fund, $200 million in trade credit guarantees, and a $200 million contribution to a currency stabilization fund to bolster the credibility of the Polish reform.

SUMMARY

- Many centrally planned economies in Eastern Europe have taken steps toward market-oriented economic reform. Poland and Hungary especially have launched ambitious restructuring programs that can promote economic growth and raise living standards.
- Because of important political and economic differences across centrally planned economies, no single blueprint for the appropriate reform package exists.

- While the transition to a market economy may involve unemployment and other costs in the short run, there are likely to be some early benefits as shortages of some goods are alleviated.
- The United States remains committed to support reform efforts among the centrally planned economies, including both financial and technical assistance.

SUPPORTING GROWTH IN INDEBTED DEVELOPING COUNTRIES

Like the economies of Eastern Europe, heavily indebted developing countries must undertake significant economic reforms in order to revive growth and gain full participation in the world economy. Many nations in Latin America and Africa have suffered severe economic stagnation in the 1980s resulting from declines in investment, high inflation, heavy debt burdens, capital flight, and extensive government interference in economic activity. The revival of growth will require continued implementation of appropriate macroeconomic and market-oriented policy reforms and reductions in debt burdens. *The United States continues to take a leadership role in developing and implementing a strategy of coordinated debt restructuring and support for economic policy reforms in the indebted countries, consistent with reviving growth and restoring their access to world capital markets.*

The recent growth rates of the severely indebted countries (as defined by the World Bank) are shown in Table 7-1. The deterioration of growth rates in per capita income in the 1980s is striking. Strong growth in the per capita incomes of these countries between 1965 and 1980 was followed by declines of 2.8 percent between 1980 and 1985, and negligible growth of 0.2 percent in the subsequent 3 years. Growth in the severely indebted low-income countries, including many in Sub-Saharan Africa, deteriorated especially sharply. In these countries, per capita income declined by 4.6 percent per year on average between 1980 and 1985, and continued to decline by an average of 1.6 percent per year between 1985 and 1988. Per capita income also declined between 1980 and 1985 in the middle-income severely indebted countries, including many in Latin America, and has since remained low. The declines in per capita income among the severely indebted countries between 1980 and 1985 and the failure to reach pre-crisis growth levels since stand in sharp contrast to the more stable growth rates of the high-income countries that belong to the Organization for Economic Cooperation and Development (OECD). The same trends also characterize the growth of total GNP in these groups of countries. Although GNP growth has risen since 1985, it is still far below pre-crisis levels.

TABLE 7-1.—*Average Annual Growth*

[Percent per year]

Item	1965 to 1980	1980 to 1985	1985 to 1988[1]
PER CAPITA REAL GNP			
Severely indebted countries			
Low income	2.5	−4.6	−1.6
Middle income	3.8	−2.2	.9
Total	3.5	−2.8	.2
High income OECD countries	2.7	1.7	2.7
REAL GNP			
Severely indebted countries			
Low income	5.2	−1.7	1.5
Middle income	6.2	−.1	2.9
Total	6.0	−.4	2.7
High income OECD countries	3.5	2.3	3.3

[1] Preliminary.
Source: The World Bank.

Estimated 1988 per capita incomes of $263 in the low-income severely indebted countries and $1,850 in the middle-income severely indebted countries are particularly striking when compared with U.S. per capita income of $19,780. The protracted decline in the incomes of many developing countries also dampened growth and contributed to trade balance deterioration in industrial nations in the mid-1980s by reducing the demand for their products.

It is important to note, however, that heavy debt burdens alone were not responsible for poor growth. Some countries that had very high debt levels in the 1980s, such as South Korea and Malaysia, have grown rapidly. Sound economic policies in these countries contributed to their strong economic performance.

Revitalizing growth is critical for the indebted developing countries as well as for the global economy more generally. The restoration of full access of these countries to world capital markets will be achieved only in conjunction with productivity improvements and output growth. Any long-term sustainable solution to the debt crisis must go beyond stabilizing the international trade and payments system to remove impediments to growth in the debtor economies.

HISTORY OF THE DEVELOPING COUNTRY DEBT CRISIS

The onset of the debt crisis in 1982 followed a decade of rapid expansion in foreign lending to developing countries. Many developing countries borrowed heavily in the mid-to-late 1970s when both the borrowing climate and prospects for repayment were particularly favorable. Their cost of borrowing was low because of low

real interest rates on world capital markets. Their access to credit was enhanced by the recycling of surpluses from the oil-exporting countries to developing countries through commercial banks. In addition, the prices of the major export commodities of many of the developing countries were at record levels.

Onset of the Crisis

The crisis in international credit markets was the product of a complex conjuncture of unexpected shocks to the world economy and decisions taken by both lenders and borrowers. The developments that had favored high levels of international lending in the 1970s reversed during 1981–82, and the debtors found themselves unable to meet the payments on their debts. Interest rates on the debtors' variable rate commercial loans rose sharply as the Federal Reserve System in the United States and central banks in other industrialized nations tightened money supplies to tame accelerating inflation. A steep increase in the value of the dollar sharply raised the effective cost of both the debtors' dollar imports and of payments on the mainly dollar-denominated debt. Although the rise in the dollar strengthened the competitiveness of many exports, this rise was offset by plummeting world prices of many of the debtors' primary export commodities. The overall effect was to reduce the net export earnings debtor countries had available to service their debt, just as the level of debt service was rising.

Debtor countries faced diverse problems. Highly indebted middle-income countries, which were concentrated in Latin America, had borrowed mainly from commercial banks, and faced sharply increased debt-servicing burdens. Highly indebted low-income countries concentrated in Sub-Saharan Africa had obtained the majority of their credit at below-market fixed rates of interest from official creditors. Although their debt-servicing burdens were not adversely affected, poor economic performance made debt servicing increasingly difficult.

In the countries that subsequently developed repayment problems, the external shocks to interest rates and commodity prices were exacerbated by economic mismanagement and political instability. Many heavily indebted countries failed to implement economic policies to correct persistent foreign and domestic imbalances. These countries used much of the borrowed money for consumption or investments with low returns, while countries that avoided repayment difficulties emphasized investments that raised productivity and diversified their export base. Between 1973 and 1982, export volume grew at 0.8 percent per year on average in the debtor countries with debt-servicing difficulties, in contrast to export growth of 4.8 percent in heavily indebted countries that did not experience servicing difficulties. Faced with rising budget deficits, the governments of many debtor countries resorted to printing

money, which fueled inflation, and simultaneously attempted to maintain overvalued exchange rates, which contributed to rising external deficits. Poor policy worsened the uncertain investment climate, causing investors in debtor countries to send their capital abroad and diminishing the resources available internally to service the debt.

Stabilizing the International Financial System

When it became clear that Mexico, one of the largest and most prosperous debtors, could not meet its payments at the height of the global recession in mid-1982, the stability of the international financial system was thrown into question. With a substantial portion of their portfolios in developing country debt, and concentrated exposure to the largest problem debtors, major U.S. banks would have been jeopardized by substantial losses on their developing country loans. Commercial banks in other industrial countries were in a similarly precarious position. U.S. commercial banks gradually strengthened their financial positions by increasing their capital base and setting aside reserves to cover losses. The banks sharply reduced new loans to debtor countries from $41.4 billion in 1981 to a low of $3.7 billion in 1986. In addition, since 1986, banks have reduced exposure by selling developing country loans on the secondary market and participating in debt exchanges such as debt-for-equity swaps. Table 7-2 shows that there was a substantial reduction in the exposure of U.S. commercial banks—especially the smaller banks—between 1982 and 1988.

The decline in new commercial loans and the increase in debt-service payments were exacerbated by high rates of capital flight in the Latin American economies, as domestic residents transferred their savings abroad in response to the uncertain and deteriorating economic conditions. One study estimates that the five largest Latin American debtors experienced outflows of $101 billion in private sector assets between 1979 and 1984.

TABLE 7-2.—*Changes in Reported Exposure of Groups of U.S. Banks to Non-OPEC Developing Countries*

Item	Millions of dollars		Percent
	June 1982 to December 1985	December 1985 to December 1988	June 1982 to December 1988
Top 9 banks	889	−11,547	−17.3
Next 13 banks	−1,730	−6,620	−40.7
All other banks	−1,739	−8,212	−50.0
Total	−2,580	−26,379	−28.4

Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey.*

The net effect of these factors was a marked reversal in the direction of resource transfer, measured as the current account defi-

cit plus net investment income. Net resource transfers to the highly indebted countries declined dramatically from inflows of $12.8 billion in 1980 to outflows of $38.3 billion in 1984. While resource transfers abroad are necessary to prevent a country's debt from growing at unsustainable rates, they reduce the resources available for domestic investment or consumption.

The international response to the debt problem was to encourage macroeconomic stabilization policies and to coordinate additional lending by commercial banks and official creditors. Some new loans were made available through the International Monetary Fund (IMF) to provide financial support for debtor countries undertaking economic reform under IMF guidance, and to encourage lenders to continue to extend credit. Stabilization programs were put into place in several countries in consultation with the IMF, with mixed results. Such programs typically emphasized fiscal discipline, such as reductions in subsidies and improved tax collection, reductions in monetary growth, devaluation of overvalued exchange rates, and export promotion. Many countries found such measures politically difficult to implement because they required substantial sacrifices in the standard of living and in investment needed for growth. A recent study concludes that, while the stabilization programs led to reduced inflation and improved external balance in many countries, little progress was made in reviving growth.

U.S. POLICY FOR DEVELOPING COUNTRY DEBT

Although the coordinated international response to the debt problem between 1982 and 1985 stabilized international financial markets and maintained the liquidity of the problem debtor countries, economic recovery in debtor countries stalled. The governments of debtor countries were caught between internal pressures to direct resources to the resumption of growth, and international pressures for continued external adjustment. And the commercial banks were increasingly reluctant to make additional loans to heavily indebted developing countries.

The Baker Plan

Concern over the failure of indebted economies to resume growth prompted the 1985 U.S. debt initiative introduced by then Treasury Secretary James Baker—the Program for Sustained Growth, known as the Baker Plan. The program addressed the factors impeding the efforts of debtor countries to improve growth and living standards, and the need to mobilize international financial resources to support debtor country reform efforts. The program called for international commercial banks to extend $20 billion in new lending and for a 50-percent increase in lending by the multilateral development banks to the heavily indebted countries over 1986 to 1988. The program also called for the World Bank to play

an expanded role in supporting institutional and sectoral reforms and market-oriented economic policies.

The major debtors made progress in reforming their economies and managing their debt burdens between 1985 and 1988, and several countries improved their economic performance. Reforms during this period reflected widespread recognition by debtor governments of the importance of well-functioning markets in generating growth: public-sector deficits were reduced, exchange rates became more competitive, real interest rates rose, and trade protection was rationalized. In spite of this progress, overall improvements in economic growth and performance on the scale that had been hoped for did not materialize, partly because of disruptive changes in oil and commodity prices. In addition, the increase in new lending from all international financing sources fell below the levels that had been expected.

The Brady Initiative

The persistence of serious problems in the debtor economies and concern over the economic hardships sustained by their populations called for a review of the U.S. debt strategy. The strategy of this Administration, outlined by Treasury Secretary Nicholas Brady in March 1989, continues to emphasize the need for market-oriented economic reforms to promote growth. The Brady Initiative emphasizes measures aimed at mobilizing private-sector financing to generate growth. The major innovation of the Brady Initiative is that it emphasizes debt and debt-service reduction by commercial banks, in recognition of the burden placed on growth by increasing levels of indebtedness. It also provides for IMF and World Bank financial support for debt and debt-service reduction to those countries implementing effective economic reform programs.

The emphasis on debt reduction represents an evolution in thinking about the needs of the debtor economies, and a change in the relative emphasis on debt rescheduling, new lending, and debt reduction. Debt reduction is promoted in order to reduce high servicing requirements, in the expectation that the freed resources will be used for investment, and thereby promote growth. The shift in emphasis stems from concerns that growth in many economies has not revived despite appropriate policy reforms. In addition, rising levels of indebtedness impede growth by creating an uncertain and unattractive environment for private investment. An important feature of the emphasis on debt reduction is that it may allow the debtors to take advantage of the secondary market discounts on the value of their debt. The discounting of developing country debt on secondary markets reflects high perceived risks of default and arrears.

The Brady Initiative also provides for debt rescheduling and new lending. Debt rescheduling efforts reduce the drain on debtor coun-

tries' cash flow and the level of resource transfer in the near term by extending the period over which debt is repaid. New lending may generate cash to assist debtors in meeting debt-service obligations without sacrificing investment.

The Brady Initiative provides a framework for negotiated debt and debt-service reduction, on a case-by-case basis, to countries committed to implementing requisite economic reforms. The debtor government and commercial bank creditors negotiate a menu of options for the conversion and reduction of outstanding loans and the extension of new loans. The options are designed to enable banks to readjust their portfolios in terms of the timing, level, and riskiness of payments, consistent with debtors readjusting their payment burdens to sustainable levels. The participation of the commercial banks is voluntary.

Negotiations between a debtor country and its commercial bank creditors are premised on a prior commitment to an economic adjustment program designed in conjunction with the IMF and the World Bank. In line with its emphasis on growth, the Brady Initiative stresses economic reforms that improve the investment climate in the debtor economies in order to encourage foreign investment and the return of domestic capital that had fled abroad. Such reforms include the following: reductions in government budget deficits to reduce inflationary pressures, devaluation of official exchange rates to reflect market levels and restore the competitiveness of exports in foreign markets, removal of interest rate ceilings to stimulate domestic savings, reductions in foreign trade barriers, relaxation of regulations restricting foreign investment, and privatization of state-owned enterprises. These measures are intended to encourage investment, raise export earnings, and decrease the drain on resources from government budget deficits and inefficient state enterprises.

Because of its case-by-case emphasis, the Brady Initiative is best understood by comparing the three programs that have been negotiated under its auspices thus far. The agreements for Mexico, the Philippines, and Costa Rica differ significantly in ways that reflect the different needs of these countries and their creditors.

Mexico

Mexico negotiated a preliminary debt agreement with commercial banks in July 1989. Prior to the debt agreement, the Mexican government had undertaken substantial economic reforms, with some encouraging results. Mexico had made sustained efforts to devalue its exchange rate and reduce its budget deficit. It made substantial progress in liberalizing the trade regime and adopting measures to encourage investment. Mexico has also made progress in privatizing state-owned enterprises. At the outset of negotiations, Mexico had foreign debt of almost $100 billion, of which approximately one-half was medium- and long-term loans owed to commer-

cial banks. Annual interest payments amounted to 28 percent of export receipts in 1988. Mexico's difficulties in servicing its commercial debt were reflected in steep discounts on the secondary market of 65 percent in early 1989. The debt agreement that was reached reflects both the large size of Mexico's commercial debt and its need for cash-flow relief.

The agreement provides for debt and debt-service reduction as well as some new credit. It gives banks a choice of three options, all of which lower Mexico's current payment burden. Banks may (1) swap existing loans for new bonds with a 35-percent discount on the initial principal value at a customary spread above the London Interbank Offer Rate (LIBOR); or (2) exchange loans for bonds with the same principal value and a reduced, fixed rate of interest; or (3) provide new loans over 3 years equivalent to one-quarter of their existing loans at the customary spread above LIBOR. Funds from the IMF, the World Bank, Japan, and Mexico are used to provide collateral for the principal and part of the interest on the debt and debt-service reduced bonds.

Mexico may benefit substantially from a reduction in its debt-service obligations. Preliminary estimates of gross interest savings on payments to banks are above $1.5 billion per year. Gross cash-flow relief between 1989 and 1992 is estimated to include approximately $5.4 billion in interest savings, $6.7 billion in rescheduled amortization, and $1.4 billion in new money. It appears that Mexico has also benefited from favorable initial reactions to the agreement in financial markets. Between July and December, domestic interest rates in Mexico fell by about 15 percentage points, which, if sustained, would reduce government payments on domestic debt substantially and thereby reduce the government budget deficit. There have also been substantial capital inflows, amounting to around $3 billion over the course of the year, attributable in part to the debt agreement.

The Philippines

In August 1989, the Philippines became the second country to reach an accord with its commercial bank creditors under the Brady Initiative. Along with debt reduction, new lending is an integral part of the Philippine agreement, reflecting an urgent need for money to close a large balance of payments financing gap and a relatively small level of commercial bank debt. Less than 25 percent of the outstanding $29 billion in the Philippines' foreign debt is medium- and long-term credit from commercial banks.

The Philippine agreement gives banks a choice between extending new credit at a customary spread above LIBOR and selling existing loans to the Philippine government at a 50-percent discount, in line with secondary market discounts. The cash buyback will

total $1.3 billion in outstanding debt; the money for the cash buyback will be provided by the World Bank, the IMF, Japan, and the Philippine government. It is too early to predict the amount of new credit that commercial banks will extend. Although the agreement emphasizes new credit, the level of buybacks is expected to exceed that of new credit, so that the overall level of debt will decline along with annual interest payments. The success of the debt agreement will depend on effective implementation of the economic reform program adopted by the Philippine government.

Costa Rica

In October 1989, commercial banks and the Costa Rican government reached an agreement in principle. Commercial bank debt represents $1.8 billion of Costa Rica's total $4.3 billion in foreign debt. The Costa Rican situation differs markedly from that of both Mexico and the Philippines in that the $1.8 billion of commercial bank debt, although onerous from the point of view of domestic resources, represents a small percentage of the developing country debt of any particular commercial bank. The commercial bank debt includes $325 million in accumulated interest arrears. Costa Rica's poor debt-service record is reflected in a secondary market discount greater than 80 percent. Accordingly, the agreement places primary emphasis on debt reduction, and makes special provisions for the interest arrears.

The agreement reached with the banks is designed to achieve a 60-percent reduction in commercial bank debt, consistent with Costa Rica's servicing capability. It gives banks the option of selling their existing loans to the Costa Rican government at a discount of above 80 percent, or swapping existing loans for bonds with the same face value and a reduced, fixed interest rate. Banks tendering at least 60 percent of their outstanding loans for buyback will receive additional enhancements on the conversion of their remaining loans, in order to achieve the target of 60-percent reduction overall. The treatment of the arrears on the debt that is not sold back to the Costa Rican government is more stringent. Costa Rica must provide an up-front cash payment for 20 percent of these arrears, and the remainder will be converted to a 15-year bond at market rates.

Maintaining Flexibility

The three agreements differ substantially in ways that reflect the different needs of the various debtors and creditors. The Mexican agreement combines debt and debt-service reduction and new lending in the most varied of the three packages. This approach reflects the large size of the Mexican debt, the diversity of its creditors, and the Mexican government's need for both increased cash flow and debt reduction. The emphasis on new lending in the Philippine

agreement reflects the large size of the financing gap relative to the commercial bank debt, and the relatively smaller burden of commercial debt. The emphasis on debt-service reduction and debt relief in the Costa Rican agreement reflects the small and diffuse holdings of the country's debt among commercial banks, and its inability to service the outstanding debt.

The flexibility of the Brady Initiative will be important in addressing the varied needs of debtor countries, based on their demonstrated commitment to appropriate economic reforms. The common feature among future debt agreements is likely to be an emphasis on reducing debt and debt service and on promoting an economic environment that mobilizes domestic and foreign resources for productive investment in order to promote growth.

SUMMARY

- Economic reforms are critical to reviving growth and raising living standards in the highly indebted developing countries, just as in the centrally planned economies of Eastern Europe.
- Debt and debt-service reduction by commercial banks in countries that undertake market-oriented reforms can be important in easing the transition to sustainable growth and healthy economies. It is a key component of the new U.S. initiative for the revival of growth in heavily indebted developing countries.
- Access to well-functioning international financial markets in the 1990s will play a central role in the continued development of those countries that are currently undertaking needed reforms.

DEVELOPMENTS IN JAPAN AND OTHER ASIAN PACIFIC RIM ECONOMIES

As a group, the Asian Pacific Rim economies—Japan, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand—present a sharp contrast to the severely indebted countries in Sub-Saharan Africa and Latin America. Most of the Asian Pacific Rim economies have benefited enormously from the international trading system, achieving high rates of growth and increases in productivity and living standards. These economies, in general, have maintained an outward orientation in their economic policies and have succeeded in diversifying and strengthening their export bases. The economic policies employed by most of the governments in this region of the world have been very sensitive to the power of the marketplace. Owing to a strong, diversified export base and a reliance on market incentives, even countries with high levels of external indebtedness, such as Korea, have managed to maintain exceptional growth.

THE ASIAN PACIFIC RIM'S ECONOMIC EXPANSION

Rates of growth in the Asian Pacific Rim, which have at times reached into the double digits, are changing the global distribution of wealth, production, income, and trade. The Asian Pacific Rim's share of world gross domestic product rose from 6.7 percent in 1965 to 19 percent in 1987. Changes in trade flows have been even greater. Since 1965, the Asian Pacific Rim's share of total world exports of manufactures has risen from 8 to 22 percent. A radical transformation has also occurred in the Asian Pacific Rim's financial position. As recently as 1970, the Asian Pacific Rim was a net debtor to the rest of the world and held a modest 15 percent of the world's international financial reserves. By the late 1980s, it had become a major net supplier of capital, holding 24 percent of global international reserves.

The economic successes of the Asian Pacific Rim economies have been accompanied in each instance by high rates of investment and saving, rapid technological transfer, and expanding international trade. In 1987, Asian Pacific Rim economies invested almost 30 percent of their gross domestic product, while saving 34 percent. Still relying heavily on imported technology, even the Asian Pacific Rim's technological leader, Japan, paid $468 million more in licensing fees and royalties than it received. High rates of investment and heavy use of technology developed abroad have gone hand in hand with an increasing role for international trade. Exports rose from 12 percent of the Pacific Rim's gross domestic product in 1965 to 16 percent in 1987. Excluding Japan, the numbers are striking, with the share of exports rising from 23 percent in 1965 to 49 percent in 1987. The composition of exports has also changed dramatically. Since 1965, Japan has shifted from being the world's preeminent exporter of textile products to being a net importer of textiles and apparel, and now two-thirds of Japanese exports are machinery and transport equipment. For the Asian Pacific Rim as a whole, machinery and transport equipment rose from 20 percent of total exports in 1965 to 46 percent in 1987.

Although the performances of the Asian Pacific Rim's successful economies have much in common, the policies pursued have varied greatly. In some Asian Pacific Rim economies, such as South Korea, the government has had a major role in shaping the allocation of resources. In others, such as Hong Kong, the government interfered relatively little with market processes. In Singapore and Hong Kong, foreign investment has been welcomed and has played a central role in promoting economic growth. By contrast, Japan's extraordinary performance has been achieved with domestic capital and management. In Taiwan, economic policy helped small firms to play a predominant role, while in South Korea, govern-

ment policy on many occasions has discriminated in favor of large-scale firms.

Rapid changes in the Asian Pacific Rim's export structure have at times imposed a faster-than-desired degree of structural adjustment on its trading partners. The emergence of exports from the Asian Pacific Rim economies in sectors long established elsewhere has often forced a reallocation of capital and labor in other countries. Although painful, such reallocations can be beneficial because they result in each country specializing in the goods and services that it can produce relatively most efficiently, leading ultimately to gains for both producers and consumers. The rising share of global economic activity taking place in the Asian Pacific Rim has made structural transformation there an increasingly important issue for other parts of the global economy. This issue is seen most vividly in Japan's international economic relations—particularly those with the United States.

JAPAN AND THE WORLD ECONOMY

Sales of Japanese goods in the United States have greatly benefited American consumers and demonstrate the significant gains from international trade. But Japan's success in American markets, as well as the large and persistent Japanese trade surplus, and complaints by U.S. firms about difficulties in penetrating Japanese markets have prompted charges of unfair Japanese trade practices. Japan does maintain many important barriers on agricultural imports, but has removed all but a few quotas and imposes low tariff barriers to imports of manufactures. Nonetheless, scope remains for further development of Japanese policies, practices, and institutions to increase trade in manufactured products. Many such developments would help domestic markets to work more competitively. Japanese consumers would gain from lower prices, and producers would gain from better functioning markets. Even if the volume of trade increased, however, the effect on market shares of U.S. or any other country's products in Japan would be difficult to predict.

Several avenues to open Japanese markets further are being pursued in the United States. Some barriers, such as Japan's ban on rice imports, are the subject of multilateral trade negotiations in GATT. There also have been recent bilateral trade discussions under the "Super 301" process. Super 301 is part of the 1988 Omnibus Trade and Competitiveness Act, which directs the U.S. Trade Representative and the Administration to identify "priority practices, including major barriers and trade distorting practices, the elimination of which are likely to have the most significant potential to increase U.S. exports..." and to initiate investigations aimed at eliminating the practices or barriers identified. Under these cri-

teria, the Administration identified three Japanese practices in 1989: government procurement of super computers, government procurement of satellites, and standards and codes for wood products. (A total of three other practices were identified under Super 301—two in India and one in Brazil.)

In identifying these practices, the Administration has endeavored to support its principle of expanding a rules-based system for open markets and an open trading system. By naming only practices that are tangible and observable, Administration policy contrasts sharply with a "managed trade" approach, which would require the U.S. Government to second-guess market outcomes and to attempt to achieve different patterns of imports and exports by regulation. Rather than try to mandate trade flows and market shares, U.S. trade initiatives seek to ensure that domestic and foreign firms have equal opportunities to compete and that markets, not governments, determine the outcomes.

A broader set of issues involving domestic structure and institutions in both the United States and Japan are currently under discussion in a series of bilateral negotiations called the Structural Impediments Initiative. These talks, which focus on aspects of each economy that may create barriers to trade or impede domestic and international economic adjustment, provide a forum for two-way exchange of perspectives and concerns. While saving and investment have been major topics of discussion, a range of issues has been raised. In many cases, these issues have already been raised domestically in both Japan and the United States. U.S. interest in these talks has focused on structural problems in six general areas:

Saving and Investment. Reducing the current account imbalance requires reducing the gap between saving and investment. It seems unwise to pursue policies that would lower saving. More public investment by the Japanese government would reduce the gap and would probably improve the quality of life in Japan. Investment in parkland, waste disposal systems, and other social infrastructure in Japan is rather low relative to other industrial nations.

Land-Use Policy. Removing the bias toward agriculture in Japanese land-use policies would reduce land prices in Japan and thereby stimulate new construction investment in Japan by households and by domestic and foreign firms.

Pricing Mechanisms. A joint study of pricing by the Japanese and U.S. Governments found that prices of a variety of goods tended to be higher in Japan than prices of identical products in the United States, in many cases even where these products were manufactured in Japan. The removal of structural impediments should work to reduce these differentials.

Distribution Systems. Laws restricting competition in the distribution and transportation sectors lead to high prices for Japanese consumers and can limit access to the Japanese market.

Antitrust Policy. For example, a more vigorous enforcement of Japan's Antimonopoly Law would ensure freer entry into Japanese markets and could have an important impact on Japanese trade.

Keiretsu Relationships. (Used here to mean firms owning each other's stock.) Promoting shareholder rights and ensuring that management cannot insulate itself from market discipline may promote increased foreign direct investment in Japan.

The Japanese government has also raised points about the U.S. economy. High on the Japanese list is the low U.S. saving rate discussed in Chapter 4 of this *Report*. Other areas include investment incentives, export promotion, and work force training and education.

Trade Barriers and the Current Account

Current account surpluses and deficits are macroeconomic phenomena that primarily reflect the gap between domestic saving and domestic investment. Japanese domestic institutions and trade barriers, such as Japan's continuing protection of its agriculture sector, can impair productivity and reduce real incomes by misallocating resources. There are good reasons to support work toward structural reform. Producers are likely to gain from more open markets, while consumers may benefit from lower prices, as firms produce more efficiently. These gains will be enjoyed by Japan as well as by its trading partners. But trade and structural barriers will only affect the overall current account balances of Japan or Japan's trading partners to the extent they affect savings and investment behavior.

It is not plausible to attribute either the $82 billion increase in Japan's current account surplus between 1981 and 1987 or its decline by more than $20 billion in the past 2 years to changes in Japanese trade barriers. Although structural policies and institutions that affect trade can influence the saving-investment gap, there are other determinants, such as fiscal and monetary policies and demographic factors. In common with the experience in all other industrialized economies, these factors are likely to have played a much larger role than trade barriers in explaining Japan's recent current account developments. Efforts to reduce the U.S. current account deficit will also need to focus primarily on measures to raise public and private saving.

Japanese policies and institutional structure may have a greater effect on the volume and commodity composition of Japanese trade than on overall external balances. Japan stands out from most other industrial countries because it is rarely a major exporter and a major importer in the same industry. Some statistical studies

have concluded that this trade pattern might be expected of a country with Japan's resource endowments; however, others do not share this finding. In any case, where low imports of manufactured or agricultural products result from distortionary Japanese government practices, change is in order.

Changes in policies that raise Japanese imports may also raise Japanese exports. Unless these policy changes affect Japan's saving-investment gap, exports may increase to offset a large portion of increases in imports. Consider barriers that act like a tax on imports—for example on agricultural products. Such barriers will tend to raise domestic prices of rice and other agricultural goods, harming Japanese consumers. They will also tend to raise prices of labor, land, and other resources used to produce agricultural goods. These higher input prices will tend to make Japanese export production less competitive as well. Thus, the import barriers also act as a tax on exports. Removal of the import barriers is likely to increase both Japanese imports and Japanese exports. The net effect on overall trade balances is unclear.

While there are barriers to open markets in many countries, bilateral trade imbalances between pairs of countries are not in and of themselves evidence of such barriers. For example, even if the overall external accounts of both Japan and the United States were balanced, and market barriers had been eliminated worldwide, neither the United States nor Japan would have trade exactly balanced with each of its individual trading partners. Because countries have different endowments of land, skilled and unskilled labor, and capital, and different tastes and technologies, each has a comparative advantage in producing a different set of goods and services. A country such as Japan, which has relatively few natural resources domestically, should be expected to have trade deficits, on average, with countries that export raw materials, offset by trade surpluses, on average, with countries that import the manufactured goods Japan produces relatively efficiently. Bilateral imbalances cannot justify increased protectionism.

Thus, removal of trade barriers, while desirable in and of itself, would not necessarily change Japan's bilateral surplus with the United States. For example, removal of the Japanese beef quota, now in progress, will raise Japan's imports of beef. The higher imports could come from Australia, the United States, or other beef exporters. Thus, the effect on particular bilateral balances is uncertain. Furthermore, the beef quota removal is likely to have little effect on saving or investment in Japan, and thus is unlikely to affect Japan's overall trade surplus very much.

SUMMARY

- Those Asian Pacific Rim economies that exhibit rapid and sustained growth provide striking examples of the potential bene-

fits from market-oriented economic policies. These economies have benefited substantially from the expanding international trading system. They are becoming an increasingly important part of the global economy.

- The persistent U.S. current account deficit and Japanese current account surplus are primarily *macroeconomic* phenomena. Macroeconomic policy is the key to improving overall current account imbalances.
- There are gains to domestic and foreign producers and consumers from changes in government practices that allow markets to allocate resources more efficiently. Such changes will only affect overall current account imbalances, however, to the extent they affect the saving-investment gap. Furthermore, bilateral trade imbalances are determined by a host of factors, and are not in and of themselves evidence of trade or market barriers.
- There is growing recognition that, like tariffs or quotas, a country's *domestic* policies can have important implications for international trade. For example, antitrust regulations or distribution systems may impede a foreign firm's access to domestic markets.

ECONOMIC INTEGRATION IN WESTERN EUROPE

Sweeping economic changes are under way in Western Europe as the member states of the European Community (EC) move toward elimination of economic barriers among them by 1992. The 12 members have a population of 324 million and a GNP close in size to that of the United States. Since the late 1960s, they have progressively reduced internal restrictions on the movement of goods, people, and capital in order to reap the economic benefits of integration. In 1985, agreement was reached to implement a set of initiatives by 1992. The EC initiatives are the most ambitious set of reforms so far. The kinds of benefits anticipated from increased integration among EC members are similar to those motivating the U.S.-Canada Free-Trade Agreement (FTA), which went into force on January 1, 1989. The EC 92 initiatives promise to move the EC closer to the level of economic integration enjoyed by the 50 States within the U.S. market, particularly if there is further integration of monetary policy through the proposed formation of a European monetary union.

The European Community was established in 1957 by the Treaty of Rome. The original six members of what was often called the Common Market were Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands. Denmark, Ireland, and the United Kingdom became members in 1973, followed by Greece in 1981 and

Portugal and Spain in 1986. Since the late 1960s, the EC has operated as a customs union with a common external tariff. Tariffs and quantitative restrictions on trade within the EC have been largely eliminated. Citizens of member countries are permitted to reside in and travel to other member countries freely for the purpose of work.

The new initiatives focus on the remaining barriers among EC countries. Some examples of these barriers are: (1) differences between countries in more than 100,000 industrial standards and technical regulations (for example, safety standards on machinery and health standards on agricultural products); (2) delays at frontiers for customs purposes and related administrative burdens for companies that sell or purchase goods and services in other member countries; (3) restrictions on participation in competition for one EC member's public procurement by suppliers from other EC member countries; and (4) restrictions on firms' ability to sell or purchase services or to become established in certain service activities in other EC countries. These restrictions have been particularly important in financial and transport services, where barriers to the entry of new firms also appear to be substantial. Taken together, these barriers impose a substantial economic cost. Large and persistent differences in consumer prices among EC members suggest that these barriers allow for a considerable degree of market segmentation and reinforce the noncompetitive structure of many member country markets.

The progress toward removing internal barriers has already been impressive. By June 1989, the EC Commission had adopted about one-half of the 279 directives in the plan to implement EC 92. However, much work remains to be done to achieve the degree of integration envisaged in the EC 92 initiatives, and obstacles to elimination of some existing barriers remain. For example, security threats, especially terrorism, make it difficult to remove border controls. These controls also help national fiscal authorities to collect taxes, the structure of which still differs widely across member countries. Proposals for fiscal harmonization are still under discussion. The process of economic integration in Europe should be seen as an ongoing and dynamic process that is likely to continue well beyond 1992.

POTENTIAL GAINS

The gains from economic integration in the EC may be substantial. The EC Commission estimates that integration of the internal market will raise the annual potential growth rate of the EC by around 1 percentage point through 1992. Longer run dynamic effects may sustain a strong growth rate for several additional years. The creation of a single European market will present substantial

opportunities and cost savings to firms operating across national boundaries. Implementation of the EC 92 initiatives will remove constraints that prevent firms from fully and efficiently using their resources. It will also establish a more competitive environment, challenging firms that have grown complacent in insulated national markets to innovate and operate more efficiently. Harmonization of technical standards and tax codes and reductions in the administrative costs of trade between countries will enable firms to produce on a much larger scale at substantial savings. Integration of financial services markets is expected to lower the cost of capital. Efficiency gains are also expected from more competitive bidding on the sizable member country government procurement expenditures.

U.S. firms and consumers also stand to benefit from the increased integration of the European economy. As long as barriers to trade and investment by firms from countries outside the EC are not raised, U.S. firms will also have new opportunities to invest in and supply goods to a large, prosperous, integrated market. American consumers will benefit to the extent that the EC 92 reforms stimulate increased competition and cheaper imports of EC products. In 1988, 19 percent of total U.S. imports came from the EC, and exports to the EC accounted for 23 percent of total U.S. exports. Growth in the European market induced by the EC 92 initiatives may increase the amount of the EC's external trade, which would raise U.S. exports to Europe.

POTENTIAL RISKS

The full gains will only be realized, however, if the EC remains open to the rest of the world. If barriers to external EC trade rise, U.S. and other non-EC firms and EC consumers may suffer. Even without new external barriers, American firms may find some opportunities constricted to the extent that the easier movement of goods within Europe gives insiders an advantage. EC consumers and firms may substitute products from firms of other member countries for imports from the United States or other nonmembers.

The EC should continue to have a strong vested interest in a liberal international trading system because it benefits from substantial foreign trade. While growth in trade within the EC has been 76 percent faster than growth in the EC's external trade between 1982 and 1988, external trade still accounts for more than 40 percent of the EC's total trade. Indeed, the EC's exports to nonmembers are 16 percent of world exports, as against a U.S. share of 12 percent and a Japanese share of 10 percent. Exports to nonmembers are equivalent to 10 percent of EC gross national product, compared with 7 percent for the United States and 10 percent for Japan. These external interests are too important to the EC to risk jeopardizing

them by inward-looking protectionist policies. In addition, low external trade barriers will continue to be the best insurance against EC firms losing their international competitiveness.

EC 92 is not an indication that the international economic system is breaking down into competing regional blocks. But it is important for the United States and other nations to monitor closely the developments in EC 92. Two areas have already been the focus of much attention.

Rules of Origin

One area of particular concern to U.S. firms is the definition and administration of rules governing the determination of the origin of products in the EC. The determination of origin influences the regulations under which products are sold, such as tariffs and duties, quotas, sanctions, and preferential treatment in trade and government procurement. There is concern that adoption of more stringent or less transparent rules of origin within the EC will result in discriminatory treatment of foreign products, especially intermediate goods. Avoidance of such rules may compel foreign companies to locate production facilities in EC markets and, for foreign companies subject to antidumping duties, to obtain inputs from EC producers rather than third-country producers. Rules of origin are an important and controversial issue for the international trading system more generally. Accordingly, the United States is engaged in multilateral discussions to develop disciplines within GATT as well as bilateral consultations with the EC to ensure greater transparency, clarity, and predictability in rules of origin.

Financial Services

An early EC proposal on financial services seemed to call for "mirror-image reciprocity," where foreign firms would receive the same treatment in the EC market that EC firms receive in the market of the foreign firm. The difficulty with this type of reciprocity is that nations have different legal and regulatory systems—often justifiably. The original proposal would have meant that firms from different countries would receive different treatment in the EC. The EC has since modified its proposal; the current proposal comes closer to the "national treatment" principle favored by the United States. Under this principle, foreign firms would be treated the same as EC firms in the EC market, as long as EC firms were treated like foreign firms in the foreign markets. This is another area where developments within the EC may have important lessons for broader multilateral agreements. The United States will continue to monitor EC developments in this area and will continue to negotiate for a multilateral agreement on financial and other services within GATT.

SUMMARY

- EC 92 represents important potential opportunities and benefits for U.S. firms and consumers as well as for EC firms and consumers. Whether U.S. firms and consumers benefit hinges on the continued openness of the European market to foreign trade and investment.
- Concerns that economic integration under EC 92 will lead to "Fortress Europe" appear to be exaggerated.
- EC 92 carries risks as well as opportunities. The United States and other countries must continue to monitor developments so as to minimize the major risk: that other countries' access to the new market will be restricted, which is likely to limit gains to EC members as well as nonmembers.

TRADE LIBERALIZATION AND GATT

A fundamental principle underlying the economic policies of this Administration is that governments should establish clear and credible rules for economic policies in which private-sector decision-making and entrepreneurial activity can flourish. This principle is as applicable to international trade policy as to fiscal and monetary policy. The goal of U.S. trade policy is to create ever-expanding trade opportunities free of barriers and based on a system of clear and enforceable rules.

Acting on this principle in the trade area, the Administration is committed to initiatives aimed at getting governments out of the business of managing trade, whether it be through export-restraining arrangements, subsidies to basic industries, managed marketing arrangements, agricultural import restrictions, or any of the myriad other ways governments distort international trade flows. Some of the more important U.S. initiatives have occurred in the multilateral trade negotiations of GATT (Box 7-2).

Several Administration initiatives have been pursued in bilateral or regional contexts—such as those reviewed earlier in this chapter in the section on the Asian Pacific Rim. But by focusing on rules such as nondiscrimination, by ensuring that reductions in barriers apply to all countries, and by eschewing the fixed quantity approach of managed trade, these efforts have also helped to increase trade opportunities for all countries and are consistent with U.S. support for multilateral trade liberalization. In fact, the principles guiding the architects of GATT—the principal international agreement regulating world trade—are the same as those underlying U.S. trade policy.

GATT comprises rules and mechanisms to encourage freer and fairer international trade. It was established in 1947, after a period in which deviations from the principles of free trade were taken to

extremes and severely damaged the world economy. Many industrial nations resorted to extremely protectionist trade policies in the 1930s. The disastrous consequence of these policies was a sharp contraction in world trade that lengthened and worsened the Great Depression.

Box 7-2.—What Is GATT?

At the conclusion of World War II, the United States and other countries sought to establish rules for the international trading system based on the principles of free, nondiscriminatory trade. The United States promoted the position that nontariff barriers should be abolished and that all tariffs should be reduced through international negotiations.

The General Agreement on Tariffs and Trade was drafted in 1947 as part of efforts to establish a broader International Trade Organization. GATT was signed by 23 countries participating in a conference in Geneva in 1947 and went into effect in 1948. Since then, membership has grown to 96 countries that account for 80 percent of world trade.

The GATT system serves several purposes:

- GATT provides a uniform set of rules and disciplines for the conduct of international trade. Each member country must give the most favorable trade treatment it gives any country to all other GATT members. Tariffs are to be used rather than other types of trade barriers.
- GATT provides an institutional framework to support international consultations and to facilitate settlement of trade policy disputes.
- GATT provides a system for trade policy liberalization through periodic multilateral negotiations to lower tariffs, and since the 1970s, also reduce nontariff barriers.

Since 1948, GATT has sponsored seven rounds of tariff reductions. These rounds successfully reduced tariffs and expanded international trade. The international trading system continues to evolve and GATT needs to address these changes. As tariffs have decreased, nontariff trade barriers have increased. Moreover, areas poorly covered by GATT, such as agriculture, or not covered at all, such as services, intellectual property rights, and investment, are of much greater importance than they once were. All told, $1 trillion or more of international trade in goods and services may not be adequately covered by the GATT rules.

THE URUGUAY ROUND

The President has made a successful conclusion to the Uruguay Round his highest trade priority. The Uruguay Round was launched in 1986 and is scheduled to end in 1990. The final year of negotiations will be critical to the outcome. The negotiations are intended to improve the existing GATT articles and procedures, to negotiate reductions in tariff and nontariff barriers, and to address 15 specific areas. In addition to agriculture, discussed below, some of these areas are:

Intellectual Property Protection. The trading system needs a comprehensive agreement on the protection of intellectual property rights, such as patents and copyrights. It should include standards and procedures for enforcement of these rights both internally and internationally.

Services. GATT rules need to be extended to areas such as telecommunications services where many countries currently impose trade restrictions.

Trade-Related Investment Measures. Trade-related restrictions on foreign investment are used increasingly by many countries. These measures distort trade and result in resource misallocation. GATT needs to develop rules and disciplines in this important area.

Textiles. The Multi-Fiber Arrangement is an exception to GATT rules that allows restrictions on textiles trade in many countries. Trade in textiles needs to be brought under normal GATT rules and disciplines.

Integration of Developing Economies. A major focus in these negotiations is to develop a system of rules that extends market-opening obligations to all participants. Bringing developing countries more fully into GATT will require tightening GATT rules governing the use of balance of payments difficulties to suspend GATT obligations and will also require greater participation by developing countries in GATT trade-liberalizing obligations.

Subsidies. The GATT negotiations offer the opportunity to establish internationally credible and enforceable regulations, or disciplines, for subsidies. This would include extending regulations for export subsidies and introducing prohibitions on domestic subsidies. It would include expanding export subsidy prohibitions to agricultural products.

AGRICULTURAL POLICY AND GATT

Among the 15 areas, agriculture is perhaps the best illustration of the limitations of the GATT system as well as of its potential to further the process of global economic integration. GATT operates on a consensus basis, and when GATT was established, agriculture was exempted from some of its rules to obtain political support for its ratification. At that time, agriculture was not an important

trading sector of most economies. Since then, agriculture has undergone a transformation from a national to a global industry. The United States, the largest food exporter in the world, exported about 25 million metric tons of agricultural products in the 1950s and now exports nearly 150 million metric tons.

Technology, trade, and government policy have all played prominent roles in this transformation. The postwar technological revolution began an unparalleled period of productivity growth in agriculture in the United States and elsewhere. U.S. agricultural productivity has grown more than 200 percent since the 1950s, and food exporting regions such as Canada, Australia, and Europe have experienced similar growth. The rice producing areas of Asia have seen rapid productivity growth since the mid-1960s. Agricultural markets became international as production expanded in the developed economies and global population, income, and food demand grew. The developing countries became major net importers of food, with a net deficit in their food production of 52 million metric tons in 1980, projected to grow to at least 69 million metric tons by the year 2000. Throughout the world, governments became increasingly involved in the production, marketing, and trade of agricultural products. Measurements of agricultural subsidies calculated by the Department of Agriculture show that subsidies in food-exporting countries increased substantially in the 1980s.

Agricultural Policies

Agricultural policies of the major food-exporting and food-importing countries now stand as a major impediment to more complete integration of agriculture into the international trading system. Because of the adverse impacts of agricultural policies on international markets, agricultural policy reform has become a priority for many countries participating in the Uruguay Round of GATT negotiations. Indeed, some countries are insisting on progress in agriculture before they will agree to reform in other areas.

All governments intervene in their agricultural sectors, either on behalf of producers or at their expense. Industrial economies tend to promote producers' interests through protection or subsidization. Developing economies, on the other hand, often use policies that have the effect of taxing agricultural producers for revenue to promote industrial development or maintain price ceilings to benefit urban consumers. In both cases, policy encourages a different pattern of resource use from what would occur in the absence of intervention. The result has been substantial distortions of agricultural resource use, production, and trade around the world.

The increasing degree to which policies have disrupted world agricultural trade has fueled the movement toward international policy reform. The inflexible trade and domestic policies of most countries limited the ability of, and the incentive for, their agricul-

tural sectors to adapt readily to abrupt changes in world market conditions caused by weather and political shocks. Recent droughts and historically low grain stocks have rekindled fears of a world food crisis. Attempts to insulate domestic producers from changes in global market conditions have depleted the budgets of many governments and strained international relations. The failure of existing policies to address the needs of the emerging global agriculture is clearly a major reason for the willingness of many governments to put agriculture on the agenda for international policy reform. It will be an important and historic achievement if the 96 GATT member countries are able to agree on improved and strengthened GATT rules for agriculture.

Recent studies suggest that meaningful policy reform would yield significant economic benefits. These studies conclude that multilateral reduction in trade-distorting policies would lead to higher world prices, higher market-generated farm income, less costly income support for farmers, and improved global economic welfare. Several studies have estimated the global economic gains from complete policy liberalization to be about $31 billion annually and $10 billion for the United States. The GATT reforms advocated by the United States, which would eliminate the most trade-distorting policies, could be expected to yield a large fraction of such benefits.

AGRICULTURAL POLICY REFORM IN GATT

The participants in the GATT negotiations reached a consensus in April 1989 to agree by the end of 1990 on a long-term agricultural reform program. The long-term objective of the reforms is to provide for substantial, progressive reductions in agricultural support and protection, sustained over an agreed period of time, to correct existing distortions in world agricultural markets and to prevent further restrictions and distortions. A key accomplishment of the Uruguay Round of GATT negotiations thus far is the recognition that domestic policies are a major cause of world market distortions. Meaningful reform must, therefore, address both domestic and trade policies.

Proposals for changes in the GATT rules and disciplines to achieve agricultural policy reform were submitted to GATT in late 1989 by major participants, including the United States, the European Community, Japan, and the Cairns Group—Argentina, Australia, Brazil, Canada, Chile, Columbia, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand, and Uruguay.

Although there is now agreement about the need for policy reform, there is little agreement on how to achieve it. One of the basic difficulties in developing GATT rules and disciplines for agricultural policy is that every country in GATT has its own complicated policies. The GATT negotiators cannot write domestic policy

for any country. The challenge facing the GATT negotiators is to develop guidelines that can help countries move to less distorting policies without compromising any country's sovereignty.

The U.S. Proposal for Comprehensive Reform

The United States has proposed broad principles for bringing agriculture into the GATT system. The application of these principles in a strengthened and more effective set of GATT rules would move the world toward a fairer and more market-oriented trading system. The U.S. proposal provides for reform in the areas of import access and export competition, internal support, and sanitary regulations pertaining to agricultural products.

The U.S. proposal to improve import access would convert all nontariff barriers to tariffs and then reduce these tariffs to zero or low levels over a 10-year period. The GATT article that currently allows countries to use import quotas to manage their domestic agricultural policies would be eliminated. Nontariff barriers would be converted to tariffs by computing the difference between internal and external prices and imposing an equivalent tariff. The U.S. proposal thus conforms to original GATT principles for liberalizing trade through tariff reductions. The U.S. proposal calls for a 5-year phaseout of all export subsidies except for bona fide food aid. The proposal also calls for elimination of restrictions and prohibitions on exports of products in short supply. Safeguard measures are proposed to achieve an orderly transition process.

A major problem with most domestic agricultural policies is that they subsidize farmers in ways that artificially stimulate production and thus indirectly distort trade. The U.S. proposal limits the types of domestic subsidies that countries can use to those that have the least effect on trade. The most distorting policies, such as administered price policies and income-support policies linked to production, would be phased out over 10 years. Other less distorting policies, such as general input subsidies, would be subject to certain disciplines. Policies that would be permitted include payments not linked to production or marketing decisions, environmental and conservation programs, general support for research and its dissemination to farmers and disaster relief.

TOWARD U.S. POLICY REFORM

The President's farm policy goals are a market-oriented agriculture that preserves an income safety net for the farm sector and meets other objectives such as environmental quality. The Administration is also committed to global agricultural policy reform fully consistent with its GATT proposal. Agricultural policy reform in the United States would maintain and enhance the U.S. role as the major world food exporter while furthering global reform. But many other countries also subsidize production and export of agri-

cultural commodities or restrict imports. Policy reform in the United States must be accompanied by comparable reforms in other countries if all countries are to reap the gains possible from mutual reductions in agricultural subsidies.

Benefits From U.S. Policy Reform

The most important reason why the United States should simultaneously pursue agricultural policy reform both at home and abroad is the economic self-interest of the United States. The move to less trade-distorting policies could improve the performance of the U.S. farm sector and benefit consumers through increased availability and lower prices of some foods. The U.S. comparative advantage in the production of major traded commodities, notably food and feed grains, means that a large segment of U.S. agriculture can compete successfully in international markets when prices are determined by market forces rather than government subsidies.

Because the United States is one of the largest agricultural producers in the world, agricultural subsidies are particularly costly to U.S. taxpayers. Reforms consistent with the U.S. GATT proposal could help achieve the President's farm policy goal of a more market-oriented agriculture at lower budget and economic cost. Reductions in the budget cost of U.S. farm programs can make a contribution to the goal of a balanced Federal budget. After deducting Social Security, defense, and interest payments on the national debt from the Federal budget, direct price and income-support payments to agriculture were about 10 percent of the remaining budget in fiscal 1986, but fell to 4 percent in fiscal 1990 because of high prices caused by the U.S. drought. Without suitable policy reforms, a return to normal weather could lead to lower commodity prices and significantly higher budget costs in the 1990s.

Moving From Price Supports to an Income Safety Net

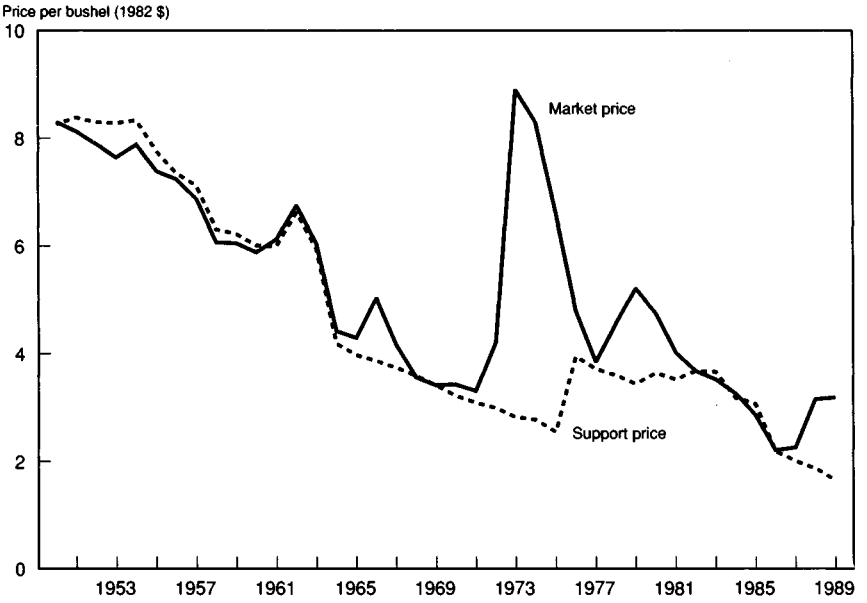
Continuing productivity growth in global agriculture will make U.S. and other countries' farm policies based on price support increasingly costly. This productivity growth is the cause of the persistent downward trend in real farm prices since the 1950s shown in Chart 7-1. The chart also shows that price supports have followed the same trend as real farm prices. This is because it is too costly for the government to keep prices above the long-run trend. The U.S. Government supports prices for certain major commodities (including grains and dairy products) by buying commodities and holding them as stocks, an expensive practice, and by managing supply through acreage reduction programs.

The acreage reduction programs are a policy response to the high costs of directly supporting prices by holding stocks. This pattern of stock buildup and supply management through acreage control is

evident in Chart 7-2, which shows wheat stocks and the forgone wheat output attributable to the idling of land through the wheat programs. A similar pattern of stock buildup and supply control occurred for feed grains. Two such policy cycles have taken place: one in the 1950s and 1960s and another in the late 1970s and 1980s.

Chart 7-1

REAL WHEAT PRICES. Real U.S. market and support prices follow a similar long-term trend.



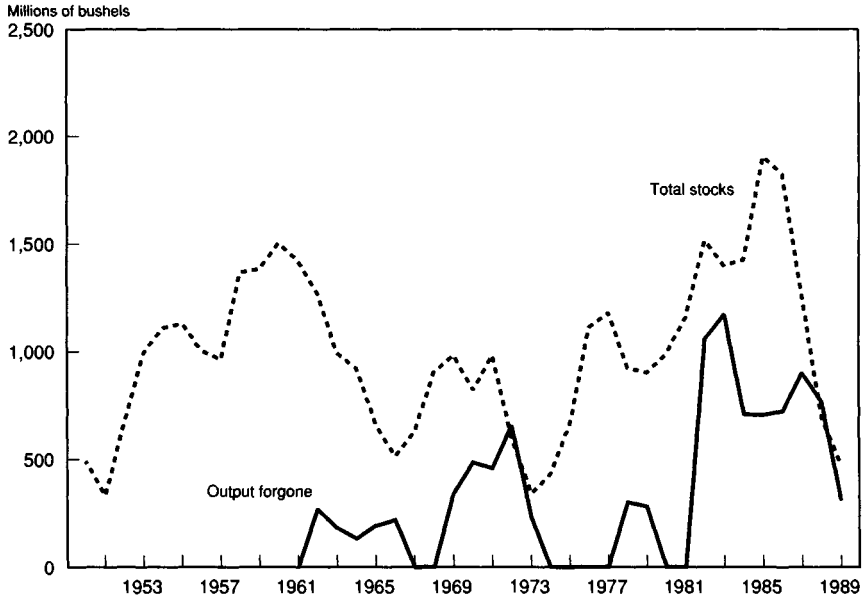
Source: Department of Agriculture.

Reliance on supply control reduces U.S. agriculture's exports by taking land out of production that could be producing crops for export. Moreover, because farmers are provided an incentive to make cropping decisions according to program rules rather than market signals, the programs reduce the responsiveness of U.S. agriculture to changes in world market conditions and reduce its international competitiveness.

Price and income supports redistribute income within the agricultural sector in unintended ways. Farmers who own assets when a price-support or supply-control policy is invoked earn capital gains because their land increases in value. Persons who subsequently want to become farmers must pay the capitalized value of the farm programs when they buy land. These newer farmers' economic survival then depends on the continuation of the support programs. Having paid the capitalized value of the programs in

Chart 7-2

WHEAT STOCKS. Large stocks lead the government to reduce acreage and thus output.



Note: Output forgone equals average yield times acres idled.
Source: Department of Agriculture.

order to farm, they need the high program prices and income subsidies to break even.

Understandably, farmers are concerned that they will have to bear much of the cost of adjusting to a new domestic policy regime. A reform program thus may need to include provisions that facilitate adjustments in the farm sector caused by policy change. To provide income support to farmers in a manner consistent with the principles espoused by the United States in the GATT negotiations, policy could be based on criteria related to income, not production. An income-based safety net for agriculture could facilitate adjustment, protect farmer income from unforeseen circumstances such as weather and political events, and do so at a much lower cost to the economy than the existing system.

SUMMARY

- The principle underlying U.S. Administration trade policy is to expand the current rules-based trading system to foster open and competitive markets. The Administration strongly opposes all attempts by governments to manage trade.

- GATT provides a set of rules for the international trading system and a process of multilateral negotiations through which further liberalization of trade can be achieved. The United States played a key role in the development of the GATT system in the late 1940s, and continues to play a leadership role.
- U.S. objectives for the Uruguay Round are to broaden and strengthen GATT rules and disciplines, and to reach agreement with other members on reductions in tariff and nontariff barriers. Some of the areas under negotiation in the Uruguay Round are agriculture, intellectual property rights, trade-related investment measures, services, and subsidies.
- Agricultural policy reform has become a priority for many countries in the Uruguay Round because domestic agricultural policies are becoming increasingly costly and are an impediment to trade policy liberalization.
- An income-based safety net could provide income protection for farmers in a manner consistent with the principles advocated by the United States in the Uruguay Round.

CONCLUSION

Recent developments in the global economy underscore the importance of free and competitive markets to promote and sustain growth. This Administration has taken a leadership role in promoting the development of open markets worldwide through important new initiatives to support economic reform in centrally planned and severely indebted countries. It has also played a leadership role in efforts to extend the GATT rules for the international trading system so as to eliminate barriers to open markets.

Market-oriented economic reforms can help to revive economic performance among the centrally planned economies, as well as among the highly indebted developing countries. While these countries must implement the necessary policy changes, assistance from the United States and other developed nations can be important. The United States continues to provide financial and technical assistance to support reform efforts in Poland and Hungary. It has also initiated a new debt strategy to support reforms in Mexico, the Philippines, Costa Rica, and other indebted countries through reduction of debt burdens.

The dramatic steps underway in the European Community to create a single, unified market by 1992 highlight the potential gains from removal of barriers. The elimination of artificial restrictions that prevent free movement of goods, services, labor, and capital across national boundaries promises to raise growth in the EC

member countries, the United States, and all nations that participate in the global economy. These gains will be realized as long as the EC provides non-EC members access to its newly expanded internal market. The dynamic Asian Pacific Rim economies also provide examples of how reliance on both domestic and international markets can generate economic expansion and raise living standards. These economies will also gain from further steps to remove barriers to open markets.

All countries must press forward to facilitate and safeguard a smoothly functioning global economy. Conflicts should be resolved through negotiation of rules. In this regard, GATT is a critical multilateral institution, providing a unified set of rules and disciplines for trade policies of member countries, and a framework for policy liberalization and dispute settlement. The current round of negotiations seeks to strengthen this rules-based system in existing areas such as agriculture, and extend it to important new areas such as services and intellectual property. The President has made successful completion of the Uruguay Round a major trade priority.

In today's highly integrated world economy, international economic policy issues are inseparably intertwined with domestic policy issues. International features arise naturally as one considers traditionally domestic issues such as fiscal policy, monetary policy, and environmental policy.

The usual concerns with international economic events and international economic policy were heightened immeasurably by the remarkable economic reform movement that began in Eastern Europe in 1989. This reform movement, as well as the economic reforms in some highly indebted countries, the ongoing integration of Western Europe, the success of the market-oriented Asian Pacific Rim economies, and the bold U.S. proposals to expand GATT point to the same theme: an open free-market economy is the surest road to economic prosperity. This is also the lesson from the success of the U.S. economy in the 1980s which the first six chapters of the *Report* have endeavored to explain. The challenge of the 1990s is to build on this success and to continue support for economic and political freedom around the world. The return from this effort will be a safer and more prosperous world in the 21st century.