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OUTLINE

U.S. FOREIGN ECONOMIC POLICY IN A POST COLD WAR WORLD

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by

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## **I. INTRODUCTION**

- A. Acknowledge introduction.
- B. Make some tie-in to Kirkpatrick's speech of last night and any panelists that have preceded me today.
- C. I want to look, from an economist's perspective, at how we came to be in a post cold-war world and what we should do in three specific policy areas.
- D. Those three policy areas are:
  - 1. Dollar exchange rate policy
  - 2. International coordination of macroeconomic policies.
  - 3. International trade policy.
- E. The primary theme of my remarks is that there are some fundamental principles on which our domestic and international economic policies, arrangements, and institutions should be based.

## **II. HOW WE REACHED THE POST COLD WAR WORLD**

- A. The U.S. won economically, not militarily.
  - 1. Military contest was a standoff, and probably still is as long as there are intercontinental ballistic missiles with nuclear warheads in the former Soviet Union.
  - 2. It is premature to say that the U.S. is the only military superpower.
  - 3. Economically, we were the clear winners, and it was economic realities that caused the collapse of the communist regimes.
- B. The U.S. is not the only economic superpower. Others are:
  - 1. Japan
  - 2. Germany

3. Eventually the EC.
- C. The U.S. economic victory came because:
1. Free market policies are superior to central planning policies.
  2. Political freedom policies are superior to political suppression policies.
  3. Political freedom and economic freedom interact and are mutually reinforcing. (See Friedman and Friedman, **Free to Choose**, pp. 54-55, 67-69, and 148-149. )
- D. U.S. economic policies that led to success are:
1. U.S. political freedom is obvious, so I will limit my comments to U.S. economic freedom and the ways in which that economic freedom has been enhanced.
  2. The U.S. has a market system that is a marvelous invention. The market system transfers information about what is wanted and needed so that economic activity is made efficient. It rewards those who are industrious and who read its signals. Its economic freedom fosters economic efficiency.
  3. At the end of WW II, the west set up institutions to enhance the economic freedom of international commerce.
    - a. The GATT was established to foster freedom in international trade.
    - b. The IMF was established with a long-run objective of promoting removal of capital controls and avoiding competitive devaluations of exchange rates. The Bretton Woods fixed exchange rate system was not so much a rejection of floating exchange rates as it was an attempt to avoid the competitive devaluations and exchange controls that had plagued the world during the 1930s.
  4. In the 1980s, the U.S. took actions to improve domestic economic efficiency and domestic economic incentives.
    - a. Price stability was greatly restored in the early 1980s.
    - b. Marginal tax rates were cut.

- c. Income tax bracket creep was ended.
  - d. Some major industries were deregulated:
    - (1) Airlines.
    - (2) Trucking.
    - (3) Many aspects of telecommunications.
    - (4) Many aspects of financial institutions.
- E. In contrast, the USSR and Eastern European satellite nations adopted policies that sowed the seeds of their ultimate collapse.
- 1. They instituted central planning, in 1918-1921 and after 1927 in the USSR, and after WW II in Eastern Europe and China.
  - 2. They suppressed political freedom, and what Hayek, in *The Road to Serfdom*, called the critical faculty of dissent that makes progress possible.
  - 3. They established COMECON, which constrained their international trade and denominated their trade balances in inconvertible currency.
- F. Eventually, the inefficiencies of their system led to economic and political collapse. The collapse occurred despite extensive use of the police powers of the state, and despite the implicit subsidies to their economies from their degradation of the environment, the use of slave labor in the USSR, and, in parts of Eastern Europe, the neglect of their infrastructure.
- G. The contrasting fortunes of the U.S. and the USSR, and more broadly, of the West and the Communist bloc, is one more piece of evidence, in my view a very large piece, that free markets are vastly superior to controlled markets.
- 1. This lesson should strengthen our resolve to apply free market principles to our economic policies in the post cold-war era.
  - 2. We should apply free market principles when developing our international economic policies in such areas as:
    - a. Exchange rate policy.
    - b. International coordination of macroeconomic policy.

c. International trade policy.

3. Next, I will discuss each of those policy areas.

### **III. EXCHANGE RATE POLICY IN THE POST COLD WAR WORLD**

- A. We should not have an exchange rate target.
- B. Stable exchange rates might be preferable to fluctuating exchange rates, but government actions to prevent exchange rates from changing are often harmful because they entail:
  - 1. Subordinating economic freedom to an exchange rate target.
  - 2. Subordinating monetary policy to an exchange rate target.
  - 3. Government speculation in foreign currencies.
- C. We should not subordinate economic freedom to an exchange rate target:
  - 1. No trade controls to support the dollar.
  - 2. No capital controls or interest equalization taxes to support the dollar.
  - 3. No restrictions on travel to support the dollar.
- D. We should not subordinate monetary policy to an exchange rate target.
- E. We should not intervene in exchange markets.
  - 1. Nonsterilized intervention can subordinate monetary policy to an exchange rate target.
  - 2. Sterilized intervention doesn't change the underlying fundamental factors that cause exchange rates to appreciate or depreciate.
  - 3. Either kind of intervention can lead our government to taking a speculative position in foreign currency.
- F. We don't need a new Bretton Woods arrangement or a gold standard for the world's exchange rates.

- G. What we do need is for the U.S. to provide a stable anchor for exchange rates by achieving domestic price stability. Then, exchange rates will depend mostly on the inflation policies of each individual country.

#### IV. INTERNATIONAL COORDINATION OF MACROECONOMIC POLICY IN THE POST COLD WAR WORLD

- A. International coordination of macroeconomic policies has been advocated by some Administration officials during the last eight or so years. Its goals are:
1. Fine tuning of business cycles.
  2. Exchange rate manipulation.
- B. Such coordination is **not** politically feasible, **not** economically feasible, and **not** necessary, but it is harmful.
- C. International policy coordination is **not** politically feasible.
1. Congress has not been able to make U.S. fiscal policy conform to the stated goals (Gramm-Rudman) of the Congress itself. If that control has proved to be politically infeasible, it is even more unrealistic to expect Congress to be able to make fiscal policy conform to the demands of international coordination.
  2. Coordination is a euphemism for getting **your** country to do what I think is best for **my** country. It is unlikely that governments would undertake to do something that is bad for their own economy, even if it would be good for another nation.
  3. Perhaps, an appeal to international coordination could provide our officials with the political cover necessary to do something for our nation that is needed but politically unpopular.
- D. International policy coordination is **not** economically feasible.
1. Domestic countercyclical policy is not feasible because:
    - a. Monetary policy and fiscal policy affect the economy with long and variable lags.
    - b. Forecasts of economic activity are not sufficiently accurate as

far in the future as those lags require.

2. If domestic fine tuning is not economically feasible, international coordination of policies for fine tuning is even more infeasible.

E. International policy coordination is **unnecessary**.

1. Empirical studies usually show that the benefits of attempts at international policy coordination are small, and that most of the little benefit that is obtained accrues from sharing information about the nature of economic shocks, rather than from jointly determining policy.
2. No international coordination is needed to pursue sensible domestic economic policies. Sound fiscal policy, and a monetary policy aimed at price stability are good for the U.S. regardless of what policies are being pursued by other nations.
3. Similarly, other nations can also pursue sound policies without coordinating with the U.S.
4. Consequently, international coordination of macroeconomic policies is unnecessary.

F. International policy coordination is **harmful**.

1. If coordinated policies are based on incorrect forecasts, the harm is magnified.
2. Coordination creates the illusion that governments can solve problems if only other nations would cooperate.
3. Therefore, coordination diverts attention from the real problems and the real sources of solutions.

## V. TRADE POLICY IN A POST COLD WAR WORLD

A. Economists have long known that free trade is beneficial to the households, communities, counties, states, regions, and nations that engage in it.

1. Excluding out-of-county products from that county's markets would impoverish the people of that county. Similarly, excluding out-of-state products from the markets of that state would lower living standards in that state.

2. Restricting international trade has the same negative effect, although for a nation as industrially diverse and prosperous as the United States, the ill effects are often less readily apparent.
- B. In addition to promoting prosperity, international trade creates international interdependence, making war more costly and peace more attractive. Therefore, it is a force for peace.
  - C. Our policy should be to promote free international trade in whatever ways we can, using both multilateral and bilateral fora.
  - D. We should continue to work through the GATT to promote multilateral free trade.
  - E. We should continue to pursue bilateral free trade treaties, like our initiatives with Israel, Canada, and Mexico.
    1. Some have objected to bilateral treaties, fearing that they will lead to isolated trade blocs, in effect Balkanizing world trade.
    2. I don't share that fear. It seems to me that when bilateral or regional free trade arrangements have been made, other nations want in, and the free trade zone becomes enlarged.
      - a. The prospect of a free trade zone in western Europe has prompted membership requests from:
        - (1) Switzerland and Austria.
        - (2) Scandinavian nations.
        - (3) Eastern European nations.
      - b. The prospect of a U.S.--Mexico free trade area prompted Canada to join the negotiations. Moreover, several Latin American nations have also asked to get in on free trade arrangements with the U.S.
  - F. A difficult question is what tactics we should use to promote free trade.
    1. Should we threaten trade retaliation as a bargaining chip to get trade barriers removed? Should a country that is promoting the idea of free markets ever use trade sanctions?

2. Or should we go in the opposite direction and unilaterally declare free trade, and then phase out all of our trade barriers?
- G. Using trade restrictions as a bargaining chip to pressure other nations to reduce their trade barriers is a dangerous strategy.
1. If the other country does not remove its trade barrier, we will have the Hobson's choice of keeping our new trade barrier or losing face by removing it.
  2. It can lead to a trade war, if the other nation feels aggrieved and retaliates.
- H. Declaring free trade unilaterally seems preferable.
1. Our trade barriers are already quite low.
  2. The barriers that we do have could be phased out to ease the adjustment of our firms and workers who will no longer be protected from free competition.
  3. The end of the cold war has removed national defense as a rationale for restricting our people's access to foreign products.
  4. Such a bold move would reassert American leadership, putting our money where our mouth is.
  5. Such a move would help to induce other nations to do the same:
    - a. We would be setting a powerful example, causing some nations to follow suit right away.
    - b. Other nations would be more likely to follow suit later on when they see that we did not suffer but instead enjoyed additional prosperity that we enjoy as a result of our move.

## VI. SUMMARY AND CONCLUSIONS

- A. Our policy should be to continue to pursue economic and political freedom domestically, encourage other nations to do the same, and seek greater freedom in international economic commerce.

- B. These policies are the surest path to prosperity and freedom here and abroad, and the greatest deterrent to international conflict.
- C. If we continue to pursue free markets, the remaining totalitarian regimes of the world will be weakened as their peoples become more aware of the benefits of economic and political freedom.
- D. Unfortunately, much of the public in our own nation doesn't understand the benefit of free-market policies.
  - 1. Consequently, politicians usually don't benefit from instituting free-market policies.
  - 2. It is analogous to children who enjoy the fruits of their parents' labors but don't comprehend what those labors are.
- E. Consequently, it is in our collective long-run interest for each of us to do what we can to improve public understanding of the benefits of the free market system.