Feb. 16, 2004 +

"How the US Government Flubbed Its Opportunity to Exercise Global Economic Leadership"

Jeffrey Frankel, in *The International Economy*, XVIII, no. 2, Spring 2004

****

Charles Kindleberger passed away last year. One of his major contributions to our understanding of international relations was the notion that the world economic system works best if a hegemon exists who is willing and able to take the initiative to supply "public goods" to the world economy: a stable international currency, leadership of a system of free trade, international lender of last resort, and so forth. The curse of the interwar period was that the United Kingdom had lost the wealth and capacity to play that role, while the United States had not yet acquired the will to do it. The blessing of the postwar period was that the United States acquired, not just the ability, but also the willingness to play the role of hegemon of the global economy. The United States was determined not to repeat the mistakes made after the first World War when traditional American isolationism had proven disastrous. Some of the U.S. actions after World War II were unilateral, such as opening its markets to trade and giving foreign aid. Some were bilateral, such as the Marshall Plan. But measures taken were primarily multilateral: The United States was the guiding force behind the founding of such multilateral institutions as the General Agreement on Tariffs and Trade, the International Monetary Fund, and the World Bank—institutions that embodied good economic values and an open system of rules under which all could play and prosper.

Intellectually, it was understood throughout the postwar period that taking a leadership role, both in these institutions and otherwise, served many important purposes simultaneously—interests of the United States as well as of other countries, economic goals as well as foreign policy. Domestic politics in the end would generally reach the same conclusion. True, some U.S. special interests when exposed to import competition would often speak more loudly—especially via members of Congress—than the majority of Americans who stand to benefit from free trade. But U.S. presidents would exercise the leadership that is supposed to go with the office, and rally the necessary political forces to accomplish what was in the national interest overall. Often they would successfully invoke the Cold War to win the extra votes. Everyone understood the desirability of working in the tradition of the aftermath of World War II—of Bretton Woods and the Marshall Plan—and avoiding Versailles and 1920s isolationism, the model of the aftermath of World War I.

With the fall of the Soviet Union in 1991, the foreign policy arguments for free trade were perceived to have diminished sharply, and the political and bureaucratic forces on that side of the table diminished. Bill Clinton was able through hard work to achieve NAFTA, normalization of trade with China, and a number of other accomplishments. But despite a record-performing economy, his best efforts, and his eloquence, he was never able to convince the American people and the Congress to give him fast-track trade negotiating authority. Clinton was unable to overcome the intransigence of Senate Foreign Relations Committee Chairman Jesse Helms (R-NC) over paying the arrears in U.S. dues to the United Nations, and unable to gain congressional support for the Mexican rescue package or the Kyoto Protocol or a BTU tax. And so on. Whether because of the end of the Cold War or the passing of the 1940s generation from positions of leadership, the necessary domestic support for internationalism had faded.

Now forward to September 11, 2001. The war on terrorism should have presented President George W. Bush with the same opportunity for international leadership that the Cold War gave every president from Truman through his father. The importance of international leadership should have been familiar from his family background. The domestic politics were more conducive to Bush's success on the international front than any in years. The American people were primed to be told what difficult steps would need to be taken in light of the appalling demonstration in lower Manhattan that they were not immune from developments on the other side of the globe. The public was begging to know what economic sacrifices it would have to make in the war on terrorism. The President had an 85% approval rating. It would have been relatively easy after September 11 to explain to the American public why America must free up imports of clothing from Pakistan, Turkey, and other developing countries; why taxation should be shifted onto fossil fuels to reduce dependence; why multilateral organizations deserved U.S. support. Instead, what was the President's answer to the public's request for guidance? Encouragement to go to the shopping mall.

The Bush Administration has squandered some tremendous opportunities. Consider the record:

Trade

Although those who are now in the Bush Administration attacked Clinton for giving in to protectionism, their own record while in office is far worse. As libertarians will tell you, President Bush turned protectionist more strongly than any other postwar president, with the possible exception of Ronald Reagan. The list of distortionary measures includes steel tariffs, increased agricultural subsidies, protection of sugar and softwood lumber, and new quotas on clothing from China. The White House rationalized these moves as politically necessary in order to get congressional support for fast track authority. But it is hard to know. The Republicans control Congress. Furthermore, the progress to date in international trade negotiations, and the future prospects, appear too meager to justify the heavy price that the Administration has paid. Other national governments are not encouraged to overcome their own domestic political opponents to trade, when the Doha Round is kicked off by the sorry spectacle of the U.S. Administration pandering to domestic interests without a fight.

The steel tariffs in particular undermined leaders in other countries who had been trying to argue in favor of free trade and the American model, including Brazil, Russia, Korea, and the countries of the European Union. The Bush Administration must have known the tariffs were illegal under the World Trade Organization. When steel mill owners and unions had come to ask the Clinton Administration for tariff protection, they had not gotten it, even though they were supposed to be Democratic constituencies. President Clinton had decided steel protection had not been in the national interest, and that it had not met the legal tests required for safeguards protection. But at least steel imports had been increasing at the time, which is one of the necessary legal tests. A few years later, the Bush Administration gave the steel people what they wanted, at a time when imports had been decreasing—obvious failure of the legal test for protection. Now that the WTO has ruled against the steel tariffs, the White House has little choice but to agree to comply with the WTO ruling. Presidential adviser Karl Rove now realizes the electoral votes that Republicans stand to gain by keeping the barriers (from steel interests) are outweighed by the votes they stand to lose (from steel users such as the auto industry and export industries that face the retaliation from our injured trade partners warranted under the WTO). But returning to where we started is not without cost. Compliance with the WTO panel ruling will further erode domestic political support for the WTO, something the Administration probably failed to factor in ahead of time.

It is not getting any better. Karl Rove's latest contribution to international economic policy was to instruct the US Trade Representative to exclude sugar from the bilateral free-trade agreement that was reached with Australia in February. Sugar-growers, though small in number, earn a lot of money behind quota walls that keep US sugar prices three times as high as world prices. They pass some of the money on to President Bush in the form of campaign contributions (especially in Florida, where they pollute the Everglades as an extra bonus for the American people). Meanwhile, high sugar prices are contributing to closures of some US candy manufacturers.

The White House would have done better with a more principled stand on these trade issues. This need not be the sort of free trade purism of academic economists, which ignores all political constraints, but rather the intermediate pragmatism of the Clinton Administration.

Developing countries served notice at talks in Cancun in September that their interests now must be taken more seriously in multilateral negotiations. Over the next few years, rising imports of textiles and clothing from developing countries will put political pressure on whoever is president to open U.S. markets fully in this key sector. If the U.S. president reneges on past promises (in the Uruguay Round, and the terms of China's accession to the WTO), U.S. free-market rhetoric will lose remaining credibility in the rest of the world.

Emerging Market Crises

When the Clinton Administration took the international leadership to organize rescue packages for Mexico (1994), Korea (1997), Russia (1998), and other emerging markets, the Republicans attacked it for fostering moral hazard. Thus when the Bush Administration came to office, it adopted tough "no bailout" language. It is true that wise leadership of the international financial system requires balancing the desirability of cushioning crises where countries merit help, against the need to limit moral hazard. But the Bush White House has spent its first three years bailing out everybody who has come along. The cost/conditionality ratio has been ratcheted up.

Early comments from the U.S. Treasury undermining confidence in South American economies might have been rationalized at the time as a necessary side effect of a new regime. But the Bush Administration soon changed its mind when it realized that defaults in South America might have bad consequences. The effect of the earlier rhetoric was merely to raise the cost of the ensuing bailouts.

In September 2003, the Bush Administration even pushed the IMF, against its better judgment, to continue lending to a new Argentine president who was not willing to concede the standard conditions. At least in some earlier controversial bailouts where, as now, the agreed macroeconomic conditions were more likely to be missed than not, there were plausible geopolitical rationales. The last package for Russia in the spring of 1998 could be justified by nuclear geopolitics, and Turkey in 2001 by its position in the Muslim world. Even the ill-fated package that Bush agreed to for Argentina itself in 2001 could be defended with the argument that if the country that had enacted so many good reforms in the 1990s went into a sharp recession, Latin America's other reformers would lose heart.

No such rationale remains for the recent decision to continue IMF lending to Argentina. The country no longer stands for reform, and in any case its economic collapse has already occurred. Argentina's strategic significance is summed up by Henry Kissinger's description of the country as a dagger pointed at the heart of Antarctica. Contagion to other countries is not a big worry at the moment either, because interest rates and spreads are unusually low internationally and the global economy is on the upswing. Argentina's new government is unwilling even to "talk the talk" of appropriate policy reforms, or to negotiate with the international financial community in good faith. The point is not whether this strategy might work out to be in the country's interest. The problem from the global viewpoint is that a dangerous precedent has now been set —that the IMF will lend merely to prevent a threatened default on earlier IMF loans. First Deputy Managing Director Anne Krueger is unhappy about the lenient treatment of Argentina. But the political campaign for the IMF to bail out the land of the tango is led by the United States. (In the January vote of the IMF Executive Board, eight of 24 executive directors -- including three G-7 partners -- refused to go along with U.S. support for disbursement of the first tranche of money, an extremely rare split in the ranks of the global economic leadership.) This is ironic in that the US Administration was the one who installed Krueger in her job as number two at the Fund job three years ago, at a time when it presumably believed its own rhetoric about free market discipline. As it has turned out, President Bush and Treasury Secretary John Snow lack the fortitude that Clinton and his Treasury showed in the summer of 1998 when they finally told Russia that enough was enough, precipitating that country's devaluation and default but demonstrating to international financial markets clearly and edifyingly that there were limits to the largesse of the G-7 and IMF.

Furthermore, the Bush Administration has been unable to set a consistent course on other aspects of the international financial architecture. It repeatedly sent conflicting signals regarding the IMF's proposed Sovereign Debt Restructuring Mechanism. Some at the international financial institutions who used to resent the firm guiding hand from the Clinton Treasury now long for the good old days.

Management of the dollar

Dollar depreciation has both advantages and disadvantages. The proper response to this tradeoff is not to switch frequently between strong dollar statements on the one hand and support for depreciation on the other. Yet this is what the Bush Treasury has done. Worse, it lately has been taking both positions at the same time, driving dollar policy with one foot on the accelerator while the other pumps the brakes. The Administration should have picked one mantra and stuck to it for a while. The financial markets want from the U.S. Treasury a sense of consistency and reliability. In light of unsustainable U.S. current account deficits, it would have made sense to abandon the strong dollar mantra three years ago, in favor of "the exchange rate is determined by the markets." This would have left open the option of switching to a genuine "strong dollar" mantra in the future if and when the depreciation is in danger of going too far, an option that may now have been foreclosed by the current strategy of making the words meaningless.

Energy policy

The United States should be trying to reduce consumption of oil and other fossil fuels. True, complete energy independence is a chimera. But some reduced dependence on imported oil and some moral leadership on international energy policy would go a long way toward strengthening the U.S. hand in the Middle East and elsewhere. The responsible policy, if not the popular one, would have been to establish a sustainable path for the effective price of fossil fuels facing consumers, to discourage consumption. With inflationary psychology far lower than it was 25 years ago, the past few years would have been a relatively good time to begin such a painful shift.

The Bush Administration energy policy has instead sought basically to accelerate the depletion of domestic supplies. The energy bill that the White House sent to the Congress consists largely of more handouts for special interests and seeks to increase rather than decrease consumption of fossil fuels, for example by setting low costs on the right to drill for oil on federal lands. Their policy to "Drain America First," supposedly to help national security, could reduce oil imports marginally in the medium run, but would actually *increase* dependence on foreign oil in the long run.

It looks terrible internationally. Most people outside the United States believe that the Bush family reversed its pre-1990 affection for Saddam Hussein for oil reasons more than for moral reasons. Moreover, the adverse environmental implications of our efforts to accelerate the burning of fossil fuels lower our moral standing in the eyes of the world even further.

Multilateral agreements

The hallmark of Bush international policy has been opposition to almost all multilateral agreements, angering most of the world . The latest scuffle is over methyl bromide. The Montreal Protocol on stratospheric ozone depletion is generally considered the best example of a successful international environmental treaty. It was successfully negotiated, with teeth, and has actually worked as advertised, reducing the hole in the ozone layer that was going to give us all skin cancer. The new development is that the Bush Administration wants to punch a hole in the Protocol by adding an exemption for methyl bromide. What is the argument? If American strawberry farmers (among others) aren't allowed to continue to use this chemical, then they may lose business to more competitive Mexican strawberry farmers. That's all. Apparently, the Bush Administration is not even bothering to go through the usual false characterizations of the state of scientific opinion or the usual nonsense language about unfair trade.

Fiscal policy

The Bush Administration threw away the record budget surpluses it inherited, with no prospect of getting them back. Bush's tax cuts have eliminated what was claimed in 2001 would be a $5 trillion surplus over the next ten years. The official forecasts now admit that it is more likely to be a cumulative *deficit* of $2 trillion over the next ten years, and an unbiased estimate would be worse still by another $4 trillion or more. Those who think that the 2001 recession bears responsibility for the failure of the Bush fiscal forecasts need to realize that the fall in growth since 2000 has not been as large a factor as the excess optimism in the original Bush revenue forecasts, which were artificially boosted in order to justify the 2001 tax cuts. Those who think that the attacks of September 11 created the deficit need to recognize all the pork-barrel spending in lower-risk states that is now masquerading under the label of homeland security, or the acceleration that has taken place even in the rest of domestic spending.

It is a challenge to figure out what the White House thinks it is doing with its tax cuts at a time of sharply increased spending. Some University of Chicago economists argue that the Bush fiscal policy is a subtly calculated plan to create a fiscal crisis, and thus force future cuts in spending. But that rationalization may not accurately describe thinking in the White House. If the Republican goal were actually to cut the rate of growth in spending, what better time to do it than now, when they control all branches of government? A simpler explanation is that the Republicans are doing nothing more than going after campaign contributions and electoral votes. Bush and Cheney may not much care what happens past the November presidential election. But what could Karl Rove be thinking? His goal is said to be to engineer a period of Republican rule lasting far beyond 2008. But this means that the Republicans themselves will have to live with the consequences of their fiscal profligacy. Are they not sufficiently competent to think ahead and realize the magnitude of the fiscal crisis that they are creating for themselves?

Fiscal deficits tend to spill over into the international balance of payments. The reason, of course, is that the budget deficit usurps private saving; the shortfall in national saving at home then has to be made up by borrowing from abroad. The U.S. current account deficit is now approaching danger levels. In other words, the twin deficits of the 1980s are back with a vengeance. The long-term macroeconomic implications are serious. Over the coming decade, the United States will find itself increasingly constrained by the need to borrow abroad in a capital-scarce world.

Is it ideology?

The Bush Administration says one thing and then does another. They act as if they will do anything for a few votes, even if their behavior is against the national economic and security interests and inconsistent with things they have always claimed to stand for: small government, free trade, macroeconomic discipline, and good neoclassical economics. And they will favor political expediency even if it creates big trouble for themselves a few months or a few years down the road. Perhaps they are genuinely unable to think ahead. Perhaps they don't realize that if they impose steel tariffs, the virtually inevitable response a year later will be an adverse WTO ruling. Or that if they talk recklessly about not bailing out Brazil because the money will "go into Swiss bank accounts," the cost of the necessary bailout they engage in a few months later will rise. Or if they tell Asia to stop buying U.S. treasury bills, because they think it will help diffuse anger at the loss of jobs in a few key electoral states, then U.S. interest rates will soon go up. Or if they launch an invasion of Iraq, a bill of a $100 billion or more will come due a year later.

To be sure in some areas what they have had to say sounds like steps in the right direction: bold proposals for long-run global trade liberalization, increases in foreign aid from its very low levels, and better treatment for Mexican immigrant workers. Perhaps they will even deliver on some of these proposals. It is wise to be on the lookout for confirmation of the proposition that nobody can be wrong all the time. But this Administration's record of broken promises, misleading labels, cynical motives, and foreseeable cost overruns (usually deferred to someone else's term in office) has been so extensive that one can't help but entertain skeptical interpretations even of the initiatives that sound good.

Where are we headed?

The big question is, is the United States eventually going to start paying a price for its neglect of the responsibilities of international economic leadership, and for poor economic policies more generally? Britain's economic and political hegemony did not long survive the loss of its large international creditor position. The record of the United Kingdom in the 20th century (specifically, from the start of World War I in1914 to the Suez Crisis in 1956) suggests that a great power that becomes a great debtor will, after a few decades, lose its dominance. The United States passed from largest net creditor to largest net debtor in the 1980s. With the re-emergence of the twin deficits, and prospects for continued widening, how long will it be before we see adverse economic and political ramifications?

Over the last four decades, our allies have been willing to pay a financial price to support American leadership of the international economy, because they correctly saw it to be in their interests. In the 1960s, Germany was willing to offset the expenses of stationing U.S. troops on bases there so as to save the United States from a balance of payments deficit. In the 1991, Saudi Arabia, Kuwait, and a number of other countries were willing to pay for the financial cost of the war against Iraq, thus temporarily wiping out the U.S. current deficit for the only time in a twenty-year period. Repeatedly the Bank of Japan, among other central banks, has been willing to buy dollars to prevent U.S. currency from depreciating (late 1960s, early 1970s, late 1980s).

The dollar has fallen sharply over the last year in response to the widening U.S. current account deficit. So far, it has not spun out of control: U.S. interest rates remain very low and securities prices high. Will other countries be willing to help us out the next time there is substantial unwanted downward pressure on the dollar, without setting conditions in return? I fear not. Sometime soon, newspaper stories will begin reporting that central banks in Asia and elsewhere are diversifying out of dollars into euros, and that the dollar is in danger of eventually losing its status as premier international currency. This will be the most obvious symbol of what is already clear: the Bush Administration has failed spectacularly the obligations of international leadership.