CHAPTER 7

American Leadership in the Emerging Global Economy

SEVENTY-EIGHT YEARS AGO, after the end of World War I, an isolationist America made a tragic mistake by retreating from international engagement. The punitive economic conditions imposed on Germany in the 1919 Treaty of Versailles, along with protectionist pressures culminating in the Trade Act of 1930 in the United States (the origin of the infamous Smoot-Hawley tariff) and other measures elsewhere, destabilized the international economy and deepened the Great Depression. These events in turn are widely believed to have contributed to political instability in Europe, thus helping bring on World War II.

After that war the United States, determined to get it right this time, did pursue a policy of international engagement. American leadership fostered the creation of a stable and predictable international economic environment and of international institutions, such as the International Monetary Fund (IMF), to promote cooperation on economic matters. The United States also played a key role in designing the postwar multilateral trading system. Mutually agreed rules, formulated under the General Agreement on Tariffs and Trade (GATT), underpinned the development of a trading regime in which countries could prosper. All these efforts greatly enhanced America's well-being, economically as well as politically. In the Cold War years, the United States led an economic partnership with other industrial democracies in Europe, North America, and the Pacific Rim. These countries flourished as economic cooperation took root.

The Cold War era also saw the decolonization of much of Africa, Asia, the Middle East, the Pacific, and the Caribbean. The new countries that emerged, together with the already independent lower and middle-income countries of Latin America, became known collectively as the developing world. Through its own direct assistance and through institutions such as the World Bank, the United States led the international coordination of aid and lending to these countries and, more recently, to the countries in transition from central planning.

Now a new era is beginning. Fundamental changes have reshaped the world economy. One of the previous central motivations

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for U.S. leadership, that of superpower competition with the Soviet Union, is gone. Yet the United States and other countries continue to benefit from U.S. leadership in international economic policy. U.S. economic leadership must move forward with a renewed vision, adapted to these changed political and economic realities.

This chapter examines how the world economy has changed, and how U.S. leadership remains necessary in international economic relationships. A policy of economic openness and engagement, supporting the kind of international economic system the United States has worked hard to establish over the past half century, will continue to yield great benefits to the Nation, through access to new markets and through enhanced international stability and cooperation. In this area some of the current policies on which the Administration places priority are:

- facilitating economic reform in the transition economies and their integration into world markets, including their accession to the World Trade Organization (WTO)
- providing adequate resources for multilateral development efforts, including full funding of U.S. commitments to the World Bank's International Development Association (IDA)
- supporting the rules-based international trading system centered on the WTO
- continuing a wide variety of efforts to open foreign markets to U.S. exports, encouraging U.S. companies to take advantage of these opportunities, and working with the Congress to negotiate further international market opening
- furthering U.S. efforts toward greater economic linkages within the Asia-Pacific Economic Cooperation (APEC) forum and the proposed Free Trade Area of the Americas (FTAA) agreement
- strengthening the international financial system and increasing the capacity of international financial institutions to respond to crises.
- fostering cooperation on common challenges in the Group of Seven at the summit of heads of state that the President will host in Denver in June 1997.

THREE SWEEPING CHANGES

At the core of the international economic system that emerged after World War II was what came to be called the liberal international trading system. It was liberal in the sense that it worked to free the flow of goods and capital from the restrictions that had often characterized the interwar regime. A few widely shared, basic premises underlay this system.

Just as competitive markets *within* economies had helped deliver remarkable increases in standards of living in the industrial world, so competition *between* economies could help sustain and enhance these increases. The economic principles underlying this belief were long established. One was that international trade allows countries to find their comparative advantage, concentrating their production on those goods in which they have the largest cost advantage over others. Another was that bigger markets spell greater scope for the gains that come from specialization.

The trading system had other, noneconomic purposes as well. The Western democracies believed that prosperity was the best insurance against the spread of Communism. Indeed, trade liberalization is a natural corollary of the paradigm of democratic market capitalism, which won an important intellectual and strategic victory in the Cold War.

Three recent changes have had a profound effect on the international economic environment: the end of the Cold War, the emergence of growing markets among the developing countries of East Asia and Latin America, and the increasing globalization of the international economy. These changes have also created important opportunities for the United States. Understanding these changes helps us see where the international economy is headed in the future, so that we can more effectively respond to these challenges, fulfill our responsibilities, and take advantage of these opportunities.

THE END OF THE COLD WAR

In 1989 the Soviet Union relaxed its control over the Eastern European countries that had suffered its domination for over 40 years. These countries immediately seized the opportunity to throw off authoritarian Communist rule. Two years later the Soviet Union itself underwent a political and ideological upheaval, which quickly led to its breakup into 15 independent states. Most of these and the other formerly centrally planned economies are now, to varying degrees, engaged in a process of transition from central planning and state ownership to market forces and private ownership.

An essential part of the West's victory in the Cold War was that it decided once and for all the contest between two radically different approaches to organizing political and economic life. The industrial democracies had allowed markets to guide most economic decisions. The Communist countries had relied on central planning, in which state-owned producers acted on instructions handed down from government ministries. By the 1980s the success of the market democracies stood in sharp contrast with the evident stagnation of the Communist economies that had stuck by central planning.

This triumph of democracy and markets was as much an intellectual victory as a political and economic one. The idea that state planners could effectively guide every aspect of production in an entire economy was thoroughly discredited. The amount of information required for planning to work far exceeded the planners' ability to gather and process it. In any case, without private property, hard budget constraints, and competition both from other domestic firms and from abroad, the managers of socialist enterprises lacked incentives to streamline production or to innovate. Consumers in these countries had to make do with increasingly shoddy products. Industrial productivity fell far short of that in the industrial democracies. Lacking a system of flexible, market-determined prices to convey information about relative scarcities, and lacking decentralized decisionmakers with the freedom and incentives to act on that information and allocate resources accordingly, the centrally planned economies fell far behind the West.

The Communist countries made another major blunder: as a matter of policy, they insulated themselves from the world economy and ignored the opportunities that international trade offers to raise living standards. This is not to say that the Communist countries did not trade. They did, but mostly with each other. In 1989, for example, Czechoslovakia, despite its location adjacent to affluent Western Europe, conducted 54 percent of its trade with its fellow Communist countries, and almost 60 percent of that trade was with the Soviet Union. Given these countries' other economic handicaps, such limited trade failed to reap many of the potential gains of comparative advantage or of expanded competition. Trade became just another misguided planning decision, and was often undertaken merely for political reasons as well.

INDUSTRIALIZATION AND GROWTH COME TO THE DEVELOPING WORLD

The second great change of recent years has been the rapid industrialization and economic growth of a number of developing countries in several parts of the world. The first of these emerging markets were the four Asian "tigers": Hong Kong, Singapore, South Korea, and Taiwan. Now Malaysia, Thailand, and some other Asian countries are following in their footsteps, and some of the Latin American countries, having overcome the debt crisis of the 1980s and undertaken economic and political reforms, have also begun to see faster, more sustained growth.

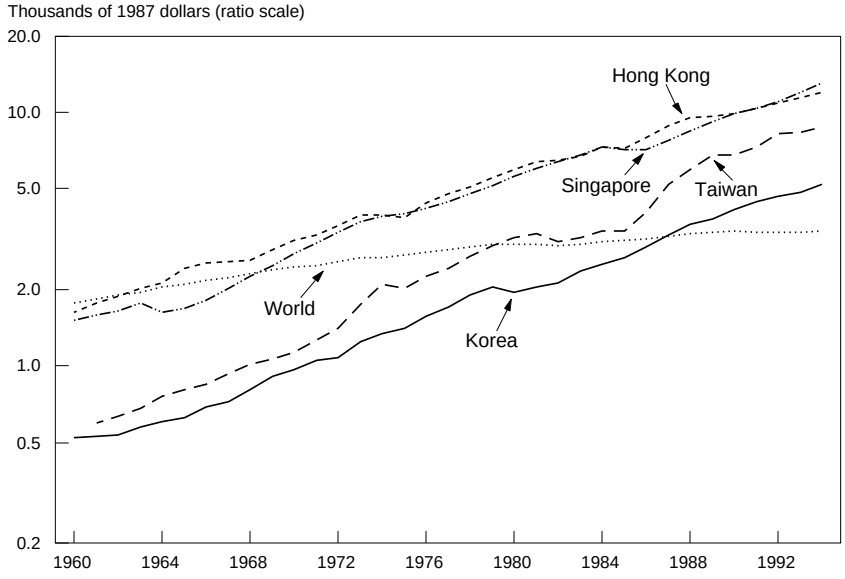
The success of these countries offers valuable insights into the necessary ingredients for successful development. It has implications for U.S. international economic policy as well. Again, because trade, and economic relations more generally, are a positive-sum enterprise, the rise of these countries also brings opportunities for

the United States and the other established economies. As a major exporter of capital goods—the tools of development—and of agricultural products, consumer goods, and commercial services, the United States is especially well poised to benefit from these economies' growing demand.

The Success of East and Southeast Asia

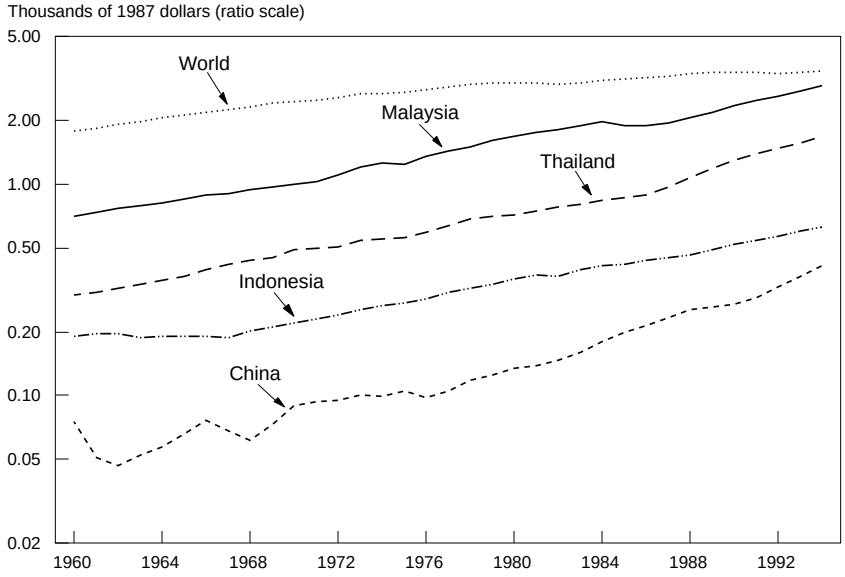
From 1960 to 1993, 8 of the world's 10 fastest-growing economies were all in the same region: East and Southeast Asia. Japan's gross domestic product (GDP) per capita, adjusted for differences in relative prices, grew from 30 percent of that of the United States in 1960 to 82 percent in 1994, and South Korea's from 9 percent to 40 percent. The four "tigers" experienced growth in GDP per capita averaging over 6 percent per year, during a period in which U.S. income per capita grew less than 2 percent per year (Chart 7–1). Malaysia's growth has averaged over 4 percent a year, and Indonesia's only slightly less (Chart 7–2). China, the world's most populous country with more than a billion inhabitants, has seen phenomenal growth in GDP per capita, averaging 8.1 percent per year since 1978. Although still under Communist rule, China has begun to recognize the tenets of market economics, including the importance of incentives and entrepreneurship, which have awakened the country's vast potential.

Chart 7-1 **GDP Per Capita in the "Four Tigers"**
Since 1960, real GDP in each of the four East Asian "tigers" has grown by more than 6 percent per year.



Source: World Bank.

Chart 7-2 **GDP Per Capita in Four Other Asian Economies**
Although still below that of the "tigers," real GDP in several other East and Southeast Asian economies has also grown quickly.



Source: World Bank.

Although their approaches to development have differed in various ways, the success of these economies teaches important lessons on the elements of a sound development strategy. These include attention to human and physical capital, a limited role for government, and export-oriented policies. Another lesson is that rapid development need not be accompanied by large income disparities.

The development of human capital has made a critical contribution to Asia's success. The region's successful economies have invested in nearly universal primary and secondary education, while at the same time developing their scientific and engineering capabilities. This has given them a labor force equipped to work with increasingly complex production processes, and has permitted them to move to increasingly sophisticated technologies over time. A particularly noteworthy aspect of their educational strategy has been its emphasis on female as well as male education.

Investment in physical capital has also contributed greatly. In the successful economies, most of this investment has been financed domestically, thanks to relatively high domestic saving rates. Some East Asian economies have achieved gross saving rates of more than 30 percent of GDP.

The role of government in many successful East Asian economies has generally been to complement markets and make them work

better, rather than to replace them. Governments made it their first responsibility to keep their fiscal affairs in order. Deficits were small, and some governments actually ran surpluses. Government expenditure focused on investment, both in people and in infrastructure. Governments also took charge of maintaining macroeconomic stability, avoiding extremes of high inflation and high unemployment.

The successful East Asian economies also adopted policies of outward orientation. Firms were expected to compete in export markets, where they would have to adopt international standards and best practices. Engagement in the international economy also facilitated the increase of technological capacity. Empirical evidence indicates that economies in East Asia and elsewhere that adopted such outward-oriented strategies enjoyed superior performance in terms of exports, overall growth, and employment. One study found that, during the 1970s and 1980s, the more open economies in a large sample of developing countries grew on average by 4.5 percent per year, compared with only 0.7 percent for more closed economies. Not a single open developing economy in the survey grew at less than 2 percent per year during this period. Of course, some of the observed correlation between openness and growth may be due to reverse causality: countries tend to liberalize trade as they develop. But even when one isolates exogenous differences in trade levels across countries (e.g., due to geography), it appears that trade leads to faster growth.

The East and Southeast Asian economies recognized the importance of exports to their economic growth, but they were not always as receptive to imports. Although they avoided the extremes of protracted import substitution policies (discussed below), which insulated the industries of many other countries behind walls of protection, they did erect a variety of barriers to trade, which were distortionary and may have impeded growth at home and abroad.

The East Asian experience upset the conventional wisdom on the relationship between growth and income equality. The established theories held that inequality was necessary to promote economic growth, because growth requires saving, and the wealthy tend to save more than the nonwealthy. Theory also held that inequality increased in the early stages of growth, as an income gap emerged between workers in the new industrial sector and those left behind in the traditional agrarian sector. The poor would *eventually* benefit from the growth in national prosperity, in this view.

Confounding these theories, several East Asian economies succeeded in growing rapidly while not only maintaining a more even income distribution than many other countries but actually reducing inequality. More-equal distribution of income contributed to rapid growth through several channels. For instance, it facilitated

the accumulation of human capital, as more households could afford to pay for their children's education. Land reform in Taiwan and some other economies after World War II both improved equality and enhanced peasants' incentives, stimulating growth.

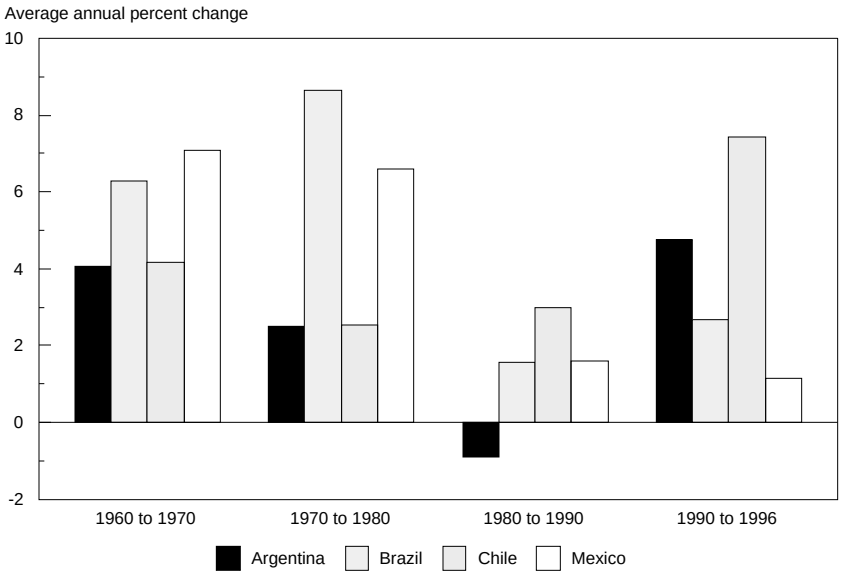
The Revival of Growth in Latin America

For many economies in Latin America the 1980s were a "lost decade." After growing robustly in the 1960s and 1970s (Chart 7–3), these countries took on large foreign debts in the late 1970s and early 1980s. They pursued inward-oriented economic policies, developing their industries to supply domestic demand behind high trade barriers that reduced competition and distorted prices. These policies left them ill equipped to service this mounting debt, much of which financed consumption rather than productive investment. In 1981–82, high dollar interest rates pushed these countries' debt-service requirements upward, a deep recession in the United States lowered demand for their exports, and prices for their export commodities declined. Debt-service payments thus rose sharply in relation to export earnings. When these problems erupted into a crisis in Mexico in August 1982, a number of countries were forced to suspend these payments. Many were compelled to make painful adjustments to continue debt payments, while investors remained reluctant to extend new financing. Through cooperative efforts led by the United States with other industrialized creditor countries and the IMF and the World Bank, many Latin American countries reformed their economies and restructured their debts, and by the early 1990s the crisis had unwound.

Most of these countries have resumed growth in the 1990s. Their governments now intervene less in their economies, and they have adopted more outward-oriented policies. The star performer has been Chile, whose relatively open, liberal economy has seen growth averaging more than 6 percent per year since 1983 while moving more than a third of the country's poor above the poverty line. Other economies have also expanded. Since 1993, real growth in Brazil, Latin America's largest economy, has averaged over 4 percent per year. Brazil has also quashed inflation after more than a decade of extreme price instability. Argentina's economy, which contracted by 1 percent per year during the 1980s, has seen an even more striking recovery.

The reentry of a dynamic Latin America into the international economy offers especially great opportunities for the United States. Our historical ties with that region as well as our geographical proximity make it likely that the United States will benefit greatly from Latin America's resurgence.

Chart 7-3 **Real GDP Growth in Latin America**
Growth has revived for some Latin American countries in the 1990s.



Note: 1995-96 data projected by the International Monetary Fund.
Sources: International Monetary Fund and World Bank.

INCREASED GLOBALIZATION

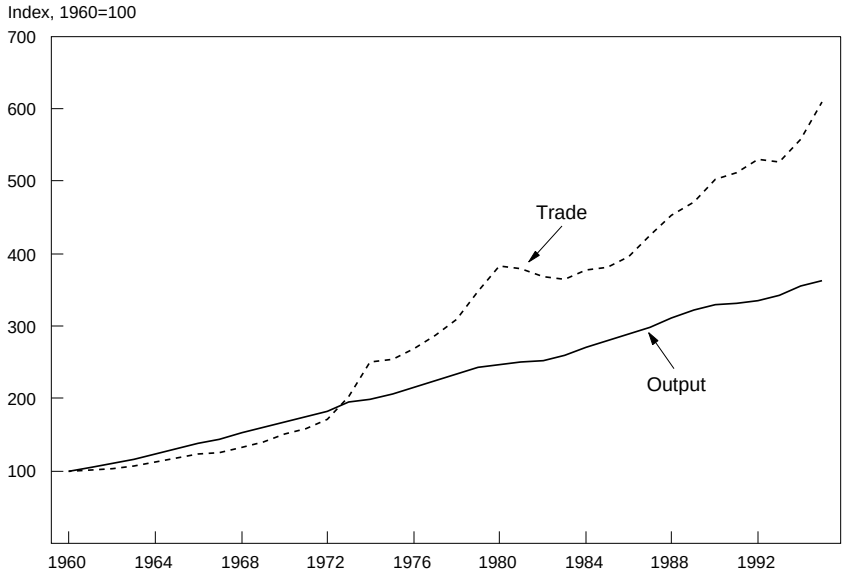
The third major change in the international economic environment is even more sweeping than the first two. National economies are becoming steadily more integrated. Technological barriers have fallen as transportation and communication costs have plummeted. Man-made barriers have also fallen, as tariffs have been drastically reduced in a series of multilateral trade negotiations since World War II, and as efforts to reduce nontariff barriers have gathered speed.

Some numbers help illustrate the shrinking economic distance between countries. Advances in shipping technology have reduced average ocean freight charges per short ton from $95 in 1920 to $29 in 1990 (these figures are for U.S. trade only and are in 1990 dollars). Between 1930 and 1990, average air transport revenue per passenger-mile fell from 68 cents to 11 cents, and the cost of a 3-minute phone call from New York to London dropped from $244.65 to $3.32 (again in 1990 dollars).

Trade has increased faster than output in the postwar era. In 1960, total world exports amounted to $629 billion (in 1995 dollars). By 1995 they had risen to over $5 trillion. In real terms, world exports have grown at an annual rate of 6.1 percent per year since 1960, while world output grew at 3.8 percent (Chart 7–4).

This growth of trade has led to wider competition, allowing countries to benefit from their comparative advantage and raising living standards everywhere.

Chart 7-4 **Growth in World Output and Trade**
Trade has expanded much faster than output, especially since the early 1970s.



Sources: International Monetary Fund and World Bank.

Globalization has made great strides but still has a long way to go. The physical and information costs of international trade are still substantial, although current trends and the history of economic and technological advancement suggest that these costs will continue to shrink. As they do, however, other barriers to trade will take on greater importance.

The Evolution of International Institutions

A number of international institutions have evolved under strong U.S. encouragement to handle the challenges posed by increased global integration. Two that are central are the International Monetary Fund and the World Bank, both created at the Bretton Woods conference at the end of World War II. The World Bank's first task was to finance Western Europe's postwar reconstruction. It has since become a major financier of infrastructure and other projects and programs in developing countries—and now transition economies as well—around the world. On its successful model, regional multilateral development banks have also been set up for Af-

rica, Asia, Latin America and the Caribbean, and most recently for Eastern Europe and the former Soviet Union.

The IMF was designed to provide temporary financing to countries with balance of payments shortfalls, as a means of supporting the international system of fixed exchange rates that the Bretton Woods conference also established. That system pegged members' currencies to the dollar, which in turn was made convertible into gold for foreign governments. Since the fixed exchange rate system collapsed in the early 1970s, the IMF has taken on several other important roles, including financing structural adjustment programs in developing and transition economies. These programs, in conjunction with funding for structural adjustment reforms by the World Bank and other multilateral development banks, involve a negotiated set of economic reforms designed to stabilize the domestic economy and facilitate the development of institutions and markets that will maximize future growth.

The architects of the Bretton Woods system also sought to create a new order in international trade, to reduce friction between trading partners and prevent a return to the beggar-thy-neighbor policies of the 1930s, in which countries imposed tariffs and devalued their currencies in an ultimately futile effort to increase domestic employment at foreigners' expense. The Bretton Woods proposal for an International Trade Organization was never ratified, but the General Agreement on Tariffs and Trade, an accord originally intended as a precursor to the ITO, was concluded in 1947. Subsequent negotiations under the GATT's auspices have done much to liberalize trade. The code of conduct that it embodies introduced two important principles to trade relations: first, that countries should eventually renounce import quotas and similar quantitative restrictions on trade, and second, that they should adopt a policy of nondiscrimination, opening their markets to all participating countries equally.

The GATT has provided a framework for countries to negotiate large reductions in tariffs and, more recently, in nontariff barriers. Successive GATT negotiating rounds have achieved reductions of over 90 percent in tariffs on industrial products traded between the major industrial countries. The GATT's Uruguay Round, completed in 1993, made landmark reductions in nontariff barriers in textiles and apparel, product standards, and intellectual property, among other areas. It also extended GATT principles both to agriculture, where certain nontariff barriers were converted to tariffs, later to be progressively reduced, and to services.

A key outcome of the 1993 Uruguay Round agreement was to set up an international trade body along the lines envisioned at Bretton Woods nearly 50 years earlier. The establishment of this body, the World Trade Organization, recognizes the need for a

forum for discussion, negotiation, and liberalization. The WTO also encompasses a system for the impartial and expeditious adjudication of trade disputes, to help ensure that countries operate fairly in international trade. The WTO's dispute settlement system applies in integrated fashion to the whole range of Uruguay Round agreements.

The WTO system respects national sovereignty. Each country retains ultimate authority for making and implementing national policy. But decades of GATT negotiations have resulted in a set of internationally accepted rules of the game. A country that is found to be engaging in an unfair trade practice has a choice: it can either desist from that practice or face appropriate retaliation from the injured country. Within the WTO, judgments are reached in a quasi-judicial framework on the consistency of countries' trade practices with WTO obligations. Section 301 of U.S. trade law has in fact always required the United States to use GATT (and now WTO) dispute settlement mechanisms where available. A problem under the former GATT system was that many restrictions and distortions of international trade did not violate any specific GATT obligation, and thus were not subject to treatment under GATT dispute settlement mechanisms. Given the success of the Uruguay Round and the resulting broader scope of the WTO, this problem has been significantly lessened, though not eliminated, for the United States and other countries. Section 301 also provides a mechanism for addressing unfair trade practices not covered by the WTO.

The WTO benefits its members individually by establishing clearer multilateral trading rules and a more effective means of enforcement. Its presence makes the international trading system more predictable, thereby facilitating trade and the advantages that derive from it.

Under U.S. leadership, the industrial countries have also created procedures to coordinate their bilateral assistance to developing countries. The primary mechanism for this coordination is the Development Assistance Committee (DAC), run under the auspices of the Organization for Economic Cooperation and Development (OECD), whose members include most of the world's richest and a growing number of upper-middle-income countries.

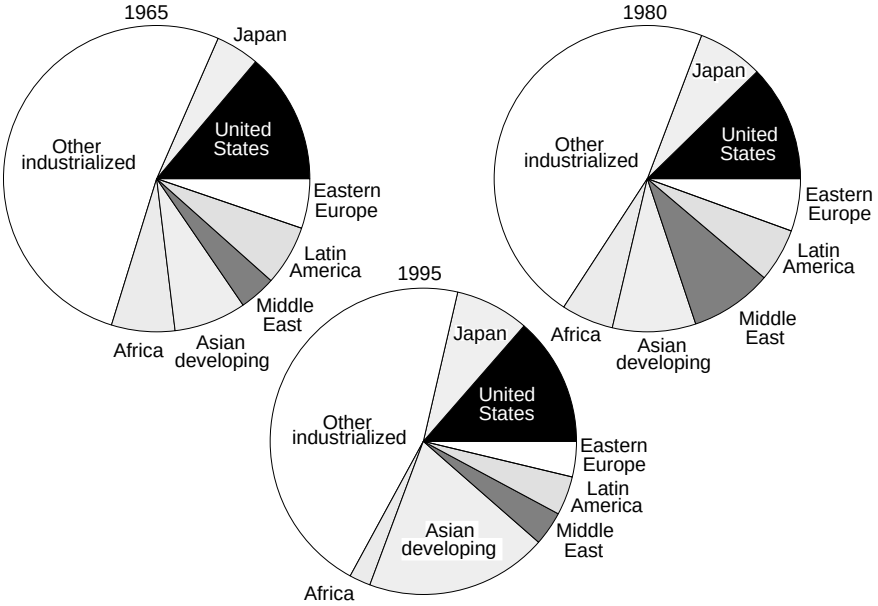
The major industrial countries have developed some other, less formal mechanisms to manage economic issues. The annual summit meetings of the Group of Seven major industrial economies (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) offer an opportunity for heads of government and their senior ministers to deal with issues of mutual importance, such as appropriate macroeconomic policies. The United States will host this year's meeting in Denver in June. Group of

Seven finance ministers and central bank governors also meet several times a year to address these issues.

The Increasing Openness of Developing Economies

Aided by policies that have opened developing-country markets, globalization has increased the involvement of developing countries in world trade and investment flows. The share of the developing countries and today's transition economies in world trade has increased dramatically over the last 30 years. These economies accounted for 27 percent of total world exports in 1965; by 1995 their share of a many-times-larger world export market had grown to 33 percent (Chart 7–5). Within this growing share, that of the Asian developing economies more than doubled, from 8 percent to 19 percent of total world trade; meanwhile the shares of the African and Latin American countries fell considerably.

Chart 7-5 **Shares of World Trade**
The share of Asian developing countries in international trade has risen greatly since 1980, increasing the overall importance of developing countries in world trade.



Note: Eastern Europe includes the (former) Soviet Union.
Source: International Monetary Fund.

The developing world's strategy toward trade and development has undergone a remarkable change. In the 1950s and 1960s many developing countries adopted policies of import-substitution industrialization: countries would build their economies by making for themselves the manufactured goods that they were used to importing. Infant-industry protection was a corollary to this argument, combining protection of new domestic industries from foreign com-

petitors with state support. The import substitution approach seldom succeeded, however, in encouraging the development of internationally competitive manufactures. Once granted protection, firms tended to settle comfortably into home-grown monopolies rather than strive to duplicate world standards of technology and productivity.

In the 1980s, engulfed by the debt crisis, many of these countries responded at first by further raising trade barriers. But as the crisis deepened, they were forced to change direction. Dismantling of trade barriers was one of the cornerstones of the structural adjustment policies many countries adopted as part of their debt-restructuring packages. Trade liberalization not only helped establish powerful, direct linkages between their domestic economies and the world system, but also compelled action on other promised reforms under the pressures of international competition. Meanwhile governments scaled back the scope of their activities, privatizing state enterprises they had set up in steel, chemicals, and other heavy industries.

ACHIEVEMENTS AND OPPORTUNITIES

A cornerstone of this Administration's economic policies has been to position the United States to benefit from the global changes described above. The United States has worked hard, through the negotiation of bilateral, regional, and multilateral agreements, to open foreign markets to American products. The past 4 years have seen perhaps the most rapid progress ever in this area, including the completion of the North American Free Trade Agreement (NAFTA), the conclusion of the Uruguay Round of the GATT, and over 200 trade agreements in all (see *Economic Report of the President 1995* and *1996* for details of some of these agreements). The Nation has reaped huge benefits from these policies and has experienced strong export growth, leading to strong job and income growth as well. One of the many economic successes of the last 4 years has been a surge in exports, which have grown by 42 percent—over $185 billion. By one reckoning, exports account for almost a third of the Nation's strong overall growth. Exports are critical to creating high-wage, high-tech jobs, because they allow the United States to expand production in those high-productivity sectors in which we have comparative advantage. Since 1992, the number of high-wage, export-related jobs in the U.S. economy has increased by 1.5 million. These jobs pay more—13 to 16 percent more on average—than the average job.

Implemented in 1994, NAFTA joins the U.S. and Canadian economies in a free-trade area with that of Mexico. In the first 3 years since NAFTA went into effect, trade between the United

States and its NAFTA partners, which are our largest and third-largest trading partners, has grown by about 33 percent. NAFTA's value was proved during Mexico's 1995 financial crisis. Despite the extreme adjustments and the sharp economic contraction that the crisis forced upon Mexico, the agreement ensured that Mexico would keep its markets open to U.S. products. The result was in sharp contrast to the restrictive policies that followed Mexico's 1982 financial crisis. In 1996 U.S. exports to Mexico rose to record highs. This forestalling of any potential reversion to insular and protectionist policies also benefited Mexico.

The United States is actively pursuing further market opening in the Western Hemisphere, building on NAFTA through ongoing talks toward a Free Trade Area of the Americas. Under the proposed FTAA, 34 Western Hemisphere countries will be linked in a free-trade area by 2005. Trade with countries in this hemisphere (including Canada and Mexico) accounted for over $170 billion in U.S. exports—well over a third of the total—in the first three quarters of 1996. A useful first step toward this goal would be completion of a free-trade agreement with Chile.

The United States is also benefiting from market opening and expanded trade with the other Pacific Rim countries. Progress within the Asia-Pacific Economic Cooperation forum has been rapid. At the 1996 leaders' summit at Subic Bay in the Philippines, the 18 APEC members—which include both industrial and developing economies and account for over half of world income—committed themselves to take the initial steps toward free and open trade and investment and a free-trade area by 2020. In addition, the Information Technology Agreement (ITA), a U.S. initiative that would liberalize trade in semiconductors, computer and telecommunications equipment, and software exports, was broadly embraced by the APEC nations at the December summit.

With strong support within APEC, completion of the ITA was a centerpiece of U.S. efforts at the WTO's first ministerial meeting, held in Singapore a few weeks later. There 28 countries endorsed the agreement, including almost all the industrial countries, several developing economies in East and Southeast Asia, and Turkey. The agreement would cover products accounting for some $500 billion in annual world trade and over $90 billion in annual U.S. exports.

One of this Administration's first initiatives was the establishment of the Trade Promotion Coordinating Committee (TPCC), which coordinates government policies affecting U.S. exports across agencies. In September 1993 the TPCC unveiled the National Export Strategy, which laid out 65 concrete recommendations for leveraging export promotion resources and removing government-imposed obstacles to exporting. The Administration quickly imple-

mented the strategy, which includes opening export assistance centers around the country, providing "one-stop shopping" for new exporters, leveling the playing field for U.S. companies by countering the advocacy efforts of foreign governments, and eliminating unnecessary export controls and licenses. The National Export Strategy also includes specific initiatives for each of the "big emerging markets".

As early initiatives are successfully implemented, the National Export Strategy continues to evolve through the identification of new areas and the development of initiatives by the TPCC. For example, the TPCC concluded that the use of illegitimate practices such as bribery was far more widespread than previously known. The TPCC was able to identify $11 billion in contracts lost to U.S. exporters over a 2-year period because of bribery by foreign firms. Last year's report on the National Export Strategy contained a blueprint for government-wide action to combat bribery. And this year the TPCC is developing a strategy against the use of product standards as barriers to U.S. exports.

At the same time, the United States has continued to take steps to ensure that globalization lifts living standards in all countries, through a serious commitment to promoting labor standards throughout the world. In its efforts within international organizations, the Administration has sought to establish a framework for multilateral discussion on how best to promote core labor standards: freedom of association, the right to organize and bargain collectively, nondiscrimination in the workplace, prohibition of forced labor, and elimination of exploitative child labor.

EXPLAINING THE BENEFITS OF INTEGRATION

Virtually all economists agree that international trade and economic integration raise the living standards of U.S. residents overall, while also increasing economic well-being in other countries. The benefits of international trade have become increasingly apparent as it has fueled growth over recent years. When unemployment is significant, as it was in 1993, an expansion of exports raises demand for U.S. goods and services and therefore increases employment. Even as the economy approaches full employment, the benefits of trade continue to manifest themselves in the form of higher incomes, and continue to influence the pattern of job creation and change.

The effects of trade opening are similar to a major technological innovation: both may require economic restructuring. It is also widely acknowledged that some companies and workers may be hurt by the opening of markets as they adjust to increased foreign competition. The U.S. Government undertakes various measures to assist workers and companies injured by trade (Box 7–1). Moreover

the core of this Administration's education policies is to ensure that all Americans have the tools they need to compete and succeed in the international economy.

Box 7–1.—Trade Adjustment Measures

Government programs such as the transitional adjustment assistance (TAA) help workers adversely affected by trade retrain and take advantage of the economic opportunities trade offers. The NAFTA-TAA program provides a short-term safety net in the form of an adjustment allowance for workers who suffer from a shift of production to or increased imports from Mexico or Canada (whether or not related to NAFTA); it also provides employment services and training to help them acquire the skills they need to enter new jobs. In fiscal year 1995, over 2,000 workers entered training under this program, and almost 1,400 began receiving adjustment allowances. Also important to adjustment is the phasing in of trade liberalization over time. Changing the rules gradually gives import-competing industries time to adjust to new competition. However, such delays must not become a device to postpone agreed liberalizations indefinitely.

Are trade deficits a source of concern? As last year's *Economic Report of the President* emphasized, trade deficits and surpluses are primarily determined by macroeconomic factors, in particular the balance between domestic saving and investment. Trade barriers have little lasting influence on the Nation's overall trade balance, although they may have marked effects on bilateral deficits, and they do affect the extent to which countries can reap the benefits of trade. It is even an oversimplification to think that deficits are necessarily bad, and surpluses necessarily good. A current account deficit merely means that a country is, on balance, borrowing from the rest of the world; a surplus means it is a net lender to the world. Whether such borrowing or lending is proper depends, as it would for any individual or company, on what the borrowing is used for or why the country is lending.

The United States has run trade and current account deficits every year since 1982. In the 1980s these deficits were a red flag that the United States was failing to save enough. The budget deficits run up during those years generated vast government dissaving: the economy was living beyond its means. In the last 4 years, however, this Administration has successfully worked with the Congress to reduce the government budget deficit and increase national saving. Nonetheless, trade deficits have persisted, although they are much smaller in proportion to GDP than in the peak years

of the 1980s. But in contrast to the surge in the trade deficit in the 1980s, this most recent increase appears to be financing a surge in U.S. investment, particularly in business equipment. The implication is that the improving economy will continue to grow and will generate the resources necessary to repay our net borrowing from the rest of the world. (The national saving rate is still low, however. The most effective way to raise it is to continue efforts to reduce the budget deficit.)

Investment, like trade, yields benefits to both sides of the transaction. Capital goes to those who are best able to make productive use of it, and the suppliers of that capital receive a higher return, for a given level of risk, than they could get elsewhere. These mutual benefits may be particularly pronounced in the case of foreign direct investment (FDI). FDI occurs when a foreign investor either sets up an enterprise in another country or obtains a large enough share in an existing enterprise to give the investor effective influence over its management. FDI benefits the country receiving it in many ways: besides the funds themselves, direct investors bring managerial, technical, and marketing know-how, which often spills over to other parts of the economy.

FDI by American companies can open the way for U.S. exports, both as inputs to foreign production and as consumer goods to supply foreign demand. It also offers U.S. companies a toehold in foreign markets from which they can further expand sales. In many cases, investment in distribution and other essential services increases a supplier's ability to export into a market. Trade between firms and their foreign affiliates (intrafirm trade) can be an efficient means of international trade, particularly when problems of imperfect information exist. Over a third of U.S. exports and two-fifths of U.S. imports are estimated to be intrafirm. Worldwide, about a third of trade is intrafirm trade.

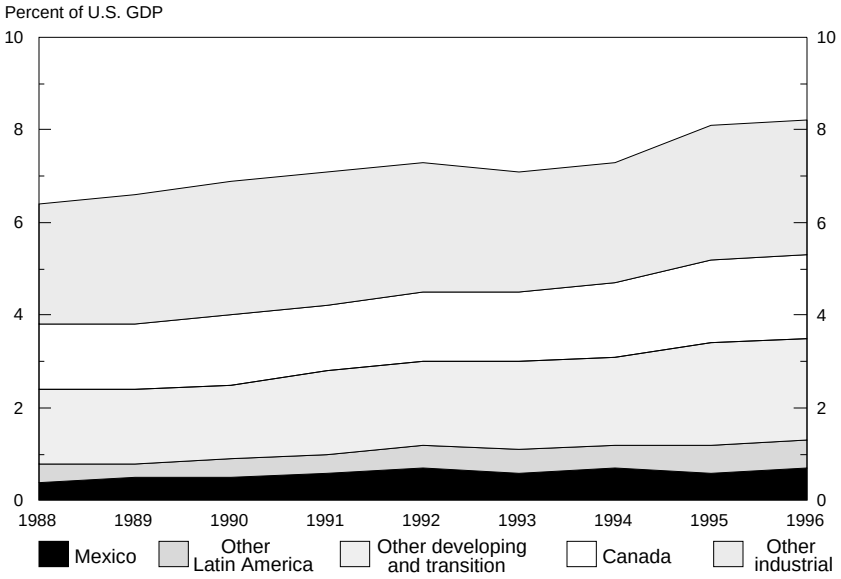
In short, whatever the short-run effects on the economy and the trade deficit, over longer periods increased globalization increases incomes both in the United States and abroad. Globalization produces greater gains from trade, through specialization according to comparative advantage and through realization of scale economies in production. And by allowing capital to flow across borders, it lowers the cost of financing investment in the recipient country, and increases the return to saving and allows for portfolio diversification in the country providing the funds.

U.S. POLICY ON TRADE WITH DEVELOPING COUNTRIES

Much of our strong recent export growth is due to demand from developing countries. During the 1990s U.S. exports to other industrial countries have grown at a satisfying rate of 5 percent per year

in real terms—but U.S. exports to developing countries have grown at almost twice that rate (Chart 7–6). U.S. exports to Latin America have been particularly strong, rising from 0.9 percent of U.S. GDP in 1990 to 1.4 percent in the first three quarters of 1996. Exports to other developing and transition economies rose from 1.6 percent to 2.2 percent of GDP.

Chart 7-6 **U.S. Exports of Goods by Destination**
U.S. exports to developing countries have grown faster than exports to markets in industrialized countries.



Note: Data for 1996 are estimated using 12 months of data ending in November.
Source: Department of Commerce.

The United States is committed to encouraging the involvement and integration of developing countries in the global trading system. To this end, a number of policies have been put in place that not only benefit U.S. consumers, but also provide special encouragement for developing countries to expand and diversify their exports. By encouraging openness and economic growth, our policies also promote democracy and stability.

One of the main U.S. programs for promoting trade with developing countries is the Generalized System of Preferences (GSP). Under the GSP, instituted in 1976, roughly 4,600 products from 148 beneficiary countries and territories are eligible for duty-free entry into the United States. In 1995 the United States imported $18.3 billion in duty-free goods under the program, accounting for 16 percent of total U.S. imports from GSP beneficiaries. Over two-thirds of all GSP imports in that year originated in six countries:

Brazil, India, Indonesia, Malaysia, the Philippines, and Thailand. As countries develop they are graduated from the program, to allow lower income countries to take better advantage of available preferences. (Malaysia, for example, graduated January 1, 1997.) The President intends to seek a renewal of the GSP arrangement beyond its presently scheduled expiration in May 1997.

Implemented in 1984, the Caribbean Basin Economic Recovery Act provides preferential access to the U.S. market for 24 Caribbean countries and territories. In 1991 the United States implemented a similar program under the Andean Trade Preferences Act for four South American countries. This program is a centerpiece of U.S. efforts to encourage these countries to reduce their production and exports of cocaine. These two programs help support growth and development in some of the hemisphere's less developed nations, which in turn have become better customers for U.S. products.

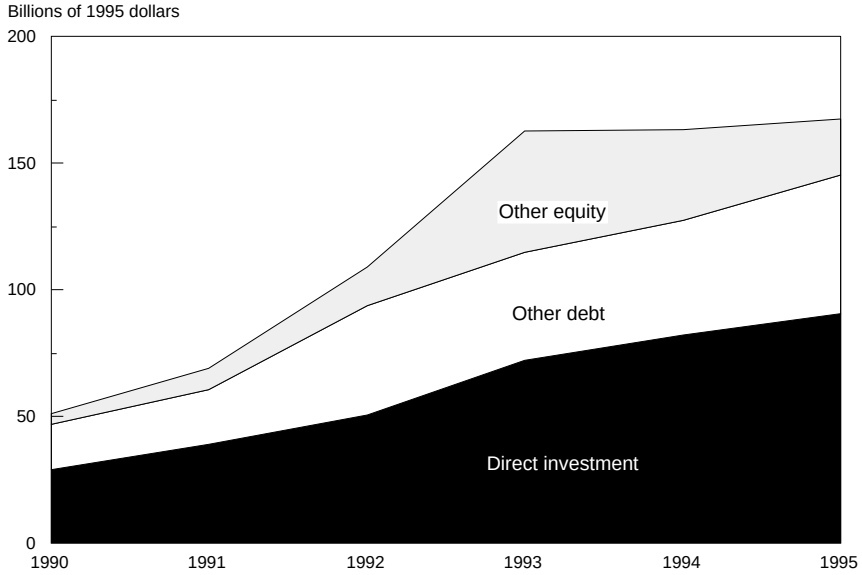
PATTERNS OF FOREIGN INVESTMENT IN DEVELOPING AND TRANSITION ECONOMIES

Developing countries tend to be importers of capital: their investment needs are massive and the potential returns large. But in the 1980s, as already noted, the debt crisis reduced and in some cases reversed the net flow of capital into these countries. At the same time, relatively large public sector deficits in the high-income countries absorbed private saving, increasing competition for international investment funds.

During the 1990s, private investment in developing countries has undergone a marked revival. Those that have restored economic and political stability have been rewarded with greatly increased access to international capital. The significant and continuing restructuring of developing countries' external public debt has greatly aided their mobilization of external private capital, by lowering the risk perceived by investors. Long-term net private capital flows to developing countries have nearly quadrupled in the 1990s, reaching $167 billion in 1995 (Chart 7–7). Most of this growth occurred in East Asia and the Pacific, where net resource flows rose from $35 billion in 1991 to over $100 billion in 1995. Flows to Eastern Europe rose sharply, too, from $6 billion in 1992 to $24 billion in 1995.

International private capital flows take three forms: FDI, portfolio investment in securities, and bank lending. FDI in developing countries has grown without interruption over the last decade. Cumulative FDI flows during the 1990–95 period totaled $345 billion. Developing countries' share of global FDI has risen rapidly, from 12 percent in 1990 to 38 percent in 1995. But the bulk of FDI into developing countries has gone to a small number of countries. In

Chart 7-7 **Net Capital Flows to Developing Countries**
Led by large increases in foreign direct investment and portfolio equity investment, investment in emerging markets has boomed in the 1990s.



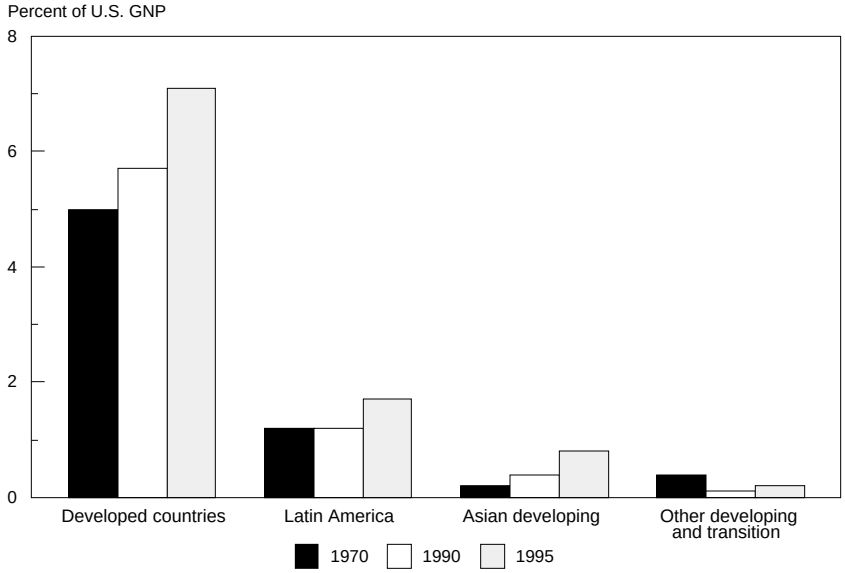
Note: Series adjusted by CPI-U.
Source: World Bank.

1994, Indonesia, Malaysia, and Mexico accounted for almost 60 percent of total FDI flows into developing countries (excluding the transition economies). East Asia has done relatively well this decade in attracting FDI, while the share of FDI going to Latin America has declined.

Only 6 years ago, less than one-quarter of the stock of U.S. outward FDI was in the world's poorer countries, a smaller share than in 1970 (Chart 7–8). Since 1990, however, in keeping with the general trend of global capital flows discussed above, U.S. investment in emerging markets has boomed. The stock of U.S. investment in these economies increased to 27 percent of all U.S. external investment. While total U.S. investment abroad rose 65 percent between 1990 and 1995, investment in developing countries nearly doubled.

The surge in FDI in the 1990s may have resulted in part from the improvements in the economic structure of developing countries already mentioned. Economic stabilization and reforms that have reduced external indebtedness and lowered the risk of balance of payments crises have also reduced transfer risk—the danger that host countries would block the remittance of earnings to the parent companies. In addition, reform of legal and regulatory regimes and the adoption of outward-oriented economic policies have probably reduced other risks perceived by foreign investors.

Chart 7-8 **Stock of U.S. Direct Investment Abroad**
Investment of U.S. companies in developing countries is still well below the stock of U.S. direct investment in other industrialized countries, but it has increased rapidly in the 1990s.



Source: Department of Commerce.

Portfolio investment—the acquisition of bonds or corporate equity in the absence of a significant ownership stake in the enterprise—has grown dramatically. Portfolio investment gives firms that are already up and running the extra finance they need to increase performance. Portfolio equity flows to developing countries have been highly volatile. After increasing 12-fold during 1990–93, they fell 23 percent in 1994 and another 37 percent in 1995, to $22 billion. The sharp drop in 1994–95 was partly a reaction to events surrounding the Mexican crisis. It also reflected higher U.S. and European interest rates and concerns about possible overheating in some Asian economies.

Corporate bond flows have grown more steadily, from $3 billion at the beginning of the decade to $34 billion in 1995. In keeping with their rapid growth and history of macroeconomic stability, East Asian borrowers enjoyed maturities three times longer than those of Latin American borrowers. Average spreads (differences in interest rates) over government bonds in the United States and other major industrial countries were one-half of those for Latin American debt.

Finally, commercial bank lending has been highly volatile, jumping from less than $2 billion in 1990 to nearly $14 billion in 1993, then reversing course to a $5 billion net outflow the following year.

By 1995, commercial bank debt inflows in developing countries had risen again to $17 billion.

OTHER ASPECTS OF U.S. POLICY TOWARD EMERGING MARKET ECONOMIES

The U.S. economy no longer dominates the world economy by its sheer size, but even so the United States carries a disproportionate weight in world economic affairs. We are looked to for leadership in part because our economy remains the largest in the world, and in part because we are the sole remaining superpower. How do we intend to exercise that leadership? Among the most important objectives of U.S. economic policy are to ensure that the United States itself benefits fully from the integration of these emerging markets into a globalized economy; to guarantee that the former Communist countries make a successful transition to the market and become integrated into the international trading system; and to help developing countries in their quest for growth and development, by fostering both their economic institutions and their human resources.

INTEGRATING THE TRANSITION ECONOMIES INTO THE WORLD ECONOMIC SYSTEM

One way in which the United States has led the pursuit of these objectives has been by promoting an international economic system that reflects our values of openness, competition, and private enterprise. A key challenge in this regard, as already noted, is to ensure that economies that are newly embracing these values undertake reforms and are assisted in integrating into this system. This will ensure that these emerging economies have a stake in preserving the system that U.S. leadership has helped create. History teaches that outcasts can make trouble.

The task of transition is daunting, especially in the newly independent republics of the former Soviet Union, where Communism had its deepest roots. By far the most important element of a successful transition is market-oriented economic and political reforms. In addition, these countries will need generous support from the established market economies through the international financial institutions, as well as private investment. Foreign assistance can help encourage the development of the political and social institutions that will allow markets and democratic principles to flourish in the countries of the former Soviet bloc. The United States has led efforts here: it has provided direct assistance to these countries (as discussed below) and has worked within the IMF and the World Bank to assist the transition. In particular, the United States has strongly supported a major focus of the inter-

national financial institutions on building a foundation for market-driven growth through the sale of state-owned enterprises, sweeping legal and regulatory reform, financial sector modernization, and comprehensive redesign of social safety nets.

If these countries are to benefit fully from their conversion to market economics, they must also be able to put their comparative advantage to work. Just as it is also in the best interests of the transition economies to play by the rules of the international marketplace, so too is it in the best interests of the established industrial economies to apply the trading rules fairly to the economies in transition. The markets of the established industrial economies must remain open to trade and investment opportunities with the transition economies. Consumers—as well as producers buying inputs—will gain from lower prices, and other producers will gain from exporting back to these new market economies and from increased opportunities for investment. In addition, all peoples will benefit from a more stable world as the transition economies successfully leave their Communist past behind.

Russia and the United States have rapidly deepened relations since Russia reemerged as an independent state at the end of the Cold War. At a series of meetings in Vancouver, Tokyo, Moscow, and Washington, the President and his Russian counterpart laid the basis for a lasting U.S.-Russian partnership. In the economic sphere, a commission headed by the Vice President and the Russian Prime Minister has worked to advance bilateral cooperation through eight working committees covering health, space, energy policy, agribusiness, defense conversion, business development, the environment, and science and technology. The commission last met in Moscow in July 1996 and is scheduled to meet in Washington in February 1997. In the area of trade, a Partnership for Economic Cooperation, signed by the two presidents at their September 1994 summit in Washington, serves as a framework for reducing barriers to expanded economic cooperation. A number of U.S. agencies—in particular, the Overseas Private Investment Corporation, the Export-Import Bank, the Trade and Development Agency, and the Department of Commerce—have programs in place aimed at facilitating trade and investment in Russia. The United States is also actively supporting the transformation of Russia from a centrally planned to a market economy. Since 1992 the U.S. Agency for International Development (USAID), which coordinates U.S. bilateral foreign development assistance, has devoted approximately $2 billion in assistance under the Freedom Support Act to helping Russia develop democratic and market institutions.

Meanwhile significant developments in the security sphere have reduced the threat of military confrontation in the post-Cold War era, while also providing economic benefits for the United States.

Most recently, Russia and the United States signed an agreement that will transfer substantial amounts of Russia's supplies of highly enriched uranium from Russian warheads to U.S. energy facilities—a real-life example of turning swords into plowshares. The Administration has been working to develop institutional arrangements to ensure that these mutually advantageous transactions, an effective part of our policy to prevent nuclear proliferation, continue.

Both China and Russia are currently negotiating accession to the WTO. Their successful integration into the multilateral trading system requires that they continue their market reforms, agree to provide mutually beneficial access to their markets, and abide by multilateral rules and obligations. Likewise, by keeping open our markets and those of our traditional allies to these new economic powers, we can increase the stake they have in maintaining the international rules-based economic system.

China and the United States together account for almost 16 percent of global trade and 30 percent of global output. Whether we meet regional and global goals for freer and more open trade—among the APEC countries and among all the members of the WTO—depends in part on the strength of the bilateral relationship between China and the United States. Recognizing this, the Administration is committed to pursuing a regular and intensive dialogue with China. Significant progress was made with the beginning of a dialogue between China's State Planning Commission and the Council of Economic Advisers in August 1996. Progress continued at the September 1996 meeting of the Joint Commission on Commerce and Trade, with the establishment of a consultative group on business operational issues and with commitments to engage in further discussions on export controls and commercial law. In the November 1996 session of the U.S.-China Joint Economic Committee, China and the United States pledged further cooperation in the areas of customs, tax collection, and financial sector reform.

With the end of the Cold War, an important rationale for foreign aid—to cement alliances with the world's poorer countries against the threat of Communism—has disappeared. But there are other important rationales. Beginning with the Marshall Plan after World War II, foreign assistance has been part of a broad effort by the United States and the other industrial democracies to foster a world order based on freedom, prosperity, and stability. In an increasingly interdependent world, these ideals retain enormous relevance.

Some foreign aid is purely an expression of our sense of humanity: Americans find it difficult to turn their backs on children starving during a famine or left homeless after an earthquake. But just

as we believe, as a matter of domestic policy, that it is better to extend a helping hand up than a handout, so we believe it is better to create the economic conditions that will enable countries abroad to stand on their own feet.

For half a century the United States has used its international influence to spread democratic and market institutions. U.S. higher education has also promoted markets and democracy overseas (Box 7–2). Aid, although much less important than trade economically, is nevertheless an essential instrument by which the United States and the other industrial democracies help less developed economies become stronger and more self-reliant. We also believe—and not without evidence—that countries with higher living standards are likely to be politically more stable, especially when improvements in living standards are spread widely within a population. By contributing to the world's political stability, these improvements in living standards contribute to America's security.

Box 7–2.—How Educating Foreign Students Promotes Markets and Democracy

The United States has clear comparative advantage in higher education. Many foreign students, especially from developing countries, come to America to study for college and graduate degrees. Their spending on tuition counts as U.S. exports of educational services and rivals U.S. exports of corn or wheat, our two largest agricultural exports. When these students return home, they take with them an appreciation of the benefits of an open society and an open economic system. The U.S. system of higher education has done much to spread our values throughout the world, including our belief in democracy and the market system.

This phenomenon is particularly evident with respect to Latin America. Many Latin Americans have come to the United States to study for graduate degrees in economics or public policy, and many have entered government service on returning home. The last two presidents of Mexico and the finance ministers of Argentina, Brazil, Chile, and Mexico, for example, all received doctorates in economics from U.S. universities. Partly because of their leadership, Latin America has embraced market-oriented economic policies.

This is one example of how the United States itself benefits from aid given to others. But we realize important economic benefits as well. When our aid helps countries grow, we benefit from increased exports. For example, 20 countries have achieved a sufficient level of development to graduate from lending programs of the Inter-

national Development Association (the World Bank affiliate that lends to the poorest countries on a concessional basis). These countries bought $61 billion in U.S. exports in 1995, or 6.3 percent of our total exports. And by deepening our economic relationship with developing countries through aid, we also make it more likely that they will turn to U.S. firms for products in the future. More broadly, U.S. assistance in setting up legal and commercial institutions in developing countries leads to foreign business environments that are transparent, open, and predictable. This makes it easier for U.S. exporters and investors to operate in these markets. Familiarity breeds trade.

How developing countries treat their environment is increasingly relevant to Americans. The decimation of a rainforest, or the use of inefficient coal-burning power plants, may affect the climate of the entire globe. The explosion at Chernobyl brought home forcefully that badly designed nuclear reactors in one country can have far-ranging effects. We all share the same planet. But poor countries may have difficulty raising the resources to do what is necessary to help preserve the global commons. Financial aid is one way we can pursue these objectives.

To respond to these varied rationales, USAID has spelled out five goals for its work: encouraging broad-based growth, protecting the environment, building democracy, helping to stabilize world population growth, and providing relief through humanitarian assistance. The web of international institutions created under U.S. leadership also plays a key role. The World Bank, together with the several regional development banks, lend on both a concessional and a nonconcessional basis, depending on the income of the borrowing country. Other international organizations also provide lending and technical assistance. The United States contributes to the capital of these institutions and to their special concessional lending funds, but the impact of these institutions is many times the level of U.S. contributions. They therefore provide an efficient means for the United States to leverage its international leadership.

A Brief History of Aid

The targets and strategies of foreign assistance have undergone a steady evolution since the end of World War II. Immediate postwar assistance was focused on countries hard hit by the war. The Marshall Plan channeled assistance to Western Europe on a vast scale, to promote economic recovery while preserving social stability and democracy. In the Marshall Plan years of 1949–52 the United States gave $18.6 billion in aid, equivalent to 1.5 percent of our gross national product (GNP) in those years. As a percentage of our output, the aid we send overseas today is far smaller than it was then.

The United States and the other industrial countries provided relatively little assistance to what are now the developing countries before the early 1960s, and what was offered usually came in the form of specific technical assistance. It was widely assumed that the income gap between these countries and ours would close over time, without much special effort on our part. In addition, many of what are now high-income countries were still well behind the United States, so that concern was not focused exclusively on the developing world.

In the early 1960s, under the leadership of President Kennedy, the United States greatly increased the resources devoted to assisting developing countries. U.S. foreign economic assistance rose from $13 billion in 1958 (in 1996 dollars) to $22 billion by 1962. The United States accounted for the great bulk of official development assistance throughout the 1960s. Apart from providing direct assistance ourselves, the United States also led efforts to coordinate bilateral assistance from other countries. In 1961 the DAC, the primary mechanism for coordinating aid among the OECD countries (see above), was established. The United States also led the way in providing development assistance and nonconcessional development finance through the multilateral development banks. The IDA was organized in 1960 to provide concessional financing to the poorest countries. The first two regional development banks, the Asian Development Bank and the Inter-American Development Bank, began operations in the 1960s, with the United States as a founding member of both.

U.S. development assistance has contributed to many successes since the 1960s. Some of the world's fastest-growing countries today have been major recipients. Targeted programs have achieved particular success. During the 1960s and 1970s, for example, USAID assistance to India for higher education and agricultural research was instrumental in the rapid growth in cereal production in that country—the so-called Green Revolution. In various countries, USAID programs have helped reduce infant mortality and population growth rates and improved basic education programs.

Over time, the intellectual focus of development assistance changed. By the early 1960s it was clear that most developing countries were not catching up with the United States as fast as Western Europe and Japan were. It was assumed that a shortage of investment resources was behind this lack of growth. Long-term growth models developed in the 1950s posited a direct relationship between a country's investment level and growth of its GDP. Countries unable to generate enough resources to fund high investment levels would fail to generate rapid growth. The role of aid was to alleviate bottlenecks to growth, by filling the gap between the de-

sired level of investment and the saving and private foreign capital available to finance it. The idea that resource transfers were an important determinant of growth was in keeping with our successful experience with the Marshall Plan.

In the 1970s the focus of assistance shifted to the direct alleviation of poverty. Although rapid economic growth held the promise of alleviating poverty over the long term, it was feared that poverty could actually worsen in the initial stages of development. Aid increasingly was allocated to projects directly designed to meet basic needs of the poorest populations in developing countries. These efforts were focused on measures targeted to population control, health, education, and rural development.

The growth rates of developing countries began to diverge widely in the 1970s, with the Asian and Latin American countries generally growing steadily and many African countries beginning to stagnate. Investment bottlenecks were not the only factor inhibiting development. How investment was used, and the environment in which it was made, were also important. The focus of development broadened to include the need to develop agriculture, exports, and human resources, as well as industry and infrastructure.

As it became clear that no simple causal relationship existed between the quantity of assistance, rates of economic growth, and changes in poverty, the policy focus in the 1980s changed once again, this time to the influence of a country's domestic economic and social policies on development and growth. The quantity of aid, which had been the focus of the earlier models, came to be seen as just one of many factors influencing development. Aid was seen as having an impact on a country's growth only if sound domestic policies were in place. Those concerned about poverty also focused on the policy environment. Growth did not necessarily cause poverty to worsen; in fact, the East Asian experience showed that growth was the most effective antidote to poverty and that egalitarian policies could facilitate growth.

This view led to an increased emphasis on conditionality: aid would only be given if a country agreed to a specific set of reforms, which generally included fiscal discipline, open capital and trade flows, deregulation and reform of public enterprises, the establishment of efficient banking systems, legal reforms, and the liberalization of prices, exchange rates, and interest rates. The IMF and the World Bank led the way in negotiating the structural adjustment programs that embodied these reforms, establishing them as a condition for providing funds to developing countries, many of which had been hard hit by the debt crisis that began in 1982. Several empirical studies during this period confirmed that reforms of this kind were a necessary, though not a sufficient, condition for economic growth.

The United States' dominance in foreign assistance diminished in the 1970s and 1980s, as other industrial countries channeled increasing resources toward this purpose, in line with their increased economic capacity. In the 1950s and most of the 1960s the United States had accounted for over half of all official development assistance provided by the market democracies. Since that time, other industrialized countries have shouldered an increased share of the burden, rising to 55 percent in 1970, 72 percent in 1980, and 88 percent in 1995.

Most of the industrial countries have reduced their bilateral assistance, and the resources of the multilateral institutions and regional development banks are coming under increased strain. The end of the Cold War has led to an increased demand for assistance to the transition economies as well, stretching development resources ever thinner. Political support for development assistance has eroded, as the need to battle Communism in the developing countries has virtually disappeared and as donor-country budgets have been squeezed. Yet the need for development assistance has continued. Countries without the social, economic, and political bases for development, in Africa and elsewhere, are likely to be left behind as other developing countries experience rapid growth.

Official development assistance from the 21 DAC members has declined by almost 6 percent in real terms since 1991 (12 percent when accounting for exchange rate fluctuations), to $59 billion, or only 0.27 percent of their aggregate GNP in 1995. Bilateral disbursements accounted for about two-thirds of the total in 1995; multilateral sources provided the remainder.

Patterns of U.S. Aid Today

In 1996, the Congress authorized $6.7 billion for foreign assistance spending. That amounts to 0.1 percent of GDP, or a per capita expenditure of $27. Contrary to conventional wisdom, evidence indicates that American public attitudes are sufficiently supportive of foreign assistance to justify a modest increase (Box 7-3). The Administration has requested an increase of 10 percent in its budget request for fiscal year 1998. If approved, that would restore spending to fiscal 1988 levels in real terms.

Over 1993–95, 30 percent of U.S. non-military bilateral aid was allocated to Egypt and Israel. Other major allocations went to Ethiopia, Haiti, India, Peru, Russia, South Africa, Turkey, and Ukraine. The share of U.S. aid going to the sub-Saharan African countries has grown in recent years, while the share to Latin America and East and South Asia has diminished. A special initiative to assist the transition to democracy in South Africa allocated over $600 million, to be disbursed over 1995–97. During the 1990s the United States and other donors have also developed assistance programs for the transition economies. U.S. aid has supported a

Box 7–3.—Foreign Aid and U.S. Public Opinion

Most Americans think the U.S. Government spends far too much on foreign aid, to the neglect of domestic needs. Yet a number of surveys and polls have found that this widespread attitude toward aid is based on false premises. In one survey the median respondent guessed that the United States provides 40 percent of all aid to developing countries; the true figure, according to the OECD, is 12 percent. Likewise, most of those surveyed believe that the United States spends a larger percentage of its GDP on aid than other industrial countries, whereas in fact we spend the smallest. Those surveyed estimated that 18 percent of the Federal budget goes to foreign aid; the true figure is well below 1 percent. The median respondent (before being told the actual level of aid) would raise the amount of aid provided to 20 percent of all international aid and 5 percent of the Federal budget. Focus groups and polls have found that Americans, in general, retain some sense of moral obligation to help those in need.

wide range of projects, including privatization programs in the Czech Republic and Russia; legal reform in Kazakstan, the Kyrgyz Republic, and Russia; public health programs in Russia and Ukraine; and humanitarian assistance in Bosnia and Herzegovina. A large portion of U.S. aid goes to social infrastructure such as health and education; less than 6 percent of U.S. bilateral development assistance is spent on economic infrastructure—in sharp contrast with Japan, which expends almost one quarter of its aid on the promotion of transport and communications alone. An increasing amount of aid from the United States and other countries is absorbed by crises and humanitarian relief.

In addition to providing bilateral aid, the Administration strongly supports the international financial institutions which provide multilateral aid. In its 1998 budget request, the Administration has asked that funding for multilateral development banks be restored to fiscal 1990 levels of more than $1.4 billion.

As already noted, in addition to their regular nonconcessional lending the international financial institutions provide concessional financing for the poorest countries that lack access to alternative financing. Funds for these "soft" loans come from contributions by the wealthier countries and income earned from past projects. The World Bank's IDA remains the single most important source of such funding, having approved an annual average of $6 billion in concessional lending over the past 5 years. It is therefore vitally important that the United States deliver in full on its outstanding commitments to the IDA. The IMF's Enhanced Structural Adjust-

ment Facility (ESAF), established in 1987 to provide concessional financing to low-income countries experiencing balance of payments problems, has been enlarged to $15 billion—roughly double its original size. Thus far, over 40 countries have borrowed from the ESAF; in return for these funds they agree to undertake 3-year structural adjustment programs. Recently the United States, together with the World Bank and the IMF, spearheaded a new initiative to reduce debt burdens for highly indebted low-income countries (Box 7–4).

A FRAMEWORK FOR FUTURE LEADERSHIP

For half a century the Cold War defined the principal objective of U.S. international policies: contain Communism. As we have seen, with the end of the Cold War the United States has had to rethink its objectives. We can all agree that the government should seek to increase economic growth, raise living standards, protect the environment, and enhance security in all its dimensions. But in this *Report* we have tried to be more precise: What are the special roles of the Federal Government? And how have these roles changed as the environment we face has changed—with the end of the Cold War, the emergence of new economic powers, and the globalization of the world economy? Markets, individual responsibility, community—all are essential to the society that we have created and are creating still.

Some guidance here is provided by the theory of international public goods. Pure public goods have two properties. First, they are nonrival in consumption. That is, their consumption by one person does not diminish the benefit another person derives from consuming them. Another way of putting this is that the cost of providing the good to the second person, given that it has already been provided to the first, is zero. The second feature of public goods is that they are nonexcludable. That is, it is difficult or impossible to prevent someone from enjoying the good, regardless of whether he or she has paid for it. Classic examples of such goods are national defense and basic scientific research.

It has long been recognized that the market, if left to itself, will tend to underproduce public goods. As discussed in Chapter 6, this creates a rationale for government action to provide public goods for the benefit of the entire community. The efficient provision of such services is essential to long-term growth, and without the government they would be inefficiently underproduced.

Some public goods are local in nature; they affect people only in a limited geographic area. Examples include police protection and urban parks. Other public goods are national, such as the defense of a country. Still other public goods are international, benefiting

Box 7–4.—Reducing the Debt Burden of Developing Countries

Heavy debt burdens have severely constrained the economies of many developing countries for well over a decade. At the end of 1995, the total external debt of developing countries was estimated at over $2 trillion, equivalent to 150 percent of their annual exports. The debt burden varies dramatically across regions: the sub-Saharan African countries faced an average debt-to-exports ratio of 270 percent in 1995, whereas in East Asia the ratio was only 83 percent. The successful reduction of commercial bank debt combined with economic policy reforms in the first half of the 1990s has helped launch many middle-income developing countries on a path of sustainable growth. For many low-income countries, however, debt remains a barrier to growth and development.

The U.S. Government has actively pursued several multilateral and bilateral initiatives to reduce the debt burden of the poorest developing countries. In mid-December 1994 the Paris Club of creditor countries (including the United States) agreed on more-generous debt reduction terms—called "Naples terms"—which would lower the debts of heavily indebted poor countries by up to 67 percent. During the 1996 fiscal year, the United States entered into debt-reduction agreements with seven countries under Naples terms. In February 1996 the Congress authorized a pilot debt buyback and swap initiative for lower income Latin American and Caribbean countries that are actively engaged in economic reforms, particularly investment reforms. Countries must also meet certain political criteria: they must have democratic governments and not have an egregious record in the areas of human rights, narcotics, and terrorism.

The United States has taken a leadership role in developing the newest multilateral debt initiative with the World Bank, the IMF, and the Paris Club. The Heavily Indebted Poorest Countries (HIPC) debt initiative would enable heavily indebted poor countries with a strong record of policy reform to achieve sustainable debt burdens, by offering them comprehensive debt relief from all creditors, including the international financial institutions. The HIPC focuses on those economies that adopt programs of adjustment and reform supported by the IMF and World Bank, but still face an unsustainable debt situation even after the full application of current debt-relief measures. Eligibility will be determined on a case-by-case basis.

people across the globe. Four important types of international public goods are international economic cooperation, international peace and order, some forms of environmental protection, and basic scientific knowledge. In all these areas the United States can benefit itself and other countries by promoting international cooperation.

INTERNATIONAL ECONOMIC COOPERATION

All countries can benefit from economic cooperation. But as with all public goods, countries have an incentive to free-ride on the cooperative efforts of other countries, deriving satisfaction from the existence of public goods but letting others bear the costs. They also have an incentive to take actions to serve their own interests, which may turn out to be short-sighted. Despite these inherent obstacles, the United States has led the international community to many notable successes in economic cooperation. One important success has been the coordination of macroeconomic policies among the major industrial countries through the annual Group of Seven summits. All nations gain from the increased international macroeconomic stability that this coordination provides. The President has also initiated separate labor summits among the Group of Seven, to provide a forum for collective exploration of how best to promote job creation and alleviate joblessness.

The Organization for Economic Cooperation and Development has served as a catalyst for successful economic cooperation. Within the OECD the industrial countries discuss policy in a host of areas, including macroeconomic policy. Another OECD accomplishment was a 1993 agreement that established a set of international principles for shipping policy, to promote a freely competitive environment for shippers and prohibit discriminatory fees and charges based on port of origin. A Maritime Transport Committee serves as a forum for dialogue, consultation, and harmonization of OECD member policy in this area.

The International Trading System

One of the most important dimensions of international economic cooperation has been the efforts led by the United States and its partners to strengthen the international trading system. This chapter has discussed the many benefits that accrue from this process. The work of expanding and reinforcing this system is ongoing, however, and there is still much to do.

As successive GATT rounds have reduced tariffs to a small fraction of their earlier levels, an important part of the agenda for trade policy now is the reduction of nontariff barriers to trade. Nontariff barriers are more complicated than tariffs and more difficult to eliminate. Indeed, many arise out of the legitimate pursuit of domestic policy goals, yet their effect is to restrict imported

goods and services. The fact that they may serve or appear to serve legitimate domestic goals makes them often hard to remove. For example, although health and safety standards usually serve legitimate domestic purposes, they may be applied in ways that discriminate against imports. This is particularly the case when these policies are not set in a transparent and open manner.

Nontariff barriers are also more difficult to measure. They are not easily expressed by a single number like the average tariff rate. Although limited progress has been made in calculating tariff equivalents for some nontariff barriers, much room for improvement remains.

The United States and other countries have made progress in reducing nontariff barriers of various kinds. Some success has been achieved in the area of product standards, which historically have been based on the attributes of domestically produced goods. Provisions of the WTO and NAFTA require that product standards have a scientific rationale; they also promote the use of internationally recognized standards.

Another consequence of globalization is the increase in cross-border competition within industries. Trade officials are concerned that this competition be fair. Antidumping and countervailing duty laws are intended to ensure fair competition. Countervailing duties may be imposed when imported goods benefit from subsidies by a foreign government and injure a domestic industry. The duties are designed to offset the subsidies, restoring a level playing field for the injured domestic producers. Antidumping duties are intended to offset international price discrimination that causes injury to a domestic industry. Both measures are covered by WTO agreements, which authorize and set boundaries on the application of the rules.

Separate domestic laws also govern competition (antitrust) policy. When barriers between markets were high, these two sets of laws, domestic and international, could operate more or less independently. With globalization proceeding apace, and with international market barriers falling, the two increasingly overlap, yet they embody distinct criteria. Competition promotes economic efficiency, and the goal of both sets of laws should continue to be to promote competition and efficiency.

In static trade theory, under perfect competition U.S. customers may actually gain from accepting foreign subsidies, which lower the cost of imports. This gain more than outweighs the loss to U.S. producers harmed by the subsidized competition, and the winners can in theory compensate the losers. However, dynamic considerations and imperfect competition may yield a different conclusion. Government subsidies may allow foreign firms to engage in predatory behavior, permanently altering strategic dynamics in favor of foreign firms and, in the extreme, driving U.S. firms out of business. There

are questions, however, about the prevalence of circumstances in which predation is likely.

Subsidy "wars," in which governments compete for market share by offering subsidies to some of their most promising firms, may occur. Such competition results in excessive investment in the subsidized industry, to the detriment of economic efficiency and welfare. To prevent subsidy wars in shipbuilding, to take one example, the OECD countries have signed an agreement to curb subsidies to shipbuilders. The President has asked the Congress to ratify this agreement, which was slated to go into effect in 1996.

Protecting the Rules-Based System. The international trading system applies a set of rules to countries' trading behavior. One of the most important is the requirement that countries not take arbitrary measures such as raising tariffs. Other core rules include the most-favored-nation principle, in which countries agree generally to extend the same tariff rates to all other countries, and national treatment, which requires countries to give foreign-based companies treatment equivalent to that received by domestic companies.

Economic dislocation may result from trade liberalization, and the Federal Government is committed to helping those adversely affected, for example through trade adjustment assistance. Safeguard provisions in WTO agreements permit a variety of temporary measures, including increased duties, to allow an industry injured by imports to adjust to the increased competition.

WTO rules permit the use of these measures, as well as countervailing duties and antidumping measures, under carefully circumscribed conditions. As traditional tariffs decline, countries are increasingly resorting to such remedies to shield their domestic industries from import competition. In certain instances it has become clear that the rules are being improperly interpreted or applied, or it is simply difficult to discern how proceedings are being conducted or to understand the basis for decisions. U.S. firms are frequently the targets. This is not surprising, given the role of the United States in the international trading system and the competitiveness of U.S. firms, which often operate with low profit margins. The United States has had to monitor closely the implementation of foreign trade remedy laws in order to discourage, identify, and correct such irregularities. The United States is committed to the active use of WTO dispute settlement provisions to address such irregularities and to ensure the fairest possible treatment for exporters.

Regional Trading Agreements. Free trade is an international public good from which all nations benefit. Regional trading arrangements can serve as a bridge to broader, even worldwide agreements—true global public goods. Toward the end of the 1980s the proliferation of regional trading agreements picked up speed. These

arrangements have always had both costs and benefits. The main benefit is that they create trade by reducing barriers between member countries. The cost is that they can also divert trade from more efficient producers outside the region to less efficient producers within the region. WTO rules permitting regional trade agreements are designed to make it more likely that the trade creation effects dominate. For the North American Free Trade Area, the benefits of trade creation are likely to have outweighed the costs of trade diversion, because its members have relatively low trade barriers for most products from outside the region and because members are free to lower their external tariffs individually.

Regional trading arrangements have also proved to be powerful tools for liberalizing trade more widely, and thus increasing economic efficiency. The President has led efforts within APEC and the FTAA talks to provide fora for neighboring countries with common interests to negotiate pathbreaking arrangements. These arrangements can then serve as a pattern on which multilateral efforts within the WTO can build. For example, the United States-Canada Free Trade Agreement contained a chapter on services that became a model for the Uruguay Round negotiation on services. When regional trade arrangements are structured on this model, the danger of their succumbing to the temptation of trade diversion is diminished.

Cooperation in Competition Policy

Noncompetitive conditions in global markets can interfere with the efficient allocation of resources and harm consumers and producers throughout the world. Global cartels restrict output and increase prices of both consumer goods and producer inputs. Anticompetitive exclusionary or predatory practices can insulate firms from competition and exclude more efficient or innovative firms from the market. Such practices reduce economic welfare and retard economic growth.

Noncompetitive conditions in a domestic market can also serve as a barrier to trade. An example is the $4.5 billion Japanese market for flat glass. Three large domestic producers, with separate, exclusive distribution systems, have dominated this market. It can be extremely difficult for new producers, foreign or domestic, to enter such a market. Under a 1995 agreement with the United States, the Japanese government and the Japanese flat glass industry agreed to a set of steps to open this market to greater competition.

International cooperation in competition policy can help prevent or mitigate the harm resulting from anticompetitive practices. Such cooperation can take three basic forms. First, authorities can reduce unnecessary regulation (which can often act as a market barrier) and eliminate legal barriers to competition by both domestic

and foreign firms. Second, they can promulgate and vigorously enforce appropriate competition policies, designed to prevent such conduct as price fixing, carving up of markets, and anticompetitive mergers. Third, they can cooperate in bilateral and multilateral efforts to investigate and share information regarding potential violations, and to enforce their competition policies.

International Capital Markets and Rules for Investment

We have already discussed the benefits to developing countries from receiving foreign investment, as well as the benefits to investor countries, including the United States, from investing in developing countries, and from the trade that accompanies foreign direct investment in particular. Impediments to FDI therefore may act as a nontariff barrier, making it more difficult to export into a market. This is a complicated issue: countries often are genuinely sensitive to the perceived loss of economic sovereignty associated with inward foreign investment, yet such concerns are often difficult to distinguish from efforts to protect domestic companies from competition. In that sense, countries engage in negative-sum behavior when they restrict foreign investment without a clear rationale for doing so, such as national security. These restrictions harm both their domestic consumers and foreign producers.

The United States has engaged in several efforts to improve the international climate for direct investment. The United States has a vigorous program to negotiate bilateral investment treaties with developing and transition economies, to ensure that U.S. firms are able to invest abroad on the same liberal terms under which foreign companies may invest here. To date, the United States has signed 38 such treaties, of which 26 are in force. Several more are pending ratification, and negotiations with other countries are ongoing. NAFTA included an agreement that substantially lowered barriers to cross-border investment and established procedures for settling investment disputes. The United States has been engaged in extending this work through the negotiation of the Multilateral Agreement on Investment (MAI) under the aegis of the OECD. This Administration helped launch the MAI negotiations in May 1995, and they are scheduled to be completed in 1997. The United States' objective in these talks is an agreement that will substantially liberalize foreign investment by establishing clear legal standards on expropriation, providing access to binding international arbitration of disputes (as in NAFTA), and allowing unrestricted investment-related transfers across borders. It is envisioned that accession to the MAI will be open to both members and nonmembers of the OECD, thus making possible an extension of MAI rules to developing and transition economies.

Funds also flow across borders in the form of securities and bank loans. Although these flows may be less stable than direct invest-

ment flows, which cannot readily be withdrawn, they can provide an important source of funding. The Group of Ten participate in the General Arrangements to Borrow, which is prepared to make roughly $24 billion available to the IMF in time of financial emergency that might pose systemic risks. Recently the Group of Ten and some other countries agreed to double the amount of emergency funding by creating an additional mechanism, the New Arrangements to Borrow. Contributors will include some of the fast-growing developing countries.

Ad hoc international coordination has also facilitated such actions as the liquidity support provided to Mexico during its early–1995 financial crisis, discussed in last year's *Report*. This U.S.-led international support helped Mexico implement the policies necessary to avert default, regain access to international capital markets, and restore the basis for sustainable growth. Confidence has now returned, and Mexico has repaid its borrowings from the United States ahead of schedule. The temporary support extended to Mexico also helped protect vital U.S. interests: American exports and jobs, the security of our common border, and the stability of other emerging market economies.

The United States worked at the June 1995 Group of Seven summit in Halifax to reduce the likelihood of similar crises in the future. Initiatives launched at Halifax included the New Arrangements to Borrow and the IMF's Special Data Dissemination Standard, which aims to increase the quality and availability of economic and financial data for emerging markets and other countries. This and other initiatives, including the IMF's capital markets surveillance, help promote a transparent and rules-based international financial system, benefiting both providers and users of capital.

In banking, the Bank for International Settlements, which promotes the cooperation of central banks and acts as agent for international financial settlements, has recently enlarged its membership to include the central banks of key emerging markets. The BIS is also the secretariat for the Basel Committee on Banking Supervision, the source of many agreements aimed at strengthening the supervision of internationally active banks. The committee is made up of representatives from 12 industrialized countries (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States), but in recent years it has extended its outreach to other countries. It is currently working with a group of developing and transition economies to formulate guidelines for effective bank supervision.

International Development and Humanitarian Assistance

The greatest contribution that the industrial countries can make to growth in developing and transition economies is to preserve

these countries' access to international markets for trade and investment. Despite the dramatic increase in private investment flows, however, many developing countries, especially the poorest, still require assistance from the high-income countries and international organizations. It is important that these programs continue if the poorest countries, especially in Africa, are to persevere in the political and economic reforms that many have undertaken in recent years. These countries particularly benefit from aid that encourages their development of the necessary human resources and institutions in which a growing economy can take root. The development of such an institutional base helps ensure that aid flows are used effectively.

As growth in the poorest countries begins to accelerate, the United States and other donor countries will benefit from new and expanding export markets and investment opportunities, as well as from greater international political stability, because it means that countries have an increasing stake in preserving the international rules-based system. Effective assistance depends on international cooperation, both through the coordination of bilateral aid within the DAC and elsewhere, and through multilateral agencies. One aspect of this cooperation has been negotiated limits on the tying of aid to the import of products and services from donor countries (Box 7–5).

Another important aspect of assistance is humanitarian assistance. Human suffering in poor countries due to war, natural disaster, or famine concerns us all; these are circumstances in which countries can be most effective if they coordinate their efforts. Much of this coordination takes place through the United Nations; thus the United States and other countries benefit from continuing to support this organization. The multilateral development banks also provide humanitarian assistance. Continued support for development assistance can also serve as preventive medicine, to forestall the social, political, and economic deterioration that creates these crises in the first place.

INTERNATIONAL PEACE AND ORDER

All the international activities discussed in this chapter presuppose an international environment in which nations act peacefully and respect international order. Throughout the 20th century the United States has led world efforts to create such an environment. Besides military and diplomatic efforts, the United States has also employed economic means to achieve peace and order. Although economic sanctions may be viewed as a somewhat blunt instrument, they are one available tool to use against countries that threaten international stability, particularly when the situation

Box 7–5.—Tied-Aid Agreements

Tied aid is officially supported concessional financing linked to procurement in the donor country. It distorts trade when used to win contracts for capital goods exports rather than to provide true aid. Tied aid can misallocate resources from more efficient to less efficient producers whose governments offer such financing.

When used for export promotion, tied aid can also distort aid flows by directing scarce resources away from high-priority development projects to projects of interest to industries in donor countries. Traditionally, tied aid has directed donor support toward, for example, large electric power generation and telecommunications projects and away from social sector projects. This skewing of resource allocation in developing countries increases the capital intensity of development and burdens the recipient country with high maintenance expenditures in the future.

In response to complaints from exporters that they often faced tied-aid competition for capital goods projects, the United States negotiated rules in the OECD to govern tied-aid programs. The rules, dubbed the Helsinki Package, became effective in February 1992. They apply to nonconcessional financing and stipulate that higher income developing countries (those with incomes per capita above $3,035) are ineligible for all tied aid. The least developed countries remain eligible for all types of financing because of their desperate shortage of capital. For countries in between, such as China, Indonesia, and India, tied aid is prohibited for projects that can generate cash flows sufficient to repay debt on commercial terms.

It is hoped that the Helsinki rules will reduce distortions and maximize the total resources—aid and commercial financing—available to promote economic development. Last year the OECD issued guidelines for the use of tied aid, to draw the line between projects that should receive export credits on commercial terms and those that may receive tied aid. Since 1992, under the Helsinki Package, annual tied aid has declined from $10 billion to about $4 billion. The tied aid that remains has been shifted away from major capital projects capable of supporting financing on commercial terms to legitimate aid projects such as water and sewerage, and health and other social services.

calls for something stronger than diplomatic protest, but less strong than military engagement.

Sanctions come in a variety of forms. Sanctioning countries can restrict exports, impede imports, freeze assets, prohibit investments, restrict financing, withdraw government aid, or ban commercial airline flights. Throughout the 20th century, sanctions have been used primarily to restrict exports to and investment in a targeted nation. Import controls are rare. Examples include the ban on oil imported from Iran in response to the 1979–81 hostage crisis and from Libya in response to terrorist threats, a 46-year ban on all imports from North Korea, and a recent prohibition on oil imports from Iraq. Formerly employed predominantly to complement war efforts or destabilize hostile regimes, sanctions have been used since the 1960s to express condemnation of human rights abuses, force compliance with international treaties (such as nuclear nonproliferation treaties), promote democracy, and secure compensation for expropriated property.

As with any policy tool, the rational evaluation of sanctions involves a weighing of the costs and benefits. This can be difficult; whereas the costs of sanctions can often be expressed in economic terms (e.g., reduced output and growth), the aims of sanctions are frequently noneconomic. Sometimes sanctions may have mainly symbolic value, as part of the imposer's efforts to demonstrate resolve and commitment.

Certain characteristics increase the likelihood that sanctions will contribute to the desired outcome. As one would expect, sanctions that inflict higher costs on the target nation tend to be more effective. The costs, to both the sanctioner and the target, depend among other things on the type of sanction employed, the extent of trade and financial linkages, the relative size of the two nations, and the ease with which the target product or transaction can be substituted.

Like other public goods, sanctions are generally more effective when more nations participate in imposing them. Multilateral sanctions usually impose greater costs than unilateral sanctions; the ability of target nations to access alternative suppliers and providers of aid decreases as the number of sanctioning countries increases. Multilateral sanctions may also reduce the likelihood of long-term costs on those who impose sanctions. Multilateral sanctions on South Africa contributed to the decision to dismantle apartheid. United Nations-sponsored sanctions against Serbia in connection with the recent Bosnian conflict contributed to a severe contraction of Serbia's economy and pressured Belgrade to negotiate a peace agreement. The success of these sanctions was due in part to the coordinated action of the international community, Ser-

bia's high dependence on foreign trade, and the narrow production base of the Serbian economy.

ENVIRONMENTAL ISSUES

Many environmental issues can be viewed through the analytic lenses of public goods and externalities. (Externalities occur when actions taken by one person have unintended and uncompensated positive or negative effects on others.) Clean air, for example, is nonrival, in that anyone can breathe it without impairing the ability of others to breathe; it is also nonexcludable, in that it is next to impossible to charge people for the right to breathe fresh air. As we have seen, some environmental issues are local or national in scope, whereas others are international or global and can therefore benefit from international coordination. We have already touched on some of the environmental challenges facing the United States as they relate to aid to developing countries. International coordination among all nations is important in such areas as global warming and preservation of the ozone layer. U.S. leadership is needed if such coordination is to take place.

All nations benefit from efforts to reduce emissions of greenhouse gases that may lead to global warming. However, in the absence of an international agreement on emissions, every nation has an economic incentive to avoid taking action on its own. That is why the United States is working toward an effective agreement entailing global reductions of greenhouse emissions. The goal of these negotiations is the signing of an international agreement in Kyoto in December 1997 to limit these emissions.

Another example is the overharvesting of ocean fisheries. Each user ignores the marginal cost of his or her use on the stock of fish required for regeneration. All potential fishing countries benefit from the efforts of all other parties to curtail fishing, but each has an incentive to deviate and overfish now. At the November 1996 annual meeting of the International Commission for the Conservation of Atlantic Tunas, the United States took a leading role in establishing an international fishery management organization to enforce fishing quotas in order to protect a declining stock of bluefin tuna. The United States was also one of the first nations to ratify the 1995 United Nations Agreement on Conservation and Management of Straddling Fish Stocks and Highly Migratory Fish Stocks, which promotes regional commissions to coordinate the management of ocean fishing and provides for binding dispute settlement in accordance with the Law of the Sea.

BASIC RESEARCH

Knowledge may be the purest of public goods, and the most important for economic growth and development. All nations benefit

from increases in scientific knowledge that form the basis for technological advances. As with other public goods, however, there is a temptation to free-ride. Some countries have specialized in adapting basic research done in other countries into profitable business opportunities. If the quest for greater basic knowledge and improved technology is to continue, it is important that all countries contribute to the support of basic research. Free-riding on other's efforts can also be minimized if owners of intellectual property are adequately compensated.

International research cooperation is a complex issue. The lines between basic and applied research are increasingly blurred. Tension often arises between the goal of increasing the competitiveness of domestic companies, by channeling research funding to them, and the goal of increasing the world's stock of scientific and technological knowledge, from which we all gain.

CONCLUSION

Enormous changes are taking place in the international economic environment, made possible by U.S. international leadership throughout the postwar era. The United States has led the development of a stable international economic system based on a clear set of rules. These rules have made possible our Nation's preeminence in exports, and thus have served our own interest, but they allow other countries to benefit from exports, too. And that, as we have seen, serves our interest as well. Rules also encourage a more stable world economy, avoiding the calamities of the 1930s and 1940s.

With the emergence of developing and transition economies onto the stage long dominated by the United States and the other industrial democracies, the need is great to ensure that the international system welcomes these new participants and allows both them and the established powers to derive mutual benefit from the system. The new participants themselves must continue to liberalize their trade regimes and their domestic markets, so that all countries can realize the gains from trade. Efforts should also continue to spread prosperity to those countries that have yet to see sustained growth, in part through assistance in developing the necessary economic institutions and human resources.

The United States must also continue to lead the ongoing effort to improve the international economic system. The international public goods of economic cooperation, peace and order, environmental protection, and basic research promise great benefits if countries work together, but such cooperation requires strong leadership.

To exercise that leadership role, we must understand the lessons of the changes that are sweeping the globe. The collapse of central

planning tells us of the dangers of overreaching by governments, and reminds us of the key role of Western governments in ensuring a rules-based domestic and international marketplace. The rise of the East Asian economies and the revival of Latin America teach us about the fundamentals of economic growth: saving, education, technological progress, stability, openness to international trade, and equity. We must work to maintain these conditions at home and assist other countries in implementing them abroad. Finally, increased globalization reminds us of our interdependence with other nations and the benefits that we all receive from our economic interactions.

If the United States continues to exercise economic leadership in the world, maintaining the international rules-based system that we, above all others, helped develop, we will contribute to our own prosperity as well as to that of the rest of the world.