Balancing the budget will always remain a goal of any Administration that believes as much as we do that the soundness of our money must be assured, and that an unbalanced budget has a very bad effect on it.

—President Dwight D. Eisenhower

In his farewell address to the American people, President Ronald Reagan listed what he considered to be the two greatest triumphs of his Administration: the recovery of the U.S. economy and the recovery of American morale.

"America," said President Reagan, "is respected again in the world, and looked to for leadership."

In his inaugural address, President George Bush struck a more pessimistic note when speaking of the U.S. economy. "... We must bring the Federal budget into balance," said the new President, "and we must insure that America stands before the world united: strong, at peace and fiscally sound. But, of course, things may be difficult."

Between the optimism of Ronald Reagan and the cautiousness of George Bush lies an America confused about its position in the changing global economy and its ability to compete in a world that seems increasingly to be drifting in the direction of economic super blocs.

The 1980s did bring some impressive changes in the U.S. economy. After one of the most severe recessions since the Great Depression of the 1930s, the nation experienced seven years of strong economic growth (1983-89), the longest peacetime expansion in U.S. history.

As economists C. Michael Aho and Marc Levinson have noted, President Reagan was able to leave Bush "both an unusually low unemployment rate and a relatively low and stable rate of inflation, perhaps the most welcome gifts of all."

On the other hand, the Reagan era was also marked by record budget and trade deficits. In less than six years, the U.S. went from being the world's largest creditor (lender) nation to its biggest debtor (borrower), and from exporting more goods than it bought to importing more than it sold. The annual Federal budget deficit tripled during the decade, peaking in 1986 at $221 billion. Just to keep the government afloat, the U.S. must now sell $10 billion in Treasury bonds each month.

Some American economists warn that unless the U.S. tightens its belt, consumes less and saves more to invest in education, training, infrastructure improvements (roads, bridges, etc.) and research and development, the country will not remain competitive in the international arena. They foresee high debt and deficits restricting the nation's economic performance well into the next century.

Others are more optimistic, citing reductions in both the budget and trade deficits as evidence of the nation's ability to adapt to a changing economic environment. They point out that the U.S. production of goods and services, the gross national product (GNP), is nearly twice that of any other nation and that the U.S. is still the world's single largest market.

Most economists, however, agree that the role of the U.S. in the global economy is changing. Rapid improvements in the economies of other developed nations and the newly industrializing countries, coupled with greater regional cooperation—particularly in Western Europe and the Far East—

### Comparison of the U.S., the European Community (EC) and Japan

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>EC</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (mid-1987, in millions)</td>
<td>244</td>
<td>325</td>
<td>122</td>
</tr>
<tr>
<td>GNP (1987, in trillions)</td>
<td>$4.5</td>
<td>$4.1</td>
<td>$2.9</td>
</tr>
<tr>
<td>Per capita GNP (1987)</td>
<td>$18,530</td>
<td>$12,732</td>
<td>$15,760</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.5%</td>
<td>10.25%</td>
<td>2.5%</td>
</tr>
<tr>
<td>U.S. exports (in billions)</td>
<td></td>
<td>$75.9</td>
<td>$37</td>
</tr>
<tr>
<td>EC exports (in billions)</td>
<td>$84.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japanese exports (in billions)</td>
<td>$89.8</td>
<td>$47</td>
<td></td>
</tr>
<tr>
<td>U.S. direct foreign investment (in billions)</td>
<td>$126</td>
<td></td>
<td>$17</td>
</tr>
<tr>
<td>EC direct foreign investment (in billions)</td>
<td>$194</td>
<td>NA</td>
<td></td>
</tr>
<tr>
<td>Japanese direct foreign investment (in billions)</td>
<td>$53</td>
<td>$6.6</td>
<td></td>
</tr>
</tbody>
</table>

All figures are for 1988 and in U.S. dollars unless otherwise noted.

Sources: World Development Report 1989; Business Week, 12/12/88; U.S. Dept. of State Bulletin; Background Notes (Japan); U.S. Commerce Department; Bank of Tokyo.
have greatly diminished U.S. influence on the world's economic course. As Japan's former Prime Minister Noboru Takeshita put it, the U.S. is no longer number one in the world economy, but rather "first among equals."

For the average citizen, an economically stronger U.S. translates into more jobs, better public services and security for the future. On the other hand, continued high debts, chronic trade and budget deficits, and a deteriorating infrastructure could lead to a drop in the U.S. standard of living.

Do "Japan, Inc.,” and "fortress Europe” present a real or imagined threat to the prosperity of the U.S.? If the era of U.S. dominance of the global economy is coming to an end, then what lies ahead? For older Americans in particular, the past holds lessons for the future.

The U.S. economy: a brief history

INTERNATIONAL COMMERCE has always played an important part in U.S. economic development. Before independence, agricultural trade with Europe and the West Indies helped to make the American colonies the richest and most materially comfortable colonies in the world. The Industrial Revolution of the 19th century brought a shift in the U.S. economy away from agriculture and toward manufacturing. By 1860 the value of U.S. manufactured products was surpassed only by that of Britain.

In the early 20th century, World War I created a surge in demand for U.S. agricultural and industrial products abroad. The U.S. economy expanded at a rapid pace, with America forging ahead of Europe in the manufacture of industrial products and consumer goods, such as steel, automobiles and refrigerators. After the stock market crash of 1929, however, U.S. economic expansion came to an abrupt halt.

In 1930, to insulate domestic industry and farming from foreign competition, the U.S. Congress passed the Hawley-Smoot Tariff Act, a trade bill that placed high tariffs on all sorts of imported products. Many U.S. trading partners retaliated with similar protectionist measures of their own. As the Great Depression spread across the globe between 1929 and 1932, U.S. foreign trade dropped 70%. The outbreak of World War II brought another boom to the U.S. economy. Unemployment sank to negligible levels while farm and industrial output set record highs.

The postwar period

In 1944, as the war was winding down, President Franklin Delano Roosevelt took the first step toward reconstructing the postwar economy by sponsoring a meeting between representatives of the U.S., Britain and 42 other nations at Bretton Woods, N.H. The purpose of the talks was to reorganize the international monetary system in order to promote world trade and economic cooperation.

The Bretton Woods delegates established the International Bank for Reconstruction and Development (or World Bank) and the International Monetary Fund (IMF). The institutions were funded by member-country contributions, with voting rights allocated according to contribution size. Since the U.S. was the largest single contributor, it held veto rights in both the World Bank and the IMF. In 1947, the General Agreement on Tariffs and Trade (GATT) was drawn up and became a forum for liberalizing trade among nations and settling trade disputes.

To stabilize the international monetary system, a standard of fixed exchange rates was set up at the Bretton Woods meeting. Under this standard, the price of gold was fixed at $35 per ounce, and the U.S. dollar became the measure for setting the value of all other currencies.

U.S. lead narrows

The Bretton Woods system remained intact for nearly three decades. During that time, the U.S. became the world's economic "locomotive," assisting recovery in Western Europe and Japan and development in the Third World. As Asia and Europe rebuilt their economies, the U.S. economic lead began to narrow. Between 1952 and 1968, for example, the U.S. share of global exports in manufactured goods shrank by 50%. During the 1960s, President Lyndon Baines Johnson's Great Society welfare programs and the escalating war in Vietnam placed a growing strain on the Federal budget. By 1968, the Federal government deficit had reached $25 billion, alarmingly high for peacetime, though less than half of what it was in 1943 at the height of World War II.

The 1970s were marked by economic turbulence around the globe. In 1971, faced with rising inflation, unemployment and a flood of red ink in the trade balance, President Richard M. Nixon ended the Bretton Woods arrangements by suspending the convertibility of the dollar into gold, which ended the system of fixed exchange rates, and for the first time in U.S. peacetime history imposed temporary price and wage controls. The economy, however, continued to limp along. Due to their large dependency on energy imports, the U.S. and other industrialized countries were hit hard by the Arab oil embargo of 1973–74 and the quadrupling of the price of oil.

During the Administrations of Presidents Gerald R. Ford and Jimmy Carter, a growing demand abroad for agricultural products and machinery helped to promote a U.S. economic recovery. Nonetheless, by the time President Carter left office in January 1981, the continued need to import oil, together with the oil price hike of 1979, contributed to a $30 billion trade deficit, a $79 billion Federal budget deficit and an annual inflation rate of 13%.

Reaganomics

When Ronald Reagan was elected President in 1980, he promised to "reverse our nation's economic decline." President Reagan based his plan for economic recovery on a controversial theory known as supply-side economics. The supply-side economists be-
believing that across-the-board cuts in personal and business tax rates would bring a higher level of savings and a more efficient allocation of investments. This in turn would lead to greater economic activity, creating more jobs and thus broadening the tax base and bringing higher government revenues.

Using supply-side economics, President Reagan hoped to eliminate the budget deficit while increasing military spending to counteract a perceived Soviet military threat. Though there were deep cuts in some nondefense domestic programs, the most expensive ones, such as Social Security entitlement payments, were left intact.

Just how successful supply-side economics has been is still being debated. According to Harvard economist Benjamin Friedman, Reagan’s program simply led to increased consumer spending. Says Friedman, “By now we should realize that being in favor of saving and investment or work effort or competitiveness is not the same as actually advancing these objectives.”

Beryl Sprinkel, chairman of President Reagan’s Council of Economic Advisers, sees things differently. He points to the decline in inflation, the large number of jobs created, the low level of unemployment, and the long period of economic expansion as evidence that the supply-side program has worked.

“I’m rather pleased with the results,” Sprinkel told The Washington Post in December 1988. “Yes, there are challenges ahead, but given the conditions we faced when we came [to office in 1981], we have done well.”

**Borrowing from abroad**

The Reagan era set two post-World War II records simultaneously: for highest peacetime budget deficits, and for highest government spending. At the same time, high consumer spending caused the personal savings rate to fall to its lowest level in 40 years—from an average of 7.2% of after-tax income during the 1950s through the 1970s, to just 3.7% in 1987, a reduction of more than 50%. Since domestic savings normally provide capital for both public and private-sector investment, which is essential for economic growth, the low savings rate due to both high personal consumption and government spending during the 1980s forced the U.S. to look abroad for funds.

The U.S. Treasury now relies heavily on foreigners to buy a big share of the $10 billion in bonds it issues each month in order to finance Federal expenditures for defense, education and other programs (Japan currently buys about 40% of the bonds). By the end of 1988, the total U.S. foreign debt was estimated at $500 billion, more than that of all the Latin American countries combined. (Some economists dispute these figures, contending that official statistics grossly underestimate the value of U.S. assets abroad and therefore are misleading.) Dividends and interest on the foreign debt cost U.S. taxpayers between $40 billion and $50 billion each year.

**Foreign ownership on rise**

The most visible sign of the growing foreign presence in the U.S. economy is the rapid increase in foreign-owned companies and real estate. The perception of the U.S. as a safe place to invest, combined with high interest rates and liberal investment policies, has attracted foreign investors. Foreigners, especially the British, Japanese and Dutch, now own such stalwart U.S. corporations as Standard Oil of Ohio, Firestone and Carnation. Foreigners also own roughly 25% of all office space in Washington, D.C., and nearly half of downtown Los Angeles, as well as substantial holdings in many other U.S. cities.

Much of the rise in foreign investment in the U.S. stems from measures taken by the Federal Reserve Board to curb the nation’s double-digit inflation. In 1979, newly appointed Federal Reserve Board chairman Paul Volcker raised the interest rate on loans to banks, known as the prime rate. The theory behind the move was that higher interest rates would encourage savings and discourage borrowing, slowing the demand for homes, automobiles and other consumer goods, and thus check inflation.

By January 1981, interest rates had hit a historically high 21%, bringing the U.S. economy to a standstill and throwing the world into a deep recession. The combination of worsening economic conditions abroad and high interest rates in the U.S. made dollar investments extremely attractive to foreigners.

As Volcker’s policy took hold and the inflation rate fell to just 4% in 1982, interest rates also began to decline. By the end of 1984, with the nation’s economic recovery well under way, the prime lending rate was lowered to 10.75%. However, real interest rates—adjusted for inflation—remained at unusually high levels, keeping the dollar attractive to foreign investors.

The Reagan Administration welcomed the dollar’s rise, seeing it as a
sign of foreign confidence in the U.S. economy. The strong dollar, however, created two major problems for U.S. industries. First, it led Americans to buy more and more foreign goods, because they could get more for their dollars than they did buying domestic products. Second, it raised the price of U.S. products abroad in terms of foreign currencies, making it more difficult for U.S. firms to compete in the international market.

**Trade deficits**

The net result was that Americans bought far more goods and services abroad than they sold to foreigners. This led to a dramatic deficit in the U.S. current account (which represents trade in goods, services and investment) of $156 billion in 1986, in contrast to a surplus of $6.9 billion in 1981.

When the U.S. imports more than it exports, this imbalance can affect the economy in many ways. First, a decline in exports can contribute to unemployment, especially in manufacturing. By one calculation, each $1 billion drop in exports equals 25,000 fewer jobs. Second, a rise in imports can put businesses out of business or discourage them from expanding production. Finally, recurring large trade deficits can undermine the nation’s status as a global leader by making it appear that the economy is out of control. On the other hand, imports can benefit consumers by providing a larger choice of lower-priced goods and services. They can also create jobs in sales, distribution and other services, and they can stimulate domestic industries to be more innovative and to raise their productivity.

In September 1985, worried over the growing current-account deficit and a rise in protectionist sentiments in the U.S. Congress, then Treasury Secretary James A. Baker 3d called a meeting of the economic policymakers from the so-called Group of Five (G5) nations—France, West Germany, Britain, Japan and the U.S.—at the Plaza Hotel in New York City. The purpose of the meeting was to develop a policy that would force the value of the dollar down and thus stabilize the world currency markets. At the same time, a cheaper dollar would help the U.S. expand its export markets and become more competitive at home against foreign imports.

**The Plaza Accords**

The Plaza Accords called for an orderly depreciation of the dollar against other major currencies. The G5 countries expressed their willingness to intervene in the currency markets by selling large amounts of dollars to force the value down. It was also agreed that West Germany and Japan would stimulate economic growth at home (creating a greater demand for imports) by lowering their domestic interest rates.

To a certain extent, the Plaza Accords were a success. Between 1985 and 1988, the dollar lost nearly 50% of its value against all other major currencies. It was not until 1988, however, that the U.S. current account improved. That year, the deficit fell to $127 billion from the 1987 high of $160 billion, almost a 21% drop. Since then the current-account deficit has continued to decline, but the strong dollar and the mid-1989 deficit in the service sector, the first in 30 years, could reverse the trend. A service surplus has traditionally helped offset the deficit in goods.

Some economists point to low unemployment rates, steady investment in American productive capacity and the continued (if slower) economic expansion as evidence of the country’s robust economic health. They see no cause for alarm in the latest trade figures. But others, among them William R. Cline, a senior fellow of the Institute for International Economics, believe there is urgent need for a change in U.S. policy—namely cutting the budget deficit and further lowering the dollar’s value against other major currencies.

**Servicing the debt**

The growing national debt also worries many economists. Though they admit that the size of the debt relative to GNP may have been higher in the past, the percentage of Federal funds necessary to service the debt, they say, has never been greater. In 1945, interest paid on the Federal debt was $3.8 billion, or about 4¢ of every $1 in revenue the government collected; in 1988, the interest paid was $151.7 billion, nearly 15¢ of every revenue dollar.

Since the U.S. government is now highly dependent on financing from abroad, how the economy is perceived from outside the country is as important as how Americans view it themselves. Many foreigners are worried that in the long run financing the U.S. deficit will place a great strain on the international financial system.

**‘Japan, Inc.’**

Many analysts believe that the global economy is poised between the era of U.S. dominance and the age of Japan. From the depths of their World War II defeat, the Japanese have come roaring back, the new lions in the realm of international trade and finance. Today, their economic strength is second only to that of the U.S., and if current trends persist, they will soon be in first place.

“**The American century is over,”** says Clyde Prestowitz, a former U.S. Commerce Department official and author of Trading Places: How WeAllowed Japan to Take the Lead. “**The big development in the latter part of the [20th] century is the emergence of Japan as a major superpower.”**

Asia-watchers have been captivated by the spectacular rise of Japan, a country with a population about half that of the U.S., living in an area slightly smaller than California. Until a little over a century ago, Japanese society was based on a feudal structure, largely unchanged for 500 years. In 1852, President Millard Fillmore commissioned Commodore Matthew C. Perry to sail into Tokyo Bay and force Japan to sign trade agreements with the U.S. This began a lasting commercial relationship between the two nations. In
1868, the Japanese adopted an aggressive modernization program, designed to bring the country into the contemporary industrial world.

During the first half of the 20th century, Japan followed an expansionary, imperialist policy toward its Asian neighbors. The stunning defeat of the Russian navy in the Russo-Japanese War (1904-5) left Japan in control of Korea and parts of China. In World War I, Japan sided with the allies against Germany, sending large quantities of munitions to Europe and occupying German possessions in the Pacific. After the war, a rapidly growing population led Japan to emphasize manufacturing and foreign trade as a means to provide employment.

The economic hardships of the Great Depression of the 1930s helped to strengthen imperialist sentiments within Japan. In 1931, the Japanese military seized Manchuria from China, setting up a puppet state under Japan’s control. The move was condemned by the League of Nations, prompting Japan to be the first major country to withdraw from the organization.

In 1937, Japan’s continued aggression in China put an end to friendly relations between Japan and the Western democracies. In 1940, Japan entered into an alliance with Nazi Germany and Fascist Italy, greatly expanding its military operations throughout the Far East. In 1941, Japan took the fateful step of bombing the U.S. Navy at Pearl Harbor, Hawaii, bringing the U.S. into World War II.

**The postwar period**

The war left Japan in ruins. Massive bombing raids throughout the country, including the dropping of two nuclear bombs, had obliterated its industrial base; total casualties reached 1,850,000, including 700,000 civilians. The U.S. postwar occupation policy called for reconstructing Japan as a free, peaceful, medium-sized economic unit with a standard of living no higher than those of its East Asian neighbors.

This policy changed radically after the outbreak of the Korean War in 1950, when the U.S. Army began to place large orders for armaments and other equipment with Japanese manufacturers. Between 1950 and 1955, such vital industries as coal mining, iron and steel works, textiles and machine tools were restored to their pre-World War II production levels. The new U.S. aim in rebuilding Japan became the creation of an economy that would fuel development throughout Southeast Asia, and thus work as a hedge against the encroachment of world communism.

**Double-digit growth**

In the 1950s and 1960s, Japan experienced phenomenal economic expansion, with its GNP growth rate averaging 11% a year. Even during the tumultuous 1970s, when high prices for oil and other commodities sent shock waves through the developed world, Japan’s economy continued to expand at a rate nearly double that of the U.S. and Western Europe.

Despite its prosperity, Japan lacked both economic and political clout in the global sphere. During the 1960s, Japanese officials at times experienced difficulties in getting appointments to see foreign heads of state. As late as 1978 Japan failed to gain the Asian seat on the UN Security Council, which went instead to Bangladesh.

All this changed radically during the past decade. With its high per capita income and enormous foreign reserves, Japan has rapidly become a major international player. Under its postwar constitution, fashioned by the U.S., Japan renounced forever its right to wage war and pledged not to maintain military forces. It was, however, allowed to establish “Self-Defense Forces,” which slowly grew in number until they reached a peak of 250,000 personnel.

Until 1987, defense spending in Japan was maintained at a self-imposed 1% of GNP, as compared with 3.3% for most Atlantic alliance countries, and 6.2% for the U.S. Now the 1% cap has been breached and defense spending is increasing at about the same rate as the economy. Even at this modest level, though, Japan’s military budget is the third largest in the world, after the U.S. and the Soviet Union. Japan now pays 40% of the annual $6 billion cost of keeping 60,000 U.S. troops on Japanese soil, and has taken responsibility for protecting sea-lanes out to a distance of 1,000 miles south and east of Tokyo.

The U.S. would like Japan to take on even more responsibility for international security, perhaps through picking up a higher percentage of the cost of maintaining U.S. troops in Japan and by increasing its aid to countries such as the Philippines. The U.S. Congress has repeatedly suggested such moves as a fair way of strengthening U.S.-Japanese security cooperation while easing the strain on economic ties.

U.S. pressure has also prompted Japan to contribute more aid to developing countries. In 1989, Japan was expected to become the world’s largest aid donor, exceeding the U.S. by more than $500 million. Tokyo currently gives more assistance than Washington to such crucial countries as China, India and the Philippines. It is even showing a greater interest in areas outside its traditional sphere of influence, especially in Latin America.

**Political power**

As Japan’s role in defense and international development has increased, so has its share in the international power equation. There has been talk, for instance, that the next president of the World Bank should be Japanese. At recent economic summit meetings, Japan has asserted American-style authority by taking the initiative on such important issues as the Third World debt. Japanese officials have even expressed their desire to enter into a special power-sharing pact with the U.S. that would harmonize strategies on trade negotiations and other sensitive international issues.

Much of Japan’s wealth and newfound political power undeniably results from its long and prosperous relationship with the U.S. America is Japan’s number one trading partner, absorbing 36% of all Japanese exports, while Japan is America’s second-largest foreign customer (Canada is the largest). In 1988, U.S.-Japanese trade totaled $127 billion, with Americans buying almost 2.5 times more goods from Japan than they sold to it.

To a large measure, the Japanese can take credit for their own economic success. In the 19th century, foreign visitors to the U.S. often remarked on the industriousness of the American people; today, many Westerners react in much the same way to the Japanese. During the postwar years it was not
A member of Japan's expanding senior citizenry, which faces economic hardships in the later years, checks for change in a cigarette dispenser.

uncommon for Japanese factory workers to labor 70 hours a week. Even now, they work an average of five hours more per week than do Americans.

Japan also leads America in a number of other important areas. For example, it spends nearly twice as much as the U.S. on nondefense research and development, and employs nearly five times as many industrial robots. Its primary and secondary education is much more rigorous. Illiteracy is virtually nonexistent in Japan, while it afflicts 1 in 5 American adults and is on the rise.

The personal saving rate in Japan is currently three times as great as that in the U.S.

Of course, the Japanese economy is not trouble free. For one thing, the country suffers from a rapidly aging population. Japan does not have a Social Security program comparable to the U.S. program, and savings are expected to shrink drastically as more and more people use up their nest eggs to finance retirement and old-age needs. Another major problem is a chronic dependence on imported materials, making Japan susceptible to even minor changes in the global trade environment. Japan imports 95% to 100% of its oil, iron ore, copper, tin, aluminum and nickel, and 80% of most other raw materials, including coal, natural gas and lead. Also, although Japan ranks second in the world in per capita income, it ranks fifth in purchasing power. The Japanese, living on some of the most crowded real estate on earth, spend 25% more on housing than do Americans and their food costs are nearly twice as high.

Japan bashing

Many Americans are worried by Japan's growing economic influence. Japanese direct investment in the U.S. totals more than $53 billion and some 250,000 U.S. workers are employed by Japanese firms in jobs ranging from finance and food processing to biotech, electronics and automobile manufacturing. According to some predictions, as many as one million Americans will be working for Japanese firms by the end of the century.

Is Japanese direct investment in the U.S. an asset or a threat? For Americans working for Japanese firms, who might otherwise be unemployed or working in low-paying jobs, it is obviously an asset. According to Daniel Burstein, author of Yen! The Japanese Financial Empire and Its Threat to America, the U.S. simply is not in a position to refuse investment from any quarter.

Burstein believes that the real issue is not whether Japanese investment is good for the U.S. economy, but, "Why are the Japanese building the most efficient factories in America? Why is it that American automakers are reducing payrolls while Japanese in this country add to theirs?"

The Japanese have become increasingly sensitive to what they consider to be unfair "Japan bashing" in the U.S. For the 22-year period between 1961 and 1982 Japan's total trade surplus with the U.S. was $35 billion, or an average of just $1.5 billion per year. However, during the 1980s, the U.S. trade balance with Japan deteriorated rapidly. In 1983, the annual trade deficit jumped to $21 billion; in 1984 it hit $35 billion; and by 1986 it had reached $60 billion.

Many Japanese point to the enormous U.S. budget and trade deficits as the real source of the economic problems now plaguing Japan-U.S. relations. Former U.S. Deputy Secretary of State John C. Whitehead seems to agree. "The U.S. trade balance can strengthen only if our domestic savings rise relative to our domestic investment spending," Whitehead said in a speech to the United Nations Association of the United States of America.

European integration

DEVELOPMENTS on the other side of the globe from Japan are also being closely watched by U.S. policymakers and economic analysts for signs of their impact on the U.S. and global economies. In 1992, the European Community (EC) of 12 nations (Belgium, Britain, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and West Germany) is scheduled to complete the first stage of its economic integration program. By 1993, over 325 million Europeans are expected to become not only the industrialized world's largest single trading bloc, but also a single lucrative market whose size and diversity will clearly surpass that of the U.S. and Japan.

This new Europe will have a combined GNP of approximately $4.1 trillion, 140% greater than Japan's and only slightly less than that of the U.S. in 1987. It will enjoy a highly educated and diverse work force, including millions of engineers and scientists; a technologically advanced industrial base, producing some of the world's most sophisticated products; and in many of its member countries, state-of-the-art com-
munication and travel facilities. All barriers to internal trade will disappear, allowing goods, services and labor to cross borders at will. The move is expected to produce as much as a 6% jump in Europe’s GNP, and to create as many as 5 million new jobs by the end of the decade—not to mention an expanded market for the U.S.

United States of Europe

Many Europeans also envision a time when Europe will be managed under a federal system similar to that of the U.S., with a single monetary unit. In fact, plans for a European central bank that would resemble the U.S. Federal Reserve system are under consideration, and use of the European Currency Unit (ECU), already employed for some transactions, is expected to be greatly expanded.

Bringing these integration plans to fruition has become the primary concern of the EC. A sense of unity and optimism for the future is sweeping the Continent. In the words of one French industrialist, "No one talks about Europe as a broken economic machine anymore. Just that psychological change gives Europe a real chance to go forward."

Stronger ties

As in the case of Japan, World War II left much of Europe in ruins. Once the initial shock of the mass devastation began to recede, Europe’s leaders took steps to organize the Continent into a more cohesive political and economic unit. In 1949, to assure their mutual defense against a threatening Soviet Union, most West European countries joined the U.S. and Canada in forming the North Atlantic Treaty Organization (NATO). That same year, 10 European countries formed the Council of Europe, an organization designed to promote political harmony.

The seeds of economic cooperation were first sown by the Marshall Plan, when American dollars helped finance the rebuilding of Europe. Under the plan, named for its chief architect, Secretary of State George C. Marshall, the U.S. provided $13 billion in direct foreign aid—most of which did not have to be repaid—to European public and private industry in the period 1948–52. The philosophy behind the plan was that an economically prosperous Europe would be better able to fight communism while providing a healthy trading partner and a strong market for American goods.

The EC

In 1951, with the economic recovery of Europe well advanced, six nations (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) formed the European Coal and Steel Community to promote cooperation in the trading of those commodities. In 1957, the Six established the European Economic Community (EEC) and the European Atomic Energy Community (Euratom). In 1967, the three organizations were united in the European Community, and all tariffs between the members were abolished. Britain, Denmark and Ireland joined the EC in 1973; Greece became a member in 1981; and Spain and Portugal joined in 1986, resulting in the current EC Twelve.

Today, the EC includes four major institutions: the Parliament, which consists of 518 members elected by popular vote; the Commission, whose 17 members represent the interests of the EC as a whole and recommend policy;
the Court of Justice, which plays a role similar to that of the U.S. Supreme Court; and the Council of Ministers, composed of ministers from each member state, which approves all EC legislation and drafts the EC budget for Parliament’s consideration.

Economic integration

The decision to seek greater economic integration within the EC grew out of a perceived threat to the community’s international competitiveness. By the early 1980s, it was obvious to many of the EC’s leaders that Europe had fallen behind the U.S. and Japan in such important fields as computers, telecommunications, aerospace, energy and biotechnology. According to Jacques Delors, the current president of the EC Commission, the time had come for the community to work toward a “common objective which would enable us to surmount our everyday problems, concentrate our strengths and combine our energies.”

The stage was set for the integration program when the EC Commission, under the direction of Delors, issued a white paper in 1985 that identified 300 directives necessary to remove remaining trade and economic barriers among the members. The EC also moved to strengthen its laws in order to enforce an integrated market. In 1987, the European Parliament passed the Single European Act, providing for a majority rather than unanimous vote on most issues in the Council of Ministers. Since then, the EC has concentrated on working out the technical aspects of integration, such as health and industrial standards, communications, and transportation.

‘Fortress Europe’

The U.S. shares broad economic interests with the EC. In 1988, two-way trade between the U.S. and Western Europe totaled more than $160 billion, and combined direct investment in each other’s markets is estimated at nearly $320 billion. The U.S. purchases 20% of all the EC’s goods and services sold abroad, while two of the three countries with the largest direct investment in the U.S. (Britain and the Netherlands) are EC members.

Throughout the postwar period and until recently, the U.S. maintained a flexible attitude toward European trade practices. U.S. policy has always called for fair treatment abroad for American exports, but trade disagreements were never allowed to interfere with NATO security relations. During the 1980s, the U.S. attitude stiffened. Plagued by growing trade deficits and under pressure from domestic exporters, Washington began to push for equal access to the EC’s markets. Agricultural trade, which is heavily subsidized on both sides of the Atlantic, was a particular bone of contention.

Trade war

In 1981, the extension of EC tariffs to Greece, its new member, provoked strong protests from the U.S. In 1986, when Spain and Portugal became EC members, the curtailment of U.S. access to those markets nearly sparked a full-scale trade war. A mini-war of sorts did erupt briefly in 1989, when the EC imposed a ban on $130 million worth of beef from hormone-treated cattle.

Many policymakers have expressed fears that a single internal market in Europe will lead to increasing discrimination against U.S. products. In a 1988 speech in Washington, D.C., then Deputy Treasury Secretary M. Peter McPherson warned the EC that the creation of a single market that reserved “Europe for the Europeans” would be “bad for Europe, bad for the U.S. and bad for the multilateral economic system.”

Open for enterprise

The Europeans deny they are planning to establish a fortress Europe, with high trade barriers to keep out foreign competition. They argue that though protectionist pressures remain strong in some European countries, notably France and Italy, the EC as a whole is dedicated to the principle of liberal trade. According to Corrado Pirzio-Biropi, the deputy head of the EC delegation in Washington, Europe is more dependent on world trade than is the U.S. “European companies,” says Pirzio-Biropi, “would not survive if we created a ‘fortress Europe.’” It would be “economic suicide,” adds British Ambassador to the U.S. Sir Anthony Acland, the motto for Europe in 1992 should be, “Open for enterprise.”

Partly as a hedge against the possible emergence of a fortress Europe, the U.S. government has worked to strengthen ties with its North American neighbors, Canada and Mexico. In 1988, the Reagan Administration signed a historic agreement with Canada calling for the elimination of all trade barriers between the two countries by 1999. Since Canada is already the largest trading partner of the U.S. (the U.S. trades more with the province of Ontario than with Japan), the free-trade agreement is expected to intertwine the two countries’ economies at every level.

Over the past few years, the U.S. has also been holding low-key discussions with Mexico about putting their trade relations on a more formal basis. Mexico, the third-largest trade partner of the U.S., is its largest foreign supplier of oil. In 1987, the Reagan Administration announced a tentative agreement with Mexico on a “framework” for future trade.

Superblocs

Some economic analysts have expressed concern over what they see as a trend toward the formation of regional trade superblocs. In recent years, Japan has forged much stronger ties with its Asian neighbors, especially the highly successful newly industrialized economies of Singapore, Taiwan, Hong Kong and South Korea. Trade within the EC already surpasses trans-Atlantic commerce, while the U.S., Canada and Mexico account for the majority of each other’s exports.

According to Jeffrey E. Garten, a trade analyst who served in the Administrations of Presidents Nixon, Ford and Carter, the danger with establishing superblocs is that they discourage international cooperation on economic, political and other issues, and they weaken multinational institutions, such as GATT, the World Bank and the IMF. Furthermore, superblocs could tend to exclude most Third World nations from the markets they so desperately need.

Decline or renewal?

Will the U.S. thrive or fall behind in this rapidly changing global economic environment? The answer to that question, many analysts believe, lies in the country’s ability to shrink its trade and
budget deficits, manage its burgeoning national debt, slow consumption, promote savings, increase productivity and improve its crumbling infrastructure. While the rest of the industrialized world moves ahead, they say, the U.S. is in danger of being stuck in an economic quagmire of its own making.

These economists offer a number of disturbing statistics to support their argument: every two days a bridge collapses somewhere in the U.S.; an estimated 20% of American 18-year-olds are now functionally illiterate while one quarter of today's high-school students drop out before graduation; government spending on commercial research and development has declined 95% over the past two decades; and savings and investment rates as a percentage of GNP are the lowest in the industrialized world. This, these analysts argue, is evidence that the nation is facing a serious decline in its ability to compete in the global marketplace.

Other analysts point to a different set of statistics to support their claims that the U.S. is entering a period of economic renewal: during the 1980s, 17 million new jobs were created in the U.S., bringing the unemployment rate to 5.5%, its lowest level in nearly two decades; productivity growth in manufacturing has picked up considerably, rising at an average pace of 4% a year since 1981; exports have grown by as much as 30% annually in recent years; and the budget deficit, though still high, is shrinking steadily.

Policy options

In planning for the future, U.S. policymakers are faced with decisions affecting a range of economic issues, from international trade to investment in infrastructure and education. Two of the more controversial issues concern U.S. savings policy and Federal subsidies for U.S. industry.

1. Should the U.S. encourage savings and discourage spending? Many analysts argue that the U.S. cannot continue to pile up large deficits and debts indefinitely. They believe American consumers must tighten their belts and save more—even if it means a drop in the standard of living of most Americans. Otherwise, the debt will be passed along to the next generation and its living standard will suffer.

One way the government could encourage personal savings is by offering tax breaks for long-term investments, much as it did under the individual retirement account (IRA) program of the early 1980s.

Critics argue that a drop in consumption would lead to a general economic slowdown, sparking a recession and bringing higher unemployment rates and, consequently, lower government revenues. They maintain that the government should both tax less and spend less, while letting consumption fuel economic growth. They point to the continued economic expansion and the steady, if slow, improvement in the trade balance as evidence that current Federal policies are working.

2. Should the government subsidize high-technology research and development and selective export industries? There is rising concern that the Federal government is not doing enough to promote development of consumer-oriented technology. Unlike Japan, where government agencies are involved at nearly every level of development of such innovations as high-definition television, U.S. government-sponsored research is nearly all concentrated in the defense industries.

Advocates of government subsidies for commercial research claim that such programs are necessary in order for the U.S. to remain competitive abroad and to insure adequate employment opportunities at home. They maintain that the development of new technologies such as high-definition television requires resources that are too diverse for commercial industries to provide on their own.

Opponents of such programs claim that it would be difficult for the government to pick winning technologies that would eventually enjoy commercial success. They say it is the marketplace, not the government, that should determine which products are eventually developed. They point out that the already low unemployment rates in the U.S. are a sign that subsidizing research is unnecessary. In addition, they say, current budgetary restraints call for reducing the existing Federal subsidies, not adding new ones.

Since World War II, the U.S. has been the undisputed leader of the global economy. Today, that role appears to be changing. Is the U.S. prepared to meet the challenges of a changing global economy? Will the American century be followed by global economic growth or by trade wars among the superblocks?
FOR DISCUSSION


2. The U.S. has long been an advocate of free trade, yet in recent years has run up large trade deficits, especially with Japan. Are U.S. trade policies too liberal? Should American workers be protected from foreign competition?

3. Japan’s Sony Corporation bought Columbia Pictures in 1989 with dollars earned from sales to the U.S. How do you feel about this investment? Do foreign investors hurt or help the U.S. economy? Should the government restrict direct foreign investment?

4. The Japanese save a much higher percentage of their personal income than Americans. The current U.S. savings rate is the lowest in 40 years. Are Americans spending too much and saving too little? Should the government offer tax incentives to increase savings?

5. In the mid-1980s, the U.S. became the world’s biggest debtor nation, owing more to foreigners than it has invested abroad. Is this cause for concern? Will being a debtor nation lead to a drop in the U.S. standard of living? Should lowering the national debt be a priority for the Bush Administration?

6. The U.S. has been nagged by persistent budget deficits for many years. Do you think this is a serious problem? If so, how would you balance the Federal budget: by raising taxes, cutting spending on defense and/or social programs, or some combination of the two?

7. Does the U.S. have anything to fear from a “fortress Europe” or a “Japan, Inc.”? Will a stronger Europe and a stronger Japan translate into a weaker U.S.?

8. Has the U.S. century come to an end, or is it just beginning?

SUGGESTED READINGS


Mann, Thomas E., and Schultzze, Charles L., “Getting Rid of the Budget Deficit: Why We Should and How We Can.” The Brookings Review, Winter 1988/89, pp. 3–17. The authors argue that the budget deficit is the most pressing economic problem for the U.S.


For further in-depth reading, write for the Great Decisions 1990 Bibliography (see page 4).