Perspectives on Economic and Foreign Policies

Charles Wolf, Jr.
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One exception is the article “Economic Instruments, Military Instruments, and National Power,” which was published in the Winter 1994 issue, Vol. 1, No. 2, of the Korean Journal of Defense Analysis. The other exception is an unpublished article, "Economics and Security in Central Europe," co-authored in January 1992 with Harold Brown, in which we sought to link the GATT negotiations, widened market access to the European Union, and potential enlargement of NATO membership. The general ideas we advanced in that article are still relevant, although the specific context has changed.

The essays have been collected here without revision on the premise that they may gain in value by being read in conjunction with one or more of the others. For example, the papers on "The New Mercantilism," "Clearing the Fog Over U.S.-Japan Economic Relations," and "Resuming the Protracted U.S.-Japan Economic Debate" are complementary, as are the essays on "Aiding Russia and Ukraine" (co-authored with King Mallory) and "Rebutting the Anti-Shock Therapists."

I have divided the eleven papers into three parts to suggest some of these complementarities. Part I deals with various facets of the post-cold war disorderly world, including the global arms market and a practical approach to its control, relationships between economic and military policy instruments, the aforementioned links between economics and security in Central and Eastern Europe, the disjuncture between the “zones of peace” and “zones of turmoil,” and the new mercantilism of strategic trade policy. Part II focuses on Japan and China, and Part III is concerned with economic reform, "shock therapy," system transformation, and Western aid to Russia and Ukraine.
CONTENTS

Preface ........................................................................ iii

I. FACETS OF THE WORLD ECONOMY

1. PITFALLS OF PUBLIC POLICY: THE NEW MERCANTILISM .......... 3
   I. Ideas, Policies, and Defunct Economists .......................... 3
   II. The Case For Strategic Trade Policy and Industrial
       Policy ..................................................................... 5
   III. The Drawbacks of Size and Experience .......................... 7
   IV. What About Japan? ................................................. 10
   V. The Politics of Preferential Industrial and Trade
       Policies in the United States ...................................... 13

2. ECONOMIC INSTRUMENTS, MILITARY INSTRUMENTS, AND NATIONAL POWER. 15
   I. Introduction ................................................................ 15
   II. Central Theme, Terminology, Measurement ..................... 17
   III. Relationships and Interactions ..................................... 22
   IV. Examples and Illustrations ......................................... 24
   V. Concluding Observations ............................................ 27

3. GUN CONTROL AT HOME, DECONTROL ABROAD .................. 30

4. ECONOMICS AND SECURITY IN CENTRAL EUROPE .................. 33

5. REVIEW OF: THE REAL WORLD ORDER: ZONES OF PEACE/ZONES OF
   TURMOIL .................................................................. 37

II. JAPAN AND CHINA

6. RESUMING THE PROTRACTED U.S.-JAPAN ECONOMIC DEBATE .......... 43

7. CLEARING THE FOG OVER U.S.-JAPAN ECONOMIC RELATIONS .......... 47

8. THE STRONG YEN OF A WEAKENED ECONOMY .................... 50

9. CHINA'S ENLARGED ECONOMY ....................................... 53

III. RUSSIA AND SYSTEM TRANSFORMATION

10. AIDING RUSSIA AND UKRAINE ....................................... 59
    The Consensus in Favor of Aiding Russia and Ukraine .......... 59
    Some General Considerations ........................................ 60
    Designing a Foreign Assistance Package .......................... 61
    1. Restructuring and Swapping Foreign Debt .................... 62
2. Encouraging Foreign Investment by Expanding Risk Insurance ............................................. 63
3. Assuring Russia and Ukraine a Reasonable Share of the World Arms Market .......................... 66
4. Dismantling Nuclear Weapons and Retrofitting Nuclear Reactors ............................................. 67
11. REBUTTING THE ANTI-SHOCK THERAPISTS: COMMENTS ON IAN MASTERS’ INTERVIEW WITH PETER REDDAWAY ................................................................. 69
I. FACETS OF THE WORLD ECONOMY
1. PITFALLS OF PUBLIC POLICY: THE NEW MERCANTILISM

I. IDEAS, POLICIES, AND DEFUNCT ECONOMISTS

In one of his many insightful observations, John Maynard Keynes noted that "practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist." He noted further that the power of ideas can be immense "both when they are right and when they are wrong," concluding that "it is ideas, not vested interests, which are dangerous for good or evil."

One of these currently captivating ideas is that aggressive government actions -- including "strategic trade policy" and "industrial policy" -- will bring about increased efficiency (the slogan is "competitiveness") of U.S. firms in international markets. It can be argued that Keynes's insight is wide of the mark in this instance because the principal sources of these ideas are not defunct, but alive, vigorous, articulate, and influential. They include such academic advocates as Paul Krugman at MIT, John Zysman at Berkeley, and Laura Tyson, formerly at Berkeley and currently Chairman of the Council of Economic Advisors, and numerous well-known commentators and popularizers including Clyde Prestowitz, James Fallows, Chalmers Johnson, Pat Choate, and Karel van Wolferen. However, Keynes's original insight can be defended by a reasonable counterargument: antecedents to these current ideas can be traced to several "defunct" mercantilists of bygone centuries, including Jean Baptiste Colbert, Thomas Mun, Antonio Serra, Friedrich List and Alexander Hamilton, who advocated state action to promote specific exports, restrict specific imports to protect domestic industries, and provide trade surpluses, gold bullion and, it was believed, enhanced state power.

"Strategic trade policy" and "industrial policy" differ from one another, in some respects. Strategic trade policy typically focuses on

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1A slightly edited version of this essay was published under the title "The New Mercantilism" in Issue No. 116 of the Summer 1994 edition of The Public Interest. Reprinted by permission. Copyright © 1994, National Affairs, Inc.
promoting specific exports and limiting specific imports. Industrial policy focuses on the development of key domestic industries, with international trade accorded a secondary role. Nevertheless, despite their differences, both policies share a fundamental premise: government can and should select certain industries, technologies, or firms whose advancement is of “critical” importance for the performance of the economy as a whole, and accord the selected ones some form of preferential treatment -- whether through government subsidies, special tax advantages, restricting imports to protect domestic producers, or promoting exports by pressing the Japanese or other trading partners to assure special market access for these critical products. To some, “critical” means “high technology” industries in general (Tyson); to others, it means semi-conductors in particular (Fallow), telecommunications, or automobiles, or machine tools, or even rice. In the interests of simplicity, and at a modest cost of precision, I will refer to both sets of policies as “preferential industrial and trade policies,” or (PITP).

The appeal of PITP to many “practical men” (as well as some impractical ones) is understandable because there are reasonable theoretical arguments as well as empirical evidence and experience to support it. What is usually overlooked by those who accept the arguments for PITP is the existence of strong counterarguments, as well as indications that the usually-cited evidence in support of PITP is at best ambiguous, and probably wrong. While the Japanese experience is usually cited in support of PITP, there is a simpler and more compelling explanation behind the Japanese story. Moreover, if a vigorous set of preferential policies were to be pursued in the context of the U.S. political system, there are strong reasons for expecting them to fail badly.

In the following discussion, I will first summarize the theory that provides support for PITP, next consider the theory’s shortcomings, then elaborate a countervailing view, and thereafter suggest why efforts to implement such policies in a pluralistic, interest-group democracy like our own can be expected to generate costs and mistakes that exceed its potential benefits. Along the way, I will suggest that Japan’s notable
economic and technological accomplishments of the past three decades -- notwithstanding a current recession that has been deeper and longer than that of the United States, and seems likely to continue in face of the U.S. recovery -- are attributable to other reasons than those allegedly provided by Japan’s own neo-mercantilist policies.

II. THE CASE FOR STRATEGIC TRADE POLICY AND INDUSTRIAL POLICY

The intellectual basis for STP rests on several well-established economic precepts: first, the concept of "economies of scale" -- the notion that large firms can realize certain gains and efficiencies not accessible to small ones; and second, the concept of "economies of learning" -- the notion that firms or individuals, or organizations, that have acquired abundant experience thereby become more proficient and efficient than less experienced entities.

A corollary of the gains associated with large size, and with accumulated learning and experience, are certain spill-over benefits ("externalities") that are presumed to accrue to the economy as a whole, or to other industries in addition to the advantages directly realized by the large and experienced firms themselves.

These externalities -- benefits external to the firm or industry generating them, and not susceptible to its control or exploitation -- may be of several types and may arise in various ways. For example, if a firm or industry achieves a large size, it may provide a large market that redounds to the advantage of feeder industries, firms, and suppliers. Thus, the large size of the automotive industry provides opportunities for electronics, tire, lighting, and other component producers that, in turn, enable them to increase their own efficiency through larger scale production. Economists refer to these spill-overs as "pecuniary externalities."

Another type of spill-over -- referred to as "technological externalities" -- may result from the experience, learning, and accumulated know-how of the originating firm or industry, and the more highly-skilled labor pool that is thereby created, with potential benefits for other firms or industries. The development and remarkable growth of the Internet system, as a result of linking computers and
telecommunications, provide a striking example of technological externalities that hugely benefit international business, finance, and commerce.

**The Effects of Size and Learning**

Describing the importance of firm size, Laura Tyson asserts that: "In such ["technology-intensive"] industries, costs fall and product quality improves as the scale of production increases, [and] the returns to technological advance create beneficial spill-overs for other economic activities" (Tyson, 1992). Economies of scale are typically represented by economists in the form of unit costs that decline as the scale of output, or its capacity, increases. Economies of scale are traceable to the increased opportunities of large firms for division of labor and specialization of tasks, and for spreading fixed costs over a larger volume of output as production rises. Thus, supermarkets typically can underprice small grocers and profit from doing so. And, at least until recently, it has been presumed that large-scale steelmakers, like USX or Kobe, can out-compete small steel producers because of the economies of scale that the larger firms can realize.

"Economies of learning" -- that is, efficiencies resulting from accumulated experience -- are also presumed to result in lower costs, and to yield a competitive advantage for more experienced firms that have been in business for a longer time. Economists typically use various proxies to measure the efficiencies that result from experience: for example, the cumulative output of individual firms, or the cumulative years they have been in business. The premise underlying these proxy measures is that the greater the cumulative output, or the greater the number of years of accumulated experience, the more proficient will be their operations, and the stronger their competitive position relative to that of less experienced firms. Thus, IBM, General Motors, and Toyota have been presumed -- at least in the past -- to derive a competitive advantage from their accumulated learning and experience relative to that of their competitors.

Economies of scale, and economies of learning, plus the corollary externalities with which they are associated, provide the intellectually
respective ideas that have led many "practical men" to accept the case for "strategic trade policy," and national "industrial policy." Because of economies of scale and economies of learning, it is argued, public policy should invoke one or another type of preference, or subsidy to "establish a lead in an industry, [and]...once this lead is established it becomes self-reinforcing and tends to persist." (Krugman, 1991.) Tyson refers to the "first-mover advantages" that can be realized by dominant firms and technologies. (Tyson, 1992.)

So much for the theoretical arguments for strategic trade policy. The trouble with them is that there are equally convincing, although less familiar, theoretical arguments against them. There are strong theoretical reasons why large size and long experience may entail offsetting burdens, risks, and disadvantages.

This debit side of the ledger consists of the "diseconomies" or rigidities due to large scale, and the diseconomies or rigidities that may be associated with learning and experience. The effect of these countervailing rigidities may be to place large firms, or firms that have been in business a long time, at a competitive disadvantage compared to some smaller-scale, less-experienced, firms. In the realm of ideas that should vie for the allegiance of "practical men," the outcome is unclear. The intellectual case for smaller and newer firms is as strong as that for large, mature ones. Sometimes Goliath will win, other times David.

III. THE DRAWBACKS OF SIZE AND EXPERIENCE

Diseconomies of scale and of accumulated experience may be especially acute in an economic environment increasingly characterized by closer and multiple linkages between domestic and international markets. These linkages are accompanied by more rapid product and process innovation due to increasing speed and frequency of information transmission and reception (additions to the Internet have recently been running at a rate of 12% per month!), increased trade in goods, services and intellectual property (between 1986 and 1992 the volume of world trade grew at an annual rate more than twice as rapid as the rate of growth in world output), and increasing mobility of capital (as
reflected by the increasingly close alignment of real interest rates in international markets).

In this rapidly changing environment, achievement of large scale and long experience may entail significant drawbacks -- specifically, rigidities of scale and rigidities of learning.

First, consider the rigidities that often characterize large organizations because of the hierarchy, bureaucracy, standard operating procedures, and cumbersome administrative routines that they spawn. These characteristics may create a wedge between the lowered costs of acquiring information from outside a large organization -- information about new production techniques, new products, new marketing and distribution methods resulting from the rapid pace of economic change and globalization mentioned earlier -- and the higher costs of processing and utilizing information inside a large organization. The wedge between acquisition and utilization costs can lead to higher internal transaction costs, and slower response and reaction times in large organizations than in smaller ones.

Consequently, opportunities for developing new products and processes, or modifying old ones, may arise outside the large-scale firm, and even be observed by its members -- products and processes that are closely related to, or substitutable for those of the large firm -- without evoking an adequate or a timely response inside the firm. The limited and dilatory responses of General Motors in the '80s, and of IBM, Toyota, Daimler-Benz, Sears Roebuck, and American Express in the '90s, to changes and challenges in their respective industries, exemplify these countervailing tendencies. To be sure, there are counterexamples: General Electric, Alcoa, Sony, and the “Baby Bells” following the breakup of AT&T have continued to be innovative and adaptive as well as large and experienced. That diseconomies of scale exist doesn’t imply that they cannot be surmounted by large firms, nor that they will uniformly dominate the advantages of large size that were referred to earlier.

Diseconomies or rigidities of learning and experience arise in ways analogous to those associated with diseconomies of scale. Acquisition of experience, through a large volume of accumulated output over time,
may immure the experienced firm by precisely what it has learned to do so well. Accumulated learning and experience may have a "lock-in" effect that induces lethargy and a failure to absorb and respond to product and process innovations that impend. These innovations may then displace or encroach upon the product line or the marketing style that the established firm has learned well and practiced long. Therefore, the experienced firm may be less accessible and receptive to information about innovations underway outside the firm than are newer and less experienced firms.

Thus, the experienced firm may suffer from an insularity that drives a wedge between information that could be acquired from outside, and information that is actually acquired. The established and experienced firm may be placed at a disadvantage relative to newer and more nimble competitors. IBM's displacement by Apple in the personal computer business and Intel's major gains over Hitachi in semiconductor dominance are cases in point.

Rigidities of learning may be likened to the familiar left-brain, right-brain duality: over-development of the left brain may result in an impediment to the stimulus and insight that the right brain can otherwise provide. Too much learning of one thing may be at the expense of reduced receptivity to learning other things.

So, the strong theoretical arguments for preferential industrial and trade policies confront equally powerful theoretical arguments against it. Large size and accumulated experience confer initial advantages, but may later entail offsetting disadvantages. This suggests there may be an optimum size -- large, but not too large -- and an optimum degree of experience -- some, but not too much -- that is conducive to strong competitive ability.

"Practical men" can be liberated from the thrall of the ideas underlying PITP by becoming aware that the supporting arguments are less convincing than they've been presumed to be, and that there are plausible arguments against them.
IV. WHAT ABOUT JAPAN?

Besides the captivating effect of some economists' theories about economies of scale and of experience, and the industrial policies and strategic trade policies these ideas ostensibly support, Japan's stellar economic performance is typically cited as a compelling example of the effectiveness of such policies and a demonstration of why the U.S. should adopt similar policies. Notwithstanding the fact that Japan's recent economic performance has been considerably less stellar than formerly -- its negative real growth in 1992 and a barely positive one in 1993 are between 2 and 3 percentage points behind the corresponding rates in the U.S. -- its economic accomplishments in the past two decades have demonstrated remarkably rapid growth, aggressive development of high technology industry, and a large and continuing current-account surplus with the United States and the rest of the world.

Some observers attribute this record to Japan's industrial and trade policies, orchestrated by the Ministry of International Trade and Industry (MITI), and encompassing various predatory Japanese business practices, "Keiretsu" industrial organizations, protection of the domestic market, discriminatory regulatory and contractual practices, and subsidized capital access for favored manufacturing industries. James Fallows invokes all of these to account for the rapid and profitable development of Japan's semiconductor industry in the 1980s. (Fallows, 1993), neglecting to mention, however, that the profits and the outlook of the principal movers in the industry -- Hitachi, Toshiba, and NEC -- have plummeted sharply in the 1990s. Moreover, even if MITI's trade and industrial policies were successful in semiconductors, its overall batting average looks much less impressive when account is taken of its efforts in other manufacturing industries -- notably, steel, shipbuilding, and aircraft.

In any event, while MITI's record is at best mixed, Japan's remarkable economic accomplishments in the past two decades can be understood, and accounted for by simple explanations, without recourse to Japan's complex industrial and trade policies. The principle known as Ockham's Razor suggests that simple explanations should be preferred
to complex ones when both are available. Recourse to complexities should only be invoked when simple explanations prove inadequate.

The most compelling explanation for Japan's formidable economic accomplishments lies in four simple factors, some of which are likely to be transitory:

- **Investment** - Japan's annual rate of aggregate domestic investment averaged about 24 percent of its gross domestic product in the 1980s, compared with 15-16 percent in the United States.
- **Savings** - Japan's domestic savings averaged 28 percent of GNP in the same period, compared with only 13-14 percent in the U.S.
- **Labor** - Japan's work force is highly disciplined, trained, industrious, and literate.
- **Management** - Japanese managers are energetic, competent, and experienced, and they have learned -- through international competition and the powerful dictates of the Japanese work ethic -- to strive continually to improve product quality and cut production costs.

Japan's high domestic investment accounts for nearly all of the difference in average annual growth rates -- about 2 or 3 percentage points -- between Japan and the United States during the 1980s. Also, the investment difference largely explains Japan's strong performance in capital intensive sectors, like automobiles, consumer electronics, and semiconductors. Investment and savings, taken together, account for Japan's persistent trade surpluses (explained by the excess of Japan's savings over its investment), as well as the persistent trade deficits of the United States (explained by the excess of American investment over its savings). To be sure, public policies in Japan -- specifically, tax policies -- have provided strong incentives to boost both savings and investment: for example, by reducing the taxation of income that is saved rather than spent, by forgoing taxation of long-term capital gains, and by using a broader interpretation of what can be
construed as research and development and thus can qualify for special tax advantages than the interpretation that is allowed in the United States. These Japanese macroeconomic policies, which have strongly encouraged savings, long-term investment and R&D, contrast with ones in the United States that have not. And these Japanese policies have been pursued with a government sector that is about 20 percent smaller than that in the United States, as measured by the size of total government spending relative to GDP.

Together with the preceding factors, the quality of Japan's labor and of its management practices account for the relatively more rapid growth of Japanese productivity -- until the past 4 or 5 years when U.S. labor productivity growth has equaled or exceeded that of Japan.

Nevertheless, after Japan recovers from its currently severe recession, the country's savings rate may fall somewhat as a result of rising consumer demand, and a population whose proportion of elderly people is increasing more rapidly than that of the United States and other industrialized countries. Japan's investment rate may also decrease due to tighter capital markets, and a reallocation of resources from the private to the public sector. As a result, its productivity growth will probably also decrease in the coming years.

In short, application of Ockham's Razor suggests that the principal explanation for Japan's impressive economic accomplishments, and for its prominent position in the world economy, is quite independent of its industrial policy and its "strategic," neo-mercantilist trade practices.

This conclusion doesn't mean that U.S. negotiators, dealing bilaterally with the Japanese as well as multilaterally in GATT, should refrain from continued efforts to change Japan's atavistic policies and practices. On the contrary, the United States should seek to bring such liberalizing changes about, even though they would principally benefit Japanese consumers rather than American exporters (because the exporters of other countries would get some share of the increased trade with Japan that would result). It remains an unresolved question whether these changes are more likely to ensue through U.S. efforts to exert external pressure directly [gaiatsu] or instead through more indirect
means, such as assisting Japanese consumers to exert pressure internally [naiatsu].

V. THE POLITICS OF PREFERENTIAL INDUSTRIAL AND TRADE POLICIES IN THE UNITED STATES

Even if the theoretical basis for PITP didn’t suffer from the shortcomings discussed earlier, and even if the example of Japan provided clearer evidence in its support, the political realities of attempting to implement such preferential policies in the United States would make this an unpromising course to follow.

Strategic trade policy, or “industrial policy,” or “managed trade” inevitably imply that some industrial or technological categories -- semiconductors, automobiles, electronics, machine tools, pharmaceuticals, or rice -- would be chosen for preferential treatment because they are considered “critical” for one reason or another. Responding to this incentive, “rational” firms and trade associations acting in the interest of their respective constituencies can be expected to allocate more time, attention, and resources to lobbying activities to obtain the potential preferment. Innovative and creative talent would be deployed either to develop persuasive reasons why particular technological or industrial categories should be interpreted so as to allow the interested parties to qualify for preferential treatment, or to argue for adding other categories because they are essential to complement and reinforce those already established. In a world of finite resources, these redeployments will be at the expense of allocating the corresponding resources toward more directly and economically productive pursuits. The outcome of such interest-group competition in the American political arena will reward the most successful political representations, rather than the most technologically promising firms. There is no particular reason for expecting these two domains to coincide. Even if it can be convincingly argued that computer chips are different from potato chips because the former generate positive “externalities,” the case for preferential policies is unconvincing on political grounds. If such policies were put in place, a swarm of second and third-tier claimants will emerge
with various degrees of persuasive arguments for their inclusion within the preferential safety net.

In sum, whatever the acknowledged shortcomings of the market and the merits of considering ways to remedy them, invoking preferential public policies toward this end entails the inevitable risk of other shortcomings that will accompany the remedial public policies. This is not to say that remedial public policies should not be considered. Rather, it is to add a note of caution lest attempts to rectify the shortcomings of the market lead to greater shortcomings of the attempted non-market remedies. Attempted therapies may be as bad as, or worse than, the maladies they seek to cure. The most promising industrial and trade policy for the United States is to persist in bringing the protracted Uruguay round of GATT to a successful conclusion, thereby promoting more open and competitive international markets for services and intellectual property, as well as commodities.
2. ECONOMIC INSTRUMENTS, MILITARY INSTRUMENTS, AND NATIONAL POWER

I. INTRODUCTION

Among the extraordinary changes that have occurred in the international arena since the late 1980s, three sets of events have provided particular support for several now widely accepted propositions pertaining to economic and military policies, national interests, and national power. The three events are the advent of perestroika in 1986 and its consequences, including the dissolution of the Soviet Union; the fall of the Wall in 1989 and its consequences in central and Eastern Europe; and Japan’s dramatic economic performance, as well as the associated occurrence of large and sustained current account deficits by the United States and surpluses by Japan.

The widely accepted propositions are:

1. Economic interests, issues, and instruments are becoming increasingly important and influential in international affairs.
2. Military issues, interests, and instruments are becoming less important and influential.
3. U.S. national power -- at least, the salient (economic) dimension of that power -- has declined and/or is declining relative to that of other countries.
4. This decline is due to overemphasis on military issues and instruments.
5. "Reversal," "renewal," and "revitalizing" of U.S. power and influence depend on redressing this misplaced emphasis by focusing more on economic issues and economic policy instruments.

Among the best illustrations of these views are the following:

From Samuel Huntington:

In this new environment . . . military capabilities are likely to be less important than they have been in the past. Economic measures will be central . . . ; diplomacy and economics will be crucial . . . the promotion of U.S. strategic interests will involve not only foreign and defense policy but also domestic policy on the budget, taxes, subsidies, industrial policy, science and technology, child care, education, and other topics.

The one area of U.S. weakness is economics and the challenge in that arena comes from Japan. In a world where economic power and economic issues are increasingly important, that challenge is a real one.²

From Paul Kennedy:

. . . because a top-heavy military establishment may slow down the rate of economic growth and lead to a decline in the nation’s share of world manufacturing output, and therefore wealth, and therefore power, the whole issue becomes of the [sic] balancing the short-term security afforded by large defense forces against the longer-term security of rising production and income.³

. . . the United States now runs the risk, so familiar to historians of the rise and fall of previous Great Powers, of what might roughly be called “imperial overstretch”: that is to say, decision-makers in Washington must face the awkward and enduring fact that the sum total of the United States’ global interests and obligations is nowadays far larger than the country’s power to defend them all simultaneously.⁴

From John Mueller:

Throughout the developed world countries are coming to the conclusion that the most desirable thing to have, after such basic concerns as life and security are taken care of, is

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prosperity. That is, just about everybody would rather be rich than just about anything else.⁵

From my RAND colleague, David Ochmanek:

As the Soviet threat atrophies, there will be less willingness on both sides of the Pacific to compromise on what used to be seen as second-tier issues. We who work on national security issues have long consigned trade and burdensharing to the second tier, focusing on deterrence of the Soviet Union and arms control in the first tier. Now these are becoming secondary or tertiary, and trade, burdensharing, and cooperation on the environment are the first-tier issues.⁶

I agree with many of these propositions and citations. They contain much truth, but what they contain is not the whole truth.

There are three reasons why at least some reservations about their validity is warranted. First, the precise meaning of some of the terms is not clear and hence some of the propositions are ambiguous. Second, the propositions seem too simple to deal adequately with the complex phenomena they purport to describe and explain. Third, errors and miscues have so often in recent years followed in the wake of commonly accepted assertions and forecasts that it is probably worthwhile to be skeptical about the validity of this new area of apparent consensus.

In this paper, I will begin to address these matters in several ways: trying to clarify some of the ambiguous terminology, suggesting various ways of measuring -- or at least thinking about measuring -- the terms that are used, and proposing several simple and explicit hypotheses about the relationships and interactions among the terms and concepts.

II. CENTRAL THEME, TERMINOLOGY, MEASUREMENT

My central thesis is that economic and military instruments of power are intimately linked, rather than each being independent of the

other, or one being clearly and invariably dominant over the other; that the relationships between them are often complex and subtle; and that these relationships vary in different post-Cold-War contexts. Economic power, to be effective, sometimes complements (reinforces, or even requires) military power or may be complemented by military power, and at other times and in other circumstances, can substitute for it. The converse proposition is also valid: Sometimes military power can substitute for economic power, and at other times and in other circumstances, military power may complement (reinforce, or require) economic power. (Nils Bohr once observed that the opposite of a shallow truth is false, while the opposite of a deep truth can also be true.) Because of these interactive relationships, it may be unwise to consign military power to abrupt neglect or precipitous decline.

I will first define these terms, and then explore the hypothesized relationships among them.

Several plausible indicators or metrics can be used, at a very aggregative level, to define and size what I mean by "economic instruments" of power: GNP, population (and hence labor supply and per capita GNP), and a country’s current account surplus. GNP and per capita GNP are typically used by the previously cited authors in their references to economic power, or to changes among countries in their relative economic power. I have added the current account surplus as an economic instrument of power on the arguable premise that it represents a capital resource that, in principle at least, can be guided or shunted, by the use of one policy device or another, toward or away from a particular target area that may be the object of a nation’s power.

At a more disaggregative level, the economic instruments of power can be defined in terms of components of the GNP that are believed to be particularly significant -- for example, advanced and advancing technology sectors such as telecommunications, microelectronics, semiconductors, fiber optics, engineering and bioengineering industries -- whose special significance resides in the economy-wide, growth-promoting effects they are thought to generate, in the monopoly market power (and supernormal profits) they may entail, or in their putative connection to present or future military capabilities. Similarly, specific components
of the population and manpower pool may be considered of greater significance as economic instruments of power than the population as a whole: for example, certain types of skilled labor; managers; design, production, and marketing engineers; and of course economists and policy analysts. One can also think of more disaggregative components of a country’s international accounts as providing another type of economic power: for example, the size of its market to which foreign access may be permitted or denied. This can be roughly proxied by its level of imports. (Note that a country’s level of imports are -- potentially, at least -- a source of economic power, not just its exports.) Another component is the volume of exports of goods and services that a country can direct toward or exclude from foreign areas.

Economic instruments of national power provide a means of influencing behavior by conferring rewards or imposing penalties. For example, a country’s capacity to provide economic assistance or to apply economic sanctions by withholding or denying trade or assistance depends on what I have defined as its economic instruments.

Indicators of a country’s “military instruments” of power are, at an aggregative level, its military spending, the size and quality of its military forces (active and reserve), and the magnitude of its military capital stock. At a more disaggregative level, the military instruments entail specific types of forces and capabilities: for example, air and sea lift; projection forces; accurate delivery systems; command, control, and intelligence capabilities; and so on.

Military instruments of national power provide a means of influencing behavior in the international arena by deterrence or compellence; that is, by using force, or a credible threat to use it, to dissuade other countries from using force; or by using force to coerce, preempt, or repel their attempts to use it.

Before being criticized for neglecting the important role of political and diplomatic instruments of power, I will simply acknowledge that I take their importance for granted. I do not mean to imply that the political and diplomatic instruments are less important than the ones I have referred to, nor that they also interact with the economic and military instruments in complex and substitutive, as well as
potentially reinforcing ways. But I want to focus here more directly on the economic and military instruments of power because much of the recent discussion about the new and changing international "order," and much of the previously cited literature, have this focus. In the following discussion, I will abstract from the acknowledged effects of political and diplomatic instruments to concentrate on the economic and military ones.\(^7\) This should not be construed as discounting or diminishing the importance of politics and diplomacy, but as a departure from realism in the interests of convenience.

To continue this glossary, I define "power" as a generalized and more or less "convertible" asset capable, within limits, of protecting and advancing national interests. I will not have much to say about "national interests." To the extent that references to them occur in what I have already said, I construe national interests as very broad goals and principles -- for example, "life, liberty, and the pursuit of happiness" or, alternatively, military security, freedom, and prosperity. Defining national interests in more operationally useful terms depends on particular policy contexts and circumstances that I will not be addressing here, although I will make some brief observations later about the relation between national or public interests, and private ones.

In defining power as an asset that can be used to protect and advance national interests, I am avoiding the question of willingness or motivation to use it.\(^8\) Thus, while the magnitude or "value" of U.S. power may be large (and may actually have grown in relative terms), our willingness to use it may have receded as a result of the end of the cold war and the dissolution of the Soviet Union, as well as our increasing disposition to attend to serious problems at home rather than those abroad.

\(^7\)In a formal sense, the political and diplomatic instruments can be thought of as other variables, or "shift" variables, that may affect the shape and impact of the economic and military instruments.

\(^8\)Alternatively, motivation and volition might be construed as encompassed by the political instruments of power that I mentioned earlier.
I have not been able to think of a suitable metric for national "power" that is independent of the contributory instruments. If one thinks of power as a convertible asset capable of protecting and advancing national interests by influencing behavior, specific examples of the exercise of that power can be cited, as well as instances in which there were serious limitations on its exercise and effectiveness. For example, the United States demonstrated its power in organizing the Desert Shield/Desert Storm coalition, and applying that power to bring about a stipulated goal: ejection of Iraq from Kuwait. U.S. power -- economic as well as military -- has also been largely -- if arguably -- responsible for victory in the cold war and the disestablishment of communism in the former Soviet Union. Recent efforts to bring about peace and stability in the Middle East by bringing Arabs and Israelis to the negotiating table have exemplified the extent of U.S. power as well as its limitations. Other illustrations of the limitations on U.S. power abound: for example, U.S. removal from naval and air bases in the Philippines; the inordinate delays and difficulty encountered in trying to bring about a phased removal of export subsidies in agricultural trade and eventual completion of the Uruguay Round of GATT; inability to bring about successful outcomes in Bosnia, Somalia, Haiti, etc.; our limited ability to control international sales of conventional weapons or to stop proliferation of nuclear, chemical, and biological weapons technology, and so on.

Before too much is made of these limitations on U.S. power, it is worth recalling that even during much of the 1960s and 1970s when the United States was supposedly "hegemonic," our ability to influence external events along lines we desired was no less, and perhaps even more, limited. Recall, for example, that a Marxist-Leninist regime became firmly entrenched in Cuba at the start of the 1960s; that nuclear weapons were acquired by France (1960), China (1964), and India (1974), despite strong U.S. opposition; that France exited from NATO in 1967; and that South Vietnam was overrun by Communist North Vietnam in 1975. If one compares the period of our supposed hegemonic past with the period of supposed U.S. decline in the 1980s and early 1990s (in which the cold war has been won, the Soviet military threat has eroded,
communism has been crumbling, and democratization and marketization are advancing, if sometimes faltering), it can be argued that our effective "power" has been greater in the recent period of supposed decline than in the prior one of putative hegemony!

III. RELATIONSHIPS AND INTERACTIONS

Having more or less clearly defined the terms, I hypothesize three sets of relationships among them:

- First, in a given context, the national "power" of the United States depends on (is a function of) its economic instruments, military instruments, and a set of other "shift" variables, including in particular the political and diplomatic ones.\(^9\)

- Second, economic instruments depend on the level of economic instruments existing in the preceding period; the level of military instruments in the current period; and a set of other influencing factors or variables, such as the GNP, its division between investment and consumption, its growth rate, or particularly significant sectors or components of the GNP.\(^10\)

- The third relationship stipulates that the level of military instruments depends on the level of military instruments in the preceding period, the current level of economic instruments, and a set of other influencing factors or variables, such as

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\(^9\) In symbolic terms, this can be expressed as:

\[
Pt^q = P(E_t, M_t, X_t)
\]

where \(P\) denotes power, \(E\) is a vector of economic instruments, as defined above, \(M\) is a vector of military instruments, as defined above, and \(X\) is a vector of other variables, including political-diplomatic ones. The index \(q\) denotes the state, context, or initial conditions, and \(t\) refers to a specified time period.

\(^10\) This relationship can be expressed as:

\[
E_t = E(E_{t-1}, M_t, Y_t)
\]

where \(Y\) is a vector of other relevant variables, and the other terms are as defined in the preceding footnote.
alliance relationships, political and social cohesion, and so on.\textsuperscript{11}

The second and third relationships reflect comments I made earlier: The effectiveness of economic instruments depends in part on the military instruments, and vice versa.

I will not conjecture about the possible functional forms of these relationships, whether they are additive or multiplicative, whether and when they are subject to increasing or decreasing returns, and so on. In general, the national power specified in the first relationship will be greater when the economic instruments or the military instruments are larger. In some circumstances, one of these may substitute for the other. In other circumstances, more of one instrument will have little or no effect on "power" without an increment of the other (complementarity). Examples of both situations are offered later.

The relationship that defines the economic instruments (equation (2)) is also complex. To the extent that the military instruments take resources away from the economic instruments, the relation between them is negative and conflicting. To the extent that military instruments (for example, military technology or foreign military sales) may generate spillovers that benefit the economy at large or particular sectors within it, the relationship between them is positive and synergistic. A similar complexity applies to the functional relationship between the military instruments and the economic instruments in the third hypothesis. Resources devoted to economic instruments reduce those available for military instruments, but the economic instruments may also raise the effectiveness of resources (e.g., technology) devoted to the military the instruments.\textsuperscript{12}

\textsuperscript{11}This can be stated as:

\begin{equation}
M_t = M(M_{t-1}, E_t, Z_t)
\end{equation}

where $Z_t$ is a vector of other relevant variables.

\textsuperscript{12}These relationships can be summarized in the following diagram:
IV. EXAMPLES AND ILLUSTRATIONS

The complex and varying relationships between economic and military instruments of national power can be illustrated by examples from the recent past, as well as by their application to potential and current national security issues.

One aspect of these relationships is illustrated by a security problem that will be increasingly serious in the new and not necessarily orderly world environment: namely, the problem of establishing and enforcing controls on arms shipments to various regions, especially arms trade involving weapons of mass destruction. To begin with, one can use standard force-on-force analysis to establish one or more stable military balances at different levels of regional military forces. This problem is not unfamiliar, although it has certain complicating characteristics in some regions. For example, in the Middle East, stability must be sufficiently robust to meet the test of different and

![Graph showing isopower curves](image)

The curves $P_1$, $P_2$, $P_3$ are "isopower" curves showing differing combinations of the economic and military instruments, $E$ and $M$, respectively, that can be combined to achieve the same level of national power, with $P_3 > P_2 > P_1$. The shift variables $x$, $y$, $z$ can move the isopower curves up or down as indicated by the two-pronged arrow. Strict complementarity between the economic and military instruments would be illustrated by L-shaped isopower curves. In this case, adding more of either instrument would be ineffectual in advancing national power, in the absence of an increment in the other instrument.
possibly changing combinations of potential adversaries, rather than a single and static adversarial alignment. However, let us assume that such more or less stable force balances can be calculated, and that they would be reassuring rather than threatening to all members of the region.

The question then arises, how might these balances be enforced by controlling weapons imports into the countries of the region, and similarly, by controlling exports from the weapons suppliers? If arms import "quotas" for different categories of weapons can be established for each country of the region (derived from the prior analysis of stable balances), then perhaps it may be possible to enforce those quotas by using, for example, the extension or threatened withholding of economic assistance as inducements for compliance by the importing countries, or by using technical assistance to provide improved defense budgeting processes for the countries of the region, to increase transparency and accountability, to facilitate collective monitoring of military transactions, and thereby contribute to compliance. In this case, a military instrument -- arms control as a contributor to stable deterrence -- might be strengthened (complemented) by the use of economic instruments.

Inducing compliance by the sellers -- both the G-5 principal ones and the second-tier ones (e.g., Brazil, Argentina, Korea, Taiwan) -- is as least as difficult as inducing compliance by the buyers. Consistent with establishing quotas for the types and quantities of arms imports by regional buyers, export quotas might be agreed upon by the arms sellers, analogous to producer agreements that have been negotiated and maintained for many years (with varying success) in connection with internationally traded commodities such as tin and coffee. Enforcement of regional arms export quotas might be accomplished by invoking another economic instrument: namely, the threat of excluding firms that engage in quota-breaking sales from access to the U.S. market. This would be another instance of using economic instruments to complement military ones.

Economic instruments will also affect the direct employment of force in the post-cold-war era. Effective use of force is likely to be
Increasingly dependent upon collaborative participation among several countries acting in concert. Whether this collaboration occurs through the United Nations or through ad hoc coalitions -- as Desert Shield/Storm reflected both elements -- the ability to form such coalitions will increasingly be influenced by the use of economic instruments to provide rewards or to impose or threaten economic penalties.

In the specific case of Desert Shield and Desert Storm, economic instruments of power were vital adjuncts of the military instruments that were employed. For example, curtailment of Iraq’s access to oil revenues and to imports of equipment and spare parts probably contributed to weakening its capabilities for resistance. And economic instruments and incentives provided important elements in bonding the extraordinary U.S.-led, 29-nation coalition engaged in Desert Shield and Desert Storm. Forgiving Egypt’s $7 billion military debt to the United States, as well as extending a promise of more direct economic support in the future, was an important inducement to enlist and sustain Egypt’s crucial role in the coalition. Assurance to Turkey that it would receive offsets to the economic sacrifices it made in embargoing oil deliveries from Iraq played a similarly crucial role in facilitating its participation in the coalition.

Although the Soviet Union’s direct participation in the Gulf coalition was limited -- confined to a couple of naval vessels in the Gulf to help enforce the embargo against Iraq -- its political role was crucial in supporting the twelve Security Council resolutions. To be sure, this role became somewhat tendentious, if not mischievous, in the final stages of the war. Nevertheless, the generally supportive stance of the then-Union government was valuable, and doubtless was influenced by Soviet interest in avoiding anything that might further impair its access to Western trade, technology, and finance.

In a similar vein, other members of the diverse coalition -- notably Syria, Pakistan, Czechoslovakia, and Poland -- were probably influenced by considerations of economic interest and access. In these cases, economic instruments contributed to enhancing the effectiveness of military ones. In other instances, the causality has run the other way. For example, Saudi Arabia’s steadfast resistance, after the Gulf
war, to OPEC pressure to reduce oil production and raise oil prices, suggests the reverse causal sequence. In this case, the U.S. military effort to protect Saudi security against the threat from Iraq resulted in economic benefits -- an enhancement of U.S. economic instruments -- as well as benefits to other oil importers.

The closeness, as well as complexity, of the linkages between economic and military instruments was also exemplified by the anomalous roles of Japan and Germany. Both countries opted to provide funds rather than forces due to real or alleged political constraints that hindered their deployment of forces abroad. To this extent, their economic instruments substituted, albeit imperfectly, for military ones. From the standpoint of the coalition as a whole, the significant Japanese and German financial commitments helped to support the coalition by providing economic benefits (or relief from costs) for several of the "front line" states whose military participation would otherwise have been more uncertain.

V. CONCLUDING OBSERVATIONS

Some of the relationships between economic and military instruments can be summarized in several propositions -- some of which are deducible from the preceding discussion, while others are not. Some of the propositions support and supplement those stated at the beginning of this paper, while others do not.

1. The international environment of the post-cold-war era will be characterized by uncertainty, unpredictability, and instability. Many, and probably most, of the instabilities will warrant a response from the United States of neglect -- benign or otherwise -- either on grounds of limitations on our power to bring about predictable improvement and relief, or on grounds of limited national interests in trying to do so. But some instabilities may warrant the application of either or both economic and military instruments, by the United States acting alone or, more likely, acting in coalition with others. To choose when and how to respond in such circumstances will
entail a capacity for resilience and flexibility in the design and deployment of economic and military instruments -- both separately and in combination.

2. In an environment in which uncertainty (in the sense of incalculability rather than of probabilistic "risk") will be greater, and a higher premium will be placed on "resilience" and flexibility, the economic instruments of power may be of increased importance relative to the military instruments. (To be more precise, the respective partial derivatives of power with respect to the economic instruments will probably rise relative to those with respect to the military instruments in the functional relationships described above). The ability to confer economic advantages or impose economic penalties will be preferred over the ability to coerce, although the latter will sometimes augment the effectiveness of the former.

3. The contention that U.S. domestic socioeconomic problems (which affect the magnitudes of the economic instruments, as defined above), are due principally to overemphasis on the military instruments is not tenable. Resources devoted to military instruments in the United States over the last several decades have varied from 3 or 4 percent to 6 or 7 percent. The resources that would be freed by lower levels of military spending would inevitably be divided between consumption and investment, with the former probably absorbing most of the savings (or peace "dividend"). Hence, the predictable incremental effect on GNP growth would be less than half of one percent per annum. Rather than resulting from the magnitude and composition of the military instruments, the socioeconomic problems that impede economic growth and "competitiveness" depend instead on many other complex and troublesome problems and issues that are quite unrelated to the military variables: for example, tax policies, education policies and institutions, health care financing, and "governance" (for example, term limits, campaign funding, executive-congressional relations, and federal-state-local government relations).
4. As already noted, economic performance is minimally affected by whether as little as 3 percent of the GNP or as much as 6 percent of it is allocated for military instruments. To the extent that sustained economic performance is equated with what is sometimes referred to as economic "security," its determinants are largely matters of domestic policy rather than foreign policy.

5. The earlier statement that national "power" can be thought of as a "convertible" asset that can be used to protect and advance national interests has begged the question of defining "national interests" in a meaningful way. While it is legitimate and valid to link national interests to the broad national purposes and values mentioned above, at this high level of generality "national interests" have limited influence on policy because they can usually be invoked to justify widely different policy positions.\(^\text{13}\) For policy-related purposes, it is perhaps more appropriate to think of the national interest or the "public interest" as constituting a weighted sum of private interests. The problem, of course, is how to determine the weights. In a democracy, the weighting of private interests depends on the political process. The "fairness" of that process depends on the access and opportunity that the competing private interests have to present and advocate their respective cases, as well as on the transparency of the process itself.

\(^{13}\)cf Schumpeter's comment: "There is no scientific sense whatsoever in creating . . . some metaphysical entity to be called The Common Good and a not less metaphysical "state," that, sailing high in the clouds and exempt from and above human struggles and group interests, worships at the shrine of that Common Good." (J. A. Schumpeter, "The Communist Manifesto in Sociology and Economics," *Journal of Political Economy*, June 1949, pp. 205-6.)
3. GUN CONTROL AT HOME, DECONTROL ABROAD

Although U.S. domestic policies are trying to restrict sales of relatively small, "old tech" weapons at home (through the Brady Law, the impending ban on assault weapons, and other gun control measures), it is ironic that U.S. foreign and defense policies are expanding sales of large, "high-tech" weapons abroad.

While gun control at home may contribute to improved domestic security, increased foreign sales of advanced weapons create serious hazards for security and stability abroad.

In the late 1980s, the United States' share of the then $55 billion international weapons market was less than that of the Soviet Union (about 25 percent compared to the Soviet Union's 40 percent), while the remaining sales were made by France, China, Britain, and other suppliers. It might have been expected that the weapons market would decrease sharply in the 1990s due both to the end of the cold war and financial constraints faced by third world buyers. In fact, the market is close to its previous peak -- it is currently over $50 billion annually -- as a result of price-cutting and eased financing from suppliers, as well as larger-than-expected demands by buyers in the Middle East, South Asia, and East Asia.

The United States has become by far the largest weapon supplier -- over 60 percent of the current market -- with the remainder divided among Russia, China, France and others. These weapon sales -- including advanced fighter aircraft, missiles, armed helicopters, radars, improved munitions, and naval vessels -- will substantially raise the level of violence in future regional conflicts and in international peacekeeping efforts in which American military forces may be involved.

Three principal reasons underlie the expanded role of U.S. weapons sales. First, improving the defense capabilities of countries friendly to the United States -- notably, Israel, Egypt, Korea, Saudi Arabia,

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Taiwan, Turkey, Greece, Indonesia, among others -- may, in the
disorderly post-cold war environment, enhance regional order and
stability by making these countries less vulnerable to aggression
against them, thereby reducing the probability of regional conflicts.

Second, third-world buyers generally prefer U.S. weapons because
their technical performance and cost characteristics are superior to the
systems provided by other potential suppliers. The weapons market is
working as markets are supposed to work: better producers acquire larger
market shares.

Third, arms exports provide a partial offset to the severe cutbacks
in U.S. defense procurement, and thus a means of keeping the U.S.
defense industrial base from eroding too rapidly.

For those who remain concerned and unconvincing by the logic or the
validity of these propositions, there is a decisive additional reason
that condones expansion of the U.S. share of the global arms market. If
U.S. firms were to forgo opportunities for increasing sales abroad,
other suppliers -- especially France, Russia, China and Britain -- would
simply rush in to fill the breach.

The result is that international weapons proliferation proceeds in
a relatively unchecked way, thereby storing up serious security problems
for the future by ignoring them in the present.

There is a better approach.

As a practical matter, the arms trade can’t be terminated, but it
can be selectively controlled. The essence of a practicable control
regime is to focus prospective controls on only those weapons whose
proliferation would seriously destabilize regional arms balances. These
balances could become unstable if arms imports were to alter
significantly the existing balance of military forces among countries
within, say, the Middle East or East Asian regions, or if such imports
made it substantially more difficult for forces from outside the region
to be brought to bear to maintain the force balance within the region.
The result would be to diminish the effectiveness of external forces as
a deterrent to aggression within the region. "High-leverage" weapon
systems, that would have such effects, can be separately identified
among the much larger set of total arms sales in the global market. For
example, high-leverage systems include missiles, advanced munitions, submarines, radar-absorbing platforms, and advanced sea and land mines.

Fortunately, such high-leverage systems constitute a relatively small proportion -- perhaps only 10 percent of the global weapons market; most weapons sales are for air and naval platforms (aircraft and naval vessels), tanks, armored vehicles, artillery, and communications. So, prohibiting the sale of high-leverage systems would impose only a modest financial loss on the major suppliers, specifically, on the U.S. as well as Russia, China, France, and Britain.

Developing such a selective control system would require agreement among the "big five" suppliers -- the United States, Russia, China, France, and Britain -- to establish a joint "market stabilizing mechanism." The proposed MSM would enforce prohibition against only the sales of specific high-leverage weapons through a system of penalties and rewards that has been developed and described in recent and ongoing work at RAND. To be sure, implementation of such a control regime would pose a formidable challenge to international negotiation among the five principal suppliers, but the task is both practicable and overdue. Accomplishing it is vastly preferable to the present myopic policy of allowing the weapons market to proceed in an unchecked manner at the cost of grievous problems in the not-too-distant future.
4. ECONOMICS AND SECURITY IN CENTRAL EUROPE

by Harold Brown and Charles Wolf, Jr.

One proposition distinguishing the post-Cold War era from the past is that economics matters relatively more, and military power less, than before. Moreover, economic issues have now become more closely and directly linked to security concerns. While these general propositions are widely accepted, specific examples and applications are rarely offered. We propose a specific and important instance of this linkage.

The stability and security of the four Central and Eastern European countries -- Poland, Hungary, and the Czech and Slovakian republics (the so called Visegrad-Four) -- depend no less on their economic condition and prospects (and, in turn, on their access to Western markets) than on assurances against military threats.

Yet a disproportionate amount of policy debate and press attention has, in the wake of President Clinton’s recent European trip, been devoted to the military dimension compared to that devoted to the economic dimension. This balance needs to be redressed.

Prospects for security and stability, as well as for prosperity and democracy, in the V-4 countries will be significantly enhanced by a double-track strategy that, on the economic track, increasingly links them with the EC (or European Union as the EC is now officially known) as well as GATT and, on the security track, links them with NATO (through the North Atlantic Cooperation Council (NACC) and through President Clinton’s “Partnership for Peace”). Moreover, progress on each track will be abetted by pursuing them in parallel and in balance with one other. Unfortunately, and inappropriately, the two tracks are too often discussed and pursued separately.

Increased and sustained economic growth in the V-4 will contribute to their internal stability and security, and these goals will be helped more by expanded trade -- specifically by expanded access of their exports to the markets of the European Community -- than by foreign aid.
Global exports by the V-4 countries are about $35 billion, of which about half already goes to the EC. Although this share has increased in the past two years, V-4 exports to the EC are constrained by the Community's agricultural tariffs and industrial quotas limiting V-4 exports of agricultural and meat products, textiles, and steel.

These restrictions are supposed to be eased during the remainder of the decade. Were they to be rapidly removed, rather than gradually eased, the potential for expanding V-4 exports to EC markets would be substantial -- perhaps 30-40% in the near term future. Although U.S. extension of MFN status to the V-4 countries will also result in some increase in their trade with the U.S., the potential for expansion in EC markets is much greater. Such a rapid expansion of exports by the V-4 countries over the next two or three years could boost their real growth by 3 or 4 percentage points -- increasing their annual GDP growth rates by about one-third. Moreover, as the growth of V-4 trade accelerates, it can be expected that foreign direct investments in the four countries -- estimated at about $2.4 billion in 1993 -- also will be stimulated.

The combined effects of such increased economic growth and foreign investment in the V-4 countries would significantly enhance political and social stability and internal security.

The EC decided in June 1993 that the V-4 could become full members of the Community at an unspecified future time, when they have "met the conditions for membership." Although an argument could be made that one or more of the V-4 already meet the "conditions for membership" to a greater extent than at least one of the present EC members, the argument is beside the point. The EC can and will decide whether and when to admit additional members. Nevertheless, the EC could, in the interim, grant the V-4 countries the greater market access that we propose, without admitting them as full EC members.

Increased market access by the V-4 countries is in the long-term national and collective interests of the EC as well as of the United States because of the impetus this will provide to progress, stability and security in Central and Eastern Europe, and to full integration of the V-4 countries in the world economy.
Expanded V-4 market access should be deliberately synchronized with an expansion of their military linkages with NATO -- through joint planning, joint military exercises, enlarged military training programs, and perhaps some joint military R&D efforts -- under the aegis of NACC and PFP. Synchronization of the economic and military efforts will enhance their mutual effectiveness because progress and confidence gained in one sphere will contribute to progress and confidence in the other. Security issues arise from both the end of the Warsaw Pact and the disjunction between ethnic and state boundaries in Central and Eastern Europe. The terrible but instructive examples of former Yugoslavia and the Caucasus may have discouraged overt conflict, but the possibility remains. Fears of a possible resurgent Russian expansionism led the Visegrad countries (and others further east) to request NATO membership, with its Article 5 commitment ("an attack on one is an attack on all"). But the Russians surely know that any such attempt on their part would revive the Cold War. Although eventual NATO membership of the Visegrad countries should not be ruled out, the NATO leaders at their meeting in January 10th and 11th, 1994, plainly wished to avoid the anti-Russian message that such an action might convey, lest it strengthen the anti-democratic and irredentist forces in Russia and thus become a self-fulfilling apprehension. The NATO Cooperation Council, which includes NATO nations plus all former Warsaw Pact members and all the states of the former Soviet Union, provides a forum for dialogue, although it is too heterogeneous to be more than a forum for dialogue.

The Clinton Administration’s offer of “Partnership for Peace” goes an appropriate step further. It asserts a NATO interest in Central European security -- sensible, provided that the relation between NATO and each partner is determined on a case-by-case basis. A commitment for consultation on possible action against aggression would be a reasonable later step. Each such decision on a country-by-country basis will involve an uncomfortable drawing of lines, with Russia and most or all other states of the FSU on the other side. Hence, Russian security concerns will have to be considered, coupled perhaps with a Russia-specific “partnership for peace” with NATO out-of-area, for example in the Persian Gulf. These uncertainties and ambiguities reinforce the
notion that the pursuit of this lengthy process is even more important than the exact nature of its early stages.

For Central Europe, the security and economic paths should be pursued in parallel because they complement one another. Investments by the West, especially direct investments by Western European and American firms so necessary to the economic development, stability and strengthened democracy of Central Europe, will flow only if there is confidence in its security. That security in turn depends on internal stability, democratization, and economic progress as well as on assurances against external domination. Now that "Partnership for Peace" has been adopted, action to provide access to Western European and North American markets would be the most valuable contribution to V-4 security, because of the economic progress and internal stability it would promote.
5. REVIEW OF: THE REAL WORLD ORDER: ZONES OF PEACE/ZONES OF TURMOIL

by Max Singer and Aaron Wildavsky,

Since the start of the post-Cold War era, policymakers, professors, and pundits have been searching for a suitable way to describe and analyze it. Max Singer and Aaron Wildavsky propose a way that is broad and provocative in The Real World Order: Zones of Peace/Zones of Turmoil (Chatham House Publishers, Chatham, New Jersey, 202 pages).

Singer, sometime head of the Hudson Institute (to whose founder, Herman Kahn, the book is dedicated), and Wildavsky, a Berkeley political science professor, conceive of the "real world order" as consisting of two fundamentally separable, but interacting, parts: the "zones of peace", and the "zones of turmoil." The zones of peace comprise the democracies of Western Europe, the U.S., Canada, Japan, and the Antipodes. Their quintessential attribute is that "modern democracies do not go to war with one another, do not even seriously imagine the possibility of being at war with one another." Singer and Wildavsky acknowledge that there will be disagreements and conflicts among members of the zones of peace, but these countries will not "be divided into competing military blocs seeking to balance each other's power," nor will "the political relations among (these) countries...be influenced by relative military power" (surely, an arguable proposition). Hence, they contend, the "real world order" in the zones of peace "will be fundamentally different from any past world order" -- a point "that most academics and diplomats have so far failed to grasp."

However, the zones of peace contain only 15% of the world's population. The remaining 85% lives in the zones of turmoil, "an immense, slowly boiling cauldron, agitated by powerful internal forces that are impossible to control...where poverty, war, tyranny, and anarchy will continue to devastate lives." Singer and Wildavsky do not

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1A slightly edited version of this essay was published in the August 30, 1993, edition of The Wall Street Journal. Reprinted by permission.
imply that the zones of turmoil are undifferentiated or unchanging. They acknowledge that several new democracies have emerged there, observing that the "difficult processes of economic and political development...will cause wealth, democracy and peace gradually to spread through these zones." However, their view of gradualism envisages 100-200 years for the spread to be extensive.

In elaborating and applying their paradigm, Singer and Wildavsky advance many valid and provocative, as well as arguable, propositions. These propositions, together with my assessment of their validity, include the following:

- military force will be "the ultimate determinant of what happens in the zones of turmoil." (valid, but exaggerated)
- in these zones, "...the transition from...poverty to...wealth...is almost inevitable almost everywhere" (probably wrong), but "the transition to democracy is weaker and more tentative". (probably valid)
- acquisition of nuclear weapons, as well as chemical and biological weapons, will be attractive to countries in the zones of turmoil because "...the democracies will be reluctant to intervene in conflicts in the zones of turmoil, against a country armed with nuclear weapons". (valid)
- in the zones of turmoil, "The United States has no geopolitical or strategic interests...important enough to dominate our policy." Consequently, "our policy -- outside of economics -- should be to support principles...chosen to try to make the international order somewhat more civilized, primarily by developing and enforcing traditional international law". (perhaps valid, surely arguable)

Singer and Wildavsky demur from much of the conventional wisdom about Russia and the former Soviet Union, which they place in the zones of turmoil. They assert that "the United States does not have enough wisdom or power to have much chance of being able to have a positive influence on the survival of stable government in Russia...(because) the
forces at work there are too strong*. Moreover, "while chaos in Russia is not without risk, ...it is not a major threat to the United States...nor will any plausible outcome in Russia produce a dangerous threat to Western Europe." Those who argue "...that American national security depends on preserving stability in Russia," according to Singer and Wildavsky, exaggerate what U.S. policy can possibly achieve there. Instead, Singer and Wildavsky suggest that we should assume that instability "is reasonably likely and do what we can to protect ourselves against its dangers."

The authors conclude that "peace in the zones of democracy is compatible with war in the zones of turmoil," and "the divisibility of peace is one of the fundamental advantages of the current world order."

The Real World Order provides an original and provocative contribution to reflection and debate about the extraordinary era that is upon us. Unfortunately, the book's merit and message are marred by too much first-draft prose and careless editing. One example among many: in discussing Russia's predicament, Singer and Wildavsky say that "no hope can be expected from no economy."
II. JAPAN AND CHINA
6. RESUMING THE PROTRACTED U.S.-JAPAN ECONOMIC DEBATE

Whether the perennial economic negotiations between the United States and Japan are advertised as a "Structural Impediments Initiative" as in the 1980s, or as a "Strategic Trade Policy" initiative as in the present, the accompanying dialogue follows a similarly ritualistic pattern. According to the ritual, the Americans begin and conclude by vigorously asserting that the fundamental problem (of Japan's chronic and large trade surplus with the United States) is Japan's closed markets, and the obvious remedy is to open them. The Japanese start and conclude by no less vigorously asserting that the real culprit is the large U.S. budget deficit, and the obvious remedy is to eliminate it by raising taxes.

In fact, neither side has much going for it. The American contention is accurate but largely irrelevant, while that of the Japanese is simply wrong. Moreover, a departure from the ritual could provide a way of both reducing the chronic Japanese surplus and turning the Japanese economy around from its currently serious recession.

The American stance in the standard ritual is irrelevant because, while Japan's domestic markets are demonstrably less permeable than markets elsewhere, the U.S. current account deficit -- covering both merchandise and services trade with Japan as well as with the rest of the world -- does not result from that fact. It results from, and is exactly equal to, the amount by which U.S. gross domestic saving falls short of U.S. gross domestic investment. Consequently, the global current account deficit -- about 90 billion dollars in 1993, over half of which was with Japan -- won't be significantly affected by the opening of Japan's markets, although such a move is long overdue to improve the well-being of Japan's short-changed consumers and taxpayers.

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and to help in adjusting Japan's mercantilist vestiges to the new GATT world.

The Japanese position has more serious flaws than the American one. The first flaw is empirical: The link that the Japanese assert between the two deficits doesn't exist! As the accompanying graphic shows, in the period since the mid-1980s, the budget deficit and the current account deficit have been uncorrelated with one another. The two deficits moved in opposite directions more often (5 years) than they moved in the same direction (2 years).

Although the two deficits have sometimes been referred to as "twins", they are, at most, only third-cousins!

Second, the Japanese refrain is also weak on theoretical grounds. Establishing a causal link between budget deficits and current account
deficits involves a questionable chain of reasoning. On the one hand, government borrowing (to finance budget deficits) is supposed to correspondingly deplete private savings, thereby increasing the imbalance between domestic savings and investment and hence raising the U.S. current account deficit. On the other hand, government borrowing also raises interest rates and "crowds out" private investment, thereby reducing the imbalance between savings and investment, and presumably lowering the current account deficit. How these complex and offsetting effects net out is neither clear nor well understood, and does not warrant the standard admonition usually imparted by the Japanese to their American interlocutors that cutting the U.S. budget deficit would cure the trade deficit.

Third, the Japanese emphasis on the causal effect of the U.S. budget deficit carries with it mistaken implications for policy. The usual policy inference is that eliminating or at least reducing the budget deficit will equivalently affect the global current account imbalance of the United States, as well as that vis-a-vis Japan. But this inference is wrong. The U.S. current account deficit can be closed or reduced if and only if gross saving in the U.S. is increased, or gross investment is decreased, or saving rises by more than investment, so the gap between them narrows. If the budget deficit is reduced by fiscal policies that increase taxes on high-saving, corporate and individual income recipients, there will be little or no effect on the current account deficit, because revenues raised from these sources will simply reduce the savings that would otherwise have occurred. Hence, the savings-investment imbalance won’t be changed, and the current account deficit won’t be reduced.

Finally, it is worth reminding Japanese policy makers and the influential bureaucracies in the Ministries of Finance, Foreign Affairs, and Trade and Industry, that the U.S. savings-investment imbalance is neither more or less culpable than is Japan’s corresponding but opposite imbalance. The excess of Japan’s domestic savings over its domestic investment is the mirror image of the U.S. shortfall of savings over its domestic investment, and this excess is the fundamental source of Japan’s chronic export surpluses.
Japan's failure to recognize this fact is unfortunately reflected by the new fiscal policies currently under discussion by the Hosokawa government in Tokyo. These policies call for lowering marginal income tax rates (a sensible as well as overdue measure), but retaining and perhaps even increasing the existing tax on consumption (clearly inappropriate, under the circumstances). Were Japan genuinely to seek to remedy, or at least mitigate, its global current account surplus, as well as that with the United States, it would combine lower income taxes with removal of the present tax on consumption, while taxing private savings that have long been treated as non-taxable income. Moreover, this set of policies is precisely what is needed to reverse Japan's economic recession by increasing disposable income and domestic spending, as well as Japan's imports from the United States and the rest of the world. Such a departure by the Japanese from the standard U.S.-Japan economic ritual would thus contribute both to reducing Japan's chronic external surplus and turning its domestic economy around.

Negotiators would be well-advised to place more emphasis on such improvements in Japan's macroeconomic policies, rather than only trying to open Japan's protected markets by seeking to "manage" them.
7. CLEARING THE FOG OVER U.S.-JAPAN ECONOMIC RELATIONS

Japanese consumers and taxpayers would surely benefit, and American exporters would perhaps benefit, if Japan opened its markets more fully, eliminated its often subtle non-tariff barriers to imports of services as well as goods, and removed existing restrictions on participation by foreign firms in Japanese government procurement contracts. That the benefits realized by American exporters would be less assured than those realized by Japanese consumers is due to the fact that other Asian and European exporters would doubtless share in the increased sales to Japan.

While these measures might have some effect in reducing the bilateral U.S. deficit in merchandise trade with Japan, they would have no effect on the more significant global U.S. current account deficit -- the excess of U.S. payments for all imports of goods and services over its earnings from exports of goods and services. This deficit, currently running at an annual rate of about $50 billion, represents the difference between the U.S. global deficit of $110 billion in merchandise trade (half of which is with Japan), and the U.S. global surplus of $60 billion in services trade (of which about $10 billion is with Japan).

The $50 billion current account deficit won't be affected by liberalization of the Japanese market because that deficit depends on, and is exactly equal to, the amount by which gross savings in the U.S. fall short of gross investment in the U.S. -- a difference of almost 1 per cent of the U.S. gross domestic product. In its turn, the savings versus investment deficit depends on U.S. macroeconomic policies -- specifically on U.S. fiscal and monetary policies -- not on the residual vestiges of Japanese mercantilism reflected in its protective trade policies.

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1A slightly edited version of this essay was published under the title "It's the Current-Account Deficit, Stupid" in the July 6, 1993, edition of The Wall Street Journal. Reprinted by permission.
Being "tough" in trade negotiations with Japan, as a reflection of what is sometimes referred to as "strategic trade policy", or "managed trade", may or may not affect Japan's willingness to adopt the liberalization measures mentioned above. But, whether the result is Japanese accommodation or, what is equally likely, Japanese resistance, the U.S. current account deficit will not be affected -- a point that has been virtually ignored in most official as well as press discussions of the subject.

Absent a rise in U.S. savings, or a fall in U.S. investment, increased U.S. exports to Japan will simply lead to increased U.S. imports from Japan or elsewhere, or reductions in other U.S. exports, without changing the overall U.S. current account deficit. Expectations to the contrary will inevitably be disappointed, resulting in scapegoating and resentment in both the U.S. and Japan. In the U.S., Japan will be blamed, however much or little it concedes, because shrinking the U.S. current account deficit depends on measures that are largely unrelated to whatever Japan does or refrains from doing on trade liberalization. In Japan, the U.S. will be blamed for unrealistically expecting from Japan what depends instead on macroeconomic conditions and policies in the U.S.

The recalcitrant U.S. current account deficit might be reduced by a rise in U.S. gross savings, or a fall in U.S. gross investment. Either or both of these might come about as a result of a serious recession -- clearly something that would be much less welcome than the current account deficit -- or by further depreciation of the already undervalued dollar, which might increase gross savings as a result of worsening the terms of trade. They might preferably come about through reductions in government spending or changes in the U.S. tax structure that could raise both savings and investment while reducing the difference between them.

Much of the foregoing is controversial. None of it should be, because it follows inescapably from the facts of the matter. That this misunderstanding is so widespread reflects the deplorable gap between rhetoric and perceptions, on the one hand, and reality, on the other.
The gap between rhetoric and reality contributed to the acerbic
tone of the April 1993 meeting in Washington between President Clinton
and Prime Minister Miyazawa. It may also mar the forthcoming July 7th
summit meeting of the G-7 heads of government in Tokyo because
international trade will be one of the two main items on the meeting’s
agenda (the other is aid to Russia). It can be hoped, although not with
great confidence, that what Mike Mansfield, the former U.S. Ambassador
to Japan, referred to as "the most important bilateral relationship in
the world, bar none", will be less troubled in the future than it
currently is by this gap between rhetoric and reality -- one that is
rife within the U.S. government no less than between it and Japan.
8. THE STRONG YEN OF A WEAKENED ECONOMY

Paradoxically, the recent strength of the Japanese yen relative to the U.S. dollar is a reflection of the weakened Japanese economy -- specifically, the depth and duration of its recession -- rather than its strength! The weakness of the U.S. dollar -- its depreciation relative to the yen -- carries with it little implication or significance with respect to the underlying health of the U.S. economy or its prospects for sustained growth.

At the start of 1994, when the yen value of the dollar was 110, a reasonably convincing case could be made -- and indeed was endorsed by various international financial mavens including George Soros -- that the dollar's foreign exchange value was likely to rise in the coming months. That case was based on six plausible reasons:

- Growth of the U.S. economy was faster than that of Japan and Western Europe -- 3 percent faster than that of Japan, and 2 - 3 percent faster than that of Germany.
- The recent growth in U.S. productivity, both in services and manufacturing, was among the highest in the industrialized world.
- Wage increases were moderate or flat, so U.S. real labor costs were relatively low.
- U.S. corporate profits were rising relative to those elsewhere.
- The U.S. price level was stable -- the annual rate of growth in the CPI was about 2 percent, and of the PPI, about 1 percent.
- The real purchasing power of the dollar at home was more than 40 percent above that of the yen or the mark, as U.S. travelers to those countries knew well.

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The first four reasons provided incentives for foreign investment in the U.S. -- especially foreign direct investment and investment in equities -- to rise. Hence, increased foreign demand for dollars from this source would tend to boost the exchange value of the dollar. Similarly, several of the reasons -- productivity growth, low real labor costs, stable prices, and the dollar’s relatively high purchasing power -- warranted a forecast that U.S. international competitiveness would be strong and exports would rise, adding to foreign demand for dollars, and tending to boost further the dollar’s exchange value.

While the case for expecting appreciation of the dollar was entirely plausible, what actually happened was quite different, as well as more complex. Instead of appreciation, a substantial depreciation of about 10 percent has occurred in the dollar’s value relative to the yen, and a somewhat smaller drop in the dollar’s value relative to the mark. At the same time, there has been a slight rise in the U.S. dollar’s exchange value relative to the Canadian dollar and the Mexican peso — currencies of two of the three principal trading partners of the United States. Netting all of these changes, the result has been a 2 or 3 percent depreciation of the dollar relative to all foreign currencies on a trade-weighted basis.

A convincing explanation for the substantial depreciation of the dollar relative to the yen lies in the unexpected length and depth of the Japanese recession. Thus, the strength of the yen is the direct result of the weakness of the Japanese economy, not its strength!

The liquidity of Japanese financial and non-financial businesses has been severely stressed in recent months by two factors: first, the slump in corporate profits of non-financial businesses, and second, the pressure on balance sheets and income statements of financial businesses due to actual and potential marking down of their non-performing loans. Underlying the pressure on these balance sheets has been the sharp fall in property values in the past few years following collapse of the “bubble economy”, as well as the very limited recovery in the asset value of corporate equities cross-held by Japanese financial institutions. As a result, several large mortgage-financing companies have filed for bankruptcy within the last year, and some of Japan’s
major money center banks have been obliged to make increasing -- though still insufficient -- provisions for loss reserves to cover their bad debts.

To relieve this liquidity crunch at home, Japanese financial and non-financial businesses have been reducing their large holdings of dollar assets -- including U.S. equities, real property, and government bonds and converting the dollar proceeds to yen.

Furthermore, Japan’s economic growth in 1994 has been a full percentage point below what was anticipated -- hovering between 0.5 percent positive growth and 0.5 percent negative growth -- resulting in a probable decrease in Japanese imports in 1994 relative to 1993. The low level of imports has reduced Japanese demand for dollars, while swelling Japan’s current account surplus with the U.S. to an estimated $80 billion in 1994 compared to $60 billion in 1993.

Thus, depreciation of the dollar has principally been due to the increased supply of dollars resulting from liquidation of dollar assets referred to earlier, and reduced Japanese demand for dollars resulting from lagging growth of the Japanese economy and decreasing imports.

The bottom line is that the reasonable grounds existing at the start of 1994 for expecting the dollar to appreciate have been overwhelmed by factors associated with the continued weakness of the Japanese economy.

Since the principal explanation for the strengthened yen lies in the depth and duration of Japan’s recession, the principal remedies lie in the purview of Japanese policy makers, not in that of the Federal Reserve Board. These remedies include reducing Japan’s tax rates, removing its consumption tax, increasing public works expenditures, and easing credit policy. With even a modest dose of these remedies, a substantial appreciation of the dollar’s value relative to the yen can be expected in the not-distant future.
9. CHINA'S ENLARGED ECONOMY

One of the professional secrets of people who work with supposedly “hard” data is that, in fact, the data are often “soft” and unreliable. Recently, the International Monetary Fund and the World Bank -- two of the most respected sources of international economic data -- provided a glimpse of this secret.

In May 1993 the Fund and the Bank announced that China's gross domestic product was between four and five times greater in 1992 than they had previously estimated it to be! (For various technical reasons, the World Bank estimates are at the higher end of this range, and the IMF's at the lower end.) According to these re-estimates, which replicate almost exactly ones made by RAND in 1988, China's economy is now the third largest in the world -- after that of the United States and Japan. Together with plausible forecasts of China's economic growth in the next few decades -- perhaps averaging 5 or 6 percent annually -- the new Fund and Bank estimates would, within the 1990s decade, make the economy of China larger than that of Japan. Were China to sustain such a high growth rate for several decades -- which is unlikely -- its GDP would overtake that of the United States during the third decade of the 21st century.

These remarkable recalculation and projections raise two interesting questions: What accounts for the enormous discrepancy between the earlier and the current estimates by the Fund and the Bank -- two of the world's supposedly most reliable and reputable data sources? And what difference, if any, will this huge change in China's current economic size and its future prospects make in the global economic and security environment during the coming decades?

The answer to the first question is straightforward. In the recent estimates of the Chinese GDP, the Fund and Bank converted the Chinese currency (yuan) figures into 1992 U.S. dollars by using a "purchasing

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1A slightly revised version of this essay was published under the title "How China Grew Overnight" in the November 16, 1993, edition of The Wall Street Journal. Reprinted by permission.
power parity* exchange rate, whereas in their prior estimates during the past decade, they used a foreign exchange rate for the conversion. The purchasing power rate is based on the cost of a specified "market-basket" of goods and services in yuan, compared to its cost in dollars. The foreign exchange rate depends on the official rate of exchange between the yuan and the dollar quoted by the International Monetary Fund. Thus, the purchasing power exchange rate depends on the relative yuan and dollar prices of the same set of goods and services, while the foreign exchange rate depends on the relative supply of and demand for yuan and dollars in official international exchange markets. Foreign exchange rates are critically dependent on international capital movements which have little effect on PPP, while PPP is influenced by the relative prices of such non-tradable services as health care, housing, and construction which have little effect on exchange rates.

Although there are some purposes for which foreign exchange rates are appropriate to use in comparing national economies, for the specific purpose of comparing the relative size of different national economies the PPP rate is clearly preferable. In published work that RAND did for the National Commission on Integrated Long-term Strategy in 1988, the PPP rate was used to make international comparisons between China's gross national product and the GNPs of more than a dozen other major national economies, including that of the United States. The estimates recently announced by the Fund and the Bank were remarkably similar to the earlier RAND results.

The IMF and World Bank are two of the most frequently cited sources of international economic data, but they are not alone in the magnitude of their mis-estimates. Overestimates by the OECD and by official U.S. government agencies of the national economies of East Germany and the then-Soviet Union prior to 1990 were nearly equivalent in scale to the previously cited underestimates of China's GDP by the Fund and the Bank. Since even these supposedly reliable data sources are sometimes prone to large errors, caution is plainly warranted in using their data. When policy choices are influenced by data derived from these and similar sources, the chosen policies may be as unreliable as the shaky data on which they are based.
The answer to the second question about what difference the re-estimates of the Chinese economy make in the international arena has two parts: one economic, the other bearing on military and security matters.

A Chinese economy that is four to five times larger than it was previously believed to be, and continues to grow at a 5 to 6 percent annual rate, will play an equivalently expanded role in the world economy. In general, changes in a country’s imports depend, among other factors, on the growth of its economy, as well as its size. If China’s economy becomes more open to foreign imports, and if one accepts the previously cited estimates that the size of the Chinese economy is currently about 2 trillion dollars, China will become an increasingly important market for exports from the U.S. as well as from the Asia-Pacific region and the rest of the world. China is still too small to be anything approaching the “locomotive” for the rest of the world’s economies that the U.S. economy was in the 1970s and 1980s. But China and the rapidly growing Southeast Asian economies amount to about 40 percent of the size of the U.S. economy, and this may be large enough to be at least a “tractor” for the rest of the world. If such other factors as successful conclusion of the Uruguay round of GATT, and adoption of growth-promoting tax policies by Asian countries, proceed in favorable and reinforcing directions, the Asia-Pacific tractor can help significantly to pull the world’s economies to higher ground.

The security dimension of China’s changed and changing economic size is more unsettling, as well as more uncertain. China is currently the only major country in the world whose military spending is increasing in real terms. About 8 percent of its GDP is allocated to defense to cover the current operating costs of the 4 million men and women in its armed forces, as well as the costs of military modernization. These figures compare to GDP shares of 4 percent for the United States, a little over 1 percent for Japan, and about 2 percent for the countries of Western Europe. Military allocations of this scale, from the large and growing economic base that China’s GDP provides, are a source of increasing concern to China’s neighbors in East Asia as well as South Asia.
Joseph Schumpeter, an economist whose interests and insights extended beyond the usual boundaries of economics, observed some four decades ago that "militarism is rooted in the autocratic state, [whereas] the bourgeois [state] is unwarlike.\(^2\) The Asia-Pacific region, as well as the rest of the world, has much to gain from China's move from autocracy toward some semblance of bourgeois democracy -- the latter, of course, "with a Chinese face."

III. RUSSIA AND SYSTEM TRANSFORMATION
10. AIDING RUSSIA AND UKRAINE

by Charles Wolf, Jr., and King Mallory

THE CONSENSUS IN FAVOR OF AIDING RUSSIA AND UKRAINE

The G-7 Summit meeting in Tokyo in July 1993 reaffirmed strong rhetorical support for international aid to Russia and Ukraine. The Clinton administration, like the Bush administration before it, favors foreign assistance to Russia and Ukraine to further their democratization, marketization, and stabilization. Moreover, the Congressional leadership of both parties has also expressed support for such aid.

Underlying this bipartisan consensus is a sometimes explicit, and always implicit, premise: that Russian and Ukrainian prospects for a less violent and more successful transition toward democratic polities and market-based economies will be significantly enhanced by foreign aid. Notwithstanding the consensus, the underlying premise is based as much on hope and good intentions as on evidence, because it can be no less plausibly argued that prospects for successful transition depend fundamentally on domestic factors and policies in Russia and Ukraine that won’t be affected in any predictable way by foreign aid.

Whether the premise is valid or not, there is a strong consensus among the leadership of both parties in the United States in favor of aid. The consensus extends as well to the leadership of the G-7 governments. There is less consensus about the amounts and types of assistance that should be provided.

Among the general public in the U.S. and among the rank-and-file members of Congress, as distinct from its leadership, there is considerably more skepticism about whether the possible benefits from extending aid to Russia and Ukraine would be greater or less than those forgone by equivalent reductions in other government spending programs,

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or by additions to the budget deficit, that would be necessary to finance such aid.

In any event, all sides in the aid debate acknowledge that other domestic and international circumstances and policies, quite apart from foreign aid, will strongly affect Russian and Ukrainian chances of successful transformation. For example, domestic policies dealing with macroeconomic stabilization, legal reform, privatization and property rights will have such effects. Various non-aid measures by foreign governments, such as opening their markets to exports from Russia and Ukraine, will have more substantial effects than foreign aid on the progress of economic change in these countries. Consequently, some of the most important policies the G-7 governments can pursue to assist the transformation of the Russian and Ukrainian economies fall outside the domain of what is generally construed as “foreign aid.” Nevertheless, this paper proceeds from the belief that assistance by the United States and the other G-7 members is warranted, and that it will be continued. It is, therefore, timely and crucial to address the issue of the types and forms of aid that would be most effective, which is the focus of this paper.

**SOME GENERAL CONSIDERATIONS**

In approaching the question of forms and types of foreign aid, several considerations should be borne in mind:

First, prior Western aid has elicited mixed, but mainly unfavorable reactions within Russia, as well as Ukraine. Criticisms, by supporters as well as opponents of Boris Yeltsin, have focused on both the small amounts of aid (far below the $24 billion promised by the G-7 in 1992 and increased to $28 billion in 1993), as well as the added debt burden that aid imposes on the already strained Russian economy. Furthermore, Western aid to Russia has elicited even more unfavorable if not bitter reactions in Ukraine. While Russians view Western aid as small if not niggardly, Ukrainians view it as relatively large because of what they see as the West’s almost total neglect of Ukraine’s own needs and interests.
Second, the resources available for aid to Russia and Ukraine from the G-7 countries are likely to be very limited because of budgetary constraints and slow economic growth in these countries. These limitations are likely to be more severe with respect to providing new funds than to reducing the servicing obligations associated with the prior debt of the Soviet Union.

Third, in the economies that Russia and Ukraine inherited from the Soviet Union, defense industry was so enormously over-developed and pervasive that the need for downsizing and conversion of defense industry should be taken into account in the design of appropriate forms of foreign aid.

Fourth, aid should be purposeful rather than personal -- that is it should be designed to advance purposes and policies linked to the fundamentals of transforming the economies and societies of Russia and Ukraine. While Presidents Yeltsin and Kravchuk are deserving of encouragement and support, aid policies should not be so narrowly or personally conceived that their rationale lapses if these government leaders were to prove transitory. For example, encouragement of new enterprises and new entrepreneurs as distinct from privatization of "old" state enterprises, legal reform, and housing design and construction are purposes to be sought through foreign aid and especially through technical assistance regardless of the particular leadership in power in Russia or Ukraine.

DESIGNING A FOREIGN ASSISTANCE PACKAGE

A four-part foreign assistance package that comports with the foregoing general considerations would consist of:

1. Debt relief, rescheduling, and cancellation of all, or at least some, debt incurred by the former Soviet Union, and swapping some or all of the remaining debt for equities in state enterprises that are undergoing privatization;

2. Stimulating foreign direct investment in Russia and Ukraine by galvanizing the presently available OPIC (Overseas Private Investment Corporation) insurance program, as well as by
providing a stimulus to increase private insurance available in the commercial market;

(3) Establishing a "market stabilizing mechanism" for global arms sales that would assure Russia and Ukraine a reasonable share of the global arms market; and

(4) Supplementing the $800 million already appropriated for the dismantling of nuclear weapons with additional funds for these and related purposes in Russia and Ukraine.

1. RESTRUCTURING AND SWAPPING FOREIGN DEBT

Russia, Ukraine, and six other republics agreed, upon dissolution of the Soviet Union at the end of 1991, to assume "joint and several" responsibility for servicing the entire Soviet external debt, much of which was accumulated preceding and during Mikhail Gorbachev’s 1985-91 tenure. This debt, together with additions to it incurred in 1992 and 1993, currently is about $80 billion. Russia is the only republic that has attempted to meet this extremely onerous servicing obligation. During the next three years, from 1993-1995, the annual burden represented by servicing long-term, hard-currency debt alone, will be between $10-14 billion, thereby preempting between one-third and one-half of Russia’s annual hard currency foreign exchange earnings.

Two measures can contribute significantly to easing this burden. The first would have the Western creditors (Germany, Italy and the other West European countries are collectively owed 70 percent of the total, the U.S. only 5 percent) forgive all or most of the debt incurred before the formal dissolution of the Soviet Union on January 1, 1992. Most of the creditors’ banking institutions have already built up loss reserves in anticipation of this prospect, so the financial impact of debt forgiveness would be eased. Moreover, by linking the debt cutoff to the historic date of the Soviet Union’s dissolution on December 31, 1991, this debt forgiveness would avoid creating a precedent that other debtor countries might invoke in an effort to obtain equal concessions for themselves.

The second measure is to swap the remaining sovereign debt for equities in state enterprises undergoing privatization in Russia and
Ukraine. Under the Russian privatization law adopted in 1992, 35,000 state enterprises are being privatized over the next three years; more are intended to follow thereafter. The privatization process calls for 25% of the shares to be given to enterprise workers and managers, 30-35% to be auctioned to Russia's 150 million citizens in exchange for ruble vouchers previously distributed to them, and the remaining 40-45% of the shares to be retained by the state. If some of these government-held shares were swapped for debt liabilities, the economic burden of meeting the fixed servicing obligations of debt would be replaced by more flexible servicing obligations that depend instead on the economic performance of the equities that have been acquired. Concerns about selling off Russia's patrimony to foreigners would be allayed because the swapped shares would, in general, not constitute majority ownership.

Moreover, foreign creditors who acquire these equities will have incentives to enhance their stakes by adding management skills, technology, and improved access to Western markets, as well as by new investments. As the value of the existing debt declines on the secondary debt market, creditors' incentives to engage in such swaps will increase. (Significantly, medium term Soviet debt that carried a 20 percent discount in the fall of 1992, carried a 50 percent discount in the spring of 1993!)

2. ENCOURAGING FOREIGN INVESTMENT BY EXPANDING RISK INSURANCE

The United States government, as well as the private insurance markets, provides insurance against the political risk of violence or expropriation that may discourage potential investors in Russia and Ukraine. The U.S. government's longer-term investment guarantees are offered through the Overseas Private Investment Corporation (OPIC). Several private insurers in the United States, as well as in the United Kingdom, offer the same types of insurance as does OPIC, but at twice the subsidized rates charged by OPIC.²

²Willis, Faber & Dumas Limited, insurance brokers in London, cited 2% of the market rate for such insurance in Russia and Ukraine in March 1993. The OPIC 1992 rate is less than 1% of the face value of insurance covered.
In the spring of 1993, OPIC had 256 unapproved insurance applications with a total face value of potential private investment in Russia of $22 billion, compared to only seven approved applications with a face value of $120 million. The corresponding figures for Ukraine were 39 applications with a face value of $1.7 billion of potential investment, and no approvals by OPIC. Expansion of insurance in the private market to meet this backlog of demand is constrained by the unwillingness of private underwriters to assume additional risk exposure in Russia and Ukraine without substantially raising the premiums charged to those seeking insurance.

The limited scale of OPIC approvals of insurance applications is due to many factors, including its understandable reluctance to increase the risks that American taxpayers would be exposed to if turmoil actually ensued in Russia or Ukraine and compensation to insured investors were required. It is also possible that the subsidized price at which OPIC offers political risk insurance, as well as OPIC’s screening of applications, has the effect of "creaming" the less-risky applications for risk insurance, and diverting the riskier ones into the private risk insurance market. This adverse selection may distort the commercial side of the political risk insurance business, because the private market becomes the insurance market of last resort for those unable to obtain the subsidized rates offered by OPIC.

Foreign aid that is directed toward encouraging private direct investment is a high-leverage form of aid for furthering market-oriented economic reform in Russia and Ukraine. The "leverage" results from several sources: First, it is likely that aid for this purpose would be more productive than other forms of aid, because it is presumably linked to the provision of management, technology, and training. As Anatoly Sobchak, the mayor of St. Petersburg, has observed: "Russia and the other former Socialist countries don’t need humanitarian aid. They need direct investment in concrete projects...political guarantees of Western investment would help."

\footnote{Interview quoted in Chief Executive, May 1993, pg. 37.}
Second, the amount of the insurance subsidy, if prudently managed, is typically a very small fraction of the total foreign direct investment that the insurance guarantees are underwriting. And third, there is probably a scale effect associated with the writing of political risk insurance: If and as the quantity of direct investment increases, prospects for successful marketization and transformation will improve, the outlook for reasonable stability in Russia and Ukraine will brighten, and the dangers of violence and expropriation will recede.

Toward these ends, foreign direct investment in Russia and Ukraine can be encouraged in several ways:

(1) OPIC’s existing activities can be galvanized by reducing the bureaucratic bottlenecks that impede it, by removing the present $200 million limit that applies to insurance for any single company’s investment, and by enabling OPIC to securitize the insurance portfolios that it accumulates (for example, in the manner of GNMA and FNMA), thereby spreading risk and tapping resources in the private capital market.

(2) Incentives can be provided to the private commercial insurance market through allowance of a tax credit of, say, 50 percent of the premiums private insurers receive from issuance of political risk insurance to U.S. investors in Russia and Ukraine, thereby increasing the after-tax profitability of privately-written political risk insurance, and making the private insurance market more directly competitive with insurance written by OPIC.

Of course, these measures will not be a panacea. The climate for foreign investment in Russia and Ukraine depends on a wide range of political, legal, and economic considerations that political risk insurance doesn’t address. And the distinction between normal (and perhaps even abnormal) business risks, and the particular limited types of political risk (against turmoil or expropriation) that OPIC insurance is intended to provide may not always be clear in practice.
3. ASSURING RUSSIA AND UKRAINE A REASONABLE SHARE OF THE WORLD ARMS MARKET

One of the salient characteristics of the militarized economy of the former Soviet Union is that the military sectors comprised something over 25 percent of the Soviet Union's gross national product. Thus, reform of the Russian and Ukrainian economies clearly requires shrinking, converting, and privatizing major parts of the former defense industry in Russia and Ukraine. Reductions of over 60 percent in defense procurement spending in Russia, and probably similar or greater reductions in Ukraine, are already forcing the shrinking to take place, and providing strong incentives for converting equipment and skilled manpower to other productive activities.

However, it should also be recognized that Russia and Ukraine have a critical need for hard currency exports, and their comparative advantage for realizing them unfortunately lies in arms sales. In the last half of the 1980s, international weapons sales accounted for about 20 percent of the former Soviet Union's export earnings, compared to less than four percent for the United States. The problem this poses is how to reconcile the shrinking of Russia's and Ukraine's military industry, on the one hand, with access to a reasonable share of the international arms market to enable them to acquire foreign exchange needed for their internal development and economic reform.

Ongoing RAND research is trying to provide a way of squaring this circle, through something we are referring to as a "market-stabilizing mechanism," while others might label it a cartel (although a beneficent one, at that). The MSM envisaged in this work would be established by the United States, Russia, and the other principal weapons exporters (France, Britain, China, and Germany) to prohibit or control exports of potentially destabilizing weapons (such as submarines, cruise missiles, or advanced sea and land mines) to such areas as the Persian Gulf and Middle East, while allowing Russia and Ukraine an appreciable share (perhaps as large as 15 percent) of the $30 billion annual weapons market in these and other areas. To be sure -- even excluding the most destabilizing weapons -- that scale of conventional arms exports still involves enormous potential lethality. Consequently, prudent efforts
should be made to reduce it. However, these efforts should proceed while 
Russia and Ukraine receive ample opportunities to realize an appreciable 
share of the international weapons market. Where restraint or 
prohibitions of weapons sales are accepted in the MSM, and where Russia 
and Ukraine are therefore obliged to forgo an otherwise bona fide 
weapons sale, a modest aid fund might be established to compensate them 
for the forgone sale.

Although the aim of this measure is to assure Russia and Ukraine a 
major stake in the tightening weapons market, they should be under no 
illusion that this stake will do more than ease somewhat the strain and 
pace at which military industry declines in their economies.

4. DISMANTLING NUCLEAR WEAPONS AND RETROFITTING NUCLEAR REACTORS

In 1992, the U.S. authorized $800 million of Defense Department 
appropriations for dismantling tactical nuclear weapons in Russia and 
Ukraine. By the middle of 1993, less than 10 percent of these so-called 
Nunn-Lugar funds have been expended, due to logistic, contracting, and 
organizational delays on both the U.S. and Russian sides, and due to a 
hardening of the Ukrainian position with respect to removal of nuclear 
weapons from Ukrainian territory. Besides expediting the effective use 
of these funds, it would be worthwhile to increase the amounts provided 
for the dismantling of additional nuclear weapons, including strategic 
one. Funding from this source should also be used to retrofit with 
radiation-containment structures the several dozen Chernobyl-type 
nuclear reactors located in Russia, Ukraine, and other former Soviet 
states, and to dismantle the 300 power reactors on Russian nuclear 
submarines that are to be decommissioned under existing arms control 
agreements.

In some respects, financial assistance for weapons dismantling and 
retrofitting nuclear facilities is analogous to the compensation fund 
discussed earlier in connection with establishing an MSM to compensate 
for forgone weapons sales. Both devices are intended to move the 
Russian economy toward a more “normal,” less militarized structure, 
while recognizing the realities of the distorted economic structures 
they’ve inherited.
In sum, the four-part aid package outlined above would advance reform and marketization in Russia and Ukraine, consistent with: (1) the sharp limitations that can be expected on the availability of resources from the G-7 countries; (2) reasonable balance in aid policies toward Russia and Ukraine; (3) emphasis on providing incentives for foreign direct investment; and (4) recognizing the importance of linking the provision of foreign aid to reductions in the military sectors and the progress of economic reform.
11. REBUTTING THE ANTI-SHOCK THERAPISTS: COMENTS ON IAN MASTERS' INTERVIEW WITH PETER REDDAWAY

One characteristic of much recent discussion of Russia is that political scientists -- who usually dominate such discussions -- offer some broad pronouncements on economic issues. Often these are preceded by a disarming remark to the effect that: "Of course, I'm not an economist, but..." after which various sweeping economic judgments are delivered with an air of unwarranted authority.

The only part of this scenario that doesn't apply to Mr. Reddaway's remarks is that they aren't preceded by the usual caveat about his not being an economist.

In the remarks that follow, I will reverse the standard ploy referred to earlier by acknowledging at the outset that: "Of course, I'm not a political scientist, but..." thereafter, I will offer some observations on various political matters in Russia that are touched on in Mr. Reddaway's remarks.

Mr. Reddaway, abetted by the deliberately leading questions and opinions of his interlocutor, Ian Masters, offers frequent and severe indictments of "shock therapy," which he characterizes as Boris Yeltsin's "serious mistake." Mr. Reddaway also includes in his indictment Russia's former acting prime minister Yegor Gaidar, Jeffrey Sachs, Graham Allison, the IMF, and other "Western individuals, groups, and eventually governments that pushed him [Yeltsin] in that direction." What these errant parties have failed to understand, opines Mr. Reddaway, is Russia's "political culture," "societal attitudes," and inadequate "economic infrastructure." Evidently convinced that he himself fully understands these things, Mr. Reddaway consigns Yeltsin's economic policies to unequivocal failure, in the process dismissing Yeltsin himself as a "spent force" (!).

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Before I turn to the economics of these matters, I would observe in passing that Reddaway's credentials as an expert and reliable soothsayer are somewhat compromised by the turn of events in Russia in the past few months. The April 25 referendum, in which Yeltsin was endorsed by 58 percent of the voters, should (but probably won't) lead Mr. Reddaway to question his own political acuity. And the 53 percent of the voters who surprisingly endorsed Yeltsin's painful economic reforms suggest that even Mr. Reddaway's judgment about the prevailing "societal attitudes" and "political culture" may be open to question. It would be gratifying indeed if the fraternity of former Sovietologists to which Mr. Reddaway belongs, and whose dicta and forecasts have so often erred in the past, would have learned from this prior experience the wisdom of humility in their assertions about what will fail and what will succeed, and who is a "spent force," and who a prospective victor. This is probably a pious and unrealistic hope.

Now, to address the issues of Russia's economic policy, and whether Yeltsin and the advisors he has listened to have erred in moving too fast, or not fast enough, or in the wrong direction. These questions can be viewed through two different lenses -- one focussing on economics, and the other on politics. I turn first to the economics.

It hardly needs saying that the problem of transforming socialist, command economic systems to market-based ones is extremely complex and multifaceted. Too little attention has been devoted to it in the past, although ironically much Western writing and thinking in the past century, reflecting the ideological inclinations of such writers as Oscar Lange, Joan Robinson, Nicholas Kaldor, Robert Heilbroner, Wassily Leontief, and John Kenneth Galbraith, has concentrated on the reverse sequence: namely, the expected transition of capitalist economic systems toward socialist, centrally-planned ones.

At the risk of some oversimplification -- although not nearly as much as that reflected in Mr. Reddaway's comments -- the generic problems of transformation are essentially the same whether the locale is Russia, the other republics of the former Soviet Union, Eastern Europe, China, or any of the centrally-controlled economies of the Third World. To be sure, there are differences in historical circumstances,
cultural affinities, institutional antecedents, and the existing physical, social, and political infrastructures. But the differences, while important, are incidental to an essentially similar and formidable task. Transformation depends on implementing simultaneously, or at least contemporaneously, a package of six closely linked and mutually supporting elements:

1. Monetary reform to ensure control of the money supply and credit;
2. Fiscal control to assure budgetary balance and to limit monetization of a budget deficit if it ensues;
3. Price and wage deregulation to link prices and wages to costs and productivity, respectively;
4. Privatization, legal protection of property rights, and the breakup of state monopolies to provide for market-based competition;
5. A social "safety net" to care for those who may become unemployed as the transformation proceeds;
6. Currency convertibility to link the transforming economy to the world economy and to competition in international markets.

The first two elements (monetary reform and fiscal control) and the fifth (the social safety net) create the broad macroeconomic environment that enables the incentive mechanisms of the other three elements to move resources toward more efficient and growth-promoting uses. The government's role in this process is both crucial and paradoxical: crucial in initiating all of the elements, yet paradoxical because the process which the government initiates should diminish its ensuing role, displace its overextended functions, and reduce its size in favor of enlarging the scope of market forces.

Each of the six elements is less likely to be effective without reciprocal support provided by the others. Hence, attempts to reform non-market economies by piecemeal steps are more likely to flounder than to succeed. This, of course, begs the crucial question of whether the political and social structure can withstand the strains and stresses
created by the transformation process -- a matter to which I will return. Nevertheless, the fact remains that the several elements are synergistically related to one another so that, from an economic viewpoint, the "therapy" has a better chance of succeeding if the patient can endure these strains and stresses.

Consider, for example, the link between the first two elements. Monetary reform is necessary to limit growth of the money supply to a rate that accords with the growth of real output. It is also a necessary means of providing access to credit on the basis of borrowers' economic capabilities and their associated risks, rather than on the basis of their political connections or credentials. A competent entrepreneur with a good idea should be able to obtain credit not available to someone whose principal distinction is membership in the former Communist Party or kinship to a government official.

Fiscal reform requires a budget process that constrains government expenditures to something close to revenues. Recourse to extra-budget subsidies to bail out deficit-ridden state enterprises has been a pervasive problem in Russia and a major cause of the monetary inflation that has occurred there.

In turn, the third element -- deregulation of prices and wages -- requires monetary and fiscal restraint if prices and wages are to be linked to real costs and productivity, while avoiding general inflation. Goods that are in short supply or are costly to produce should experience price increases relative to those that are more abundant and less costly. In turn, these price increases provide signals and incentives for increasing output of goods that are in greater demand. Similarly, wages paid for more productive labor and skills should be expected to rise relative to those that are less productive. The newly established parities among costs and prices should operate in the public sector as well as the private sector.

For deregulation of prices and wages to promote efficient use of resources, the fourth element -- privatization, legal protection of property rights, and the breakup of large state monopolies into smaller competing entities -- must be implemented as well. This requires an appropriate legal code and appropriate procedures for resolving disputes...
over property transactions and acquisitions, as well as settling litigation associated with prior ownership claims. It also requires a choice among several ways of changing from state ownership to private ownership, including ample opportunity for new enterprises to enter the market in competition with newly privatized enterprises or the residues of old state enterprises.

The fifth element — establishing a social security system as a "safety net" — is also essential for the transformation process to succeed. Without it the process may create fear and widespread unemployment and political instability, thereby seriously impeding the transition.

In Russia, as well as most other command economies, social protection — against illness, disability, old age, and unemployment — has principally been the responsibility of state enterprises. This has been especially characteristic of the large military industrial complexes in Russia. As privatization proceeds, and especially as new firms enter the market without the burden of these social overheads to attend to, these social responsibilities are likely to become one of the principal functions of government, financed by taxation and by charges levied on the insured. In the initial stages of transformation, taxation will probably have to bear most of the burden.

The final element — currency convertibility — is essential to complete the transformation process by linking internal markets and their prices, wages, productivities, and technology to those of international markets. This linkage provides an opportunity for comparative costs and comparative advantage to operate for the benefit of the national economy that is undergoing transformation. With a convertible currency, the transforming economy can determine those goods and services it can produce at relatively low costs compared to the costs of other countries, and those it produces at relatively high costs. In response to convertibility, exports of the relatively low-cost goods will expand, as will imports of the relatively high-cost ones.

If and as the other elements of the reform package — especially monetary and fiscal discipline and market-determined prices — are
implemented, Russia can move toward currency convertibility on the basis of a floating ruble exchange rate. Moreover, this can be sustained with only minimal hard-currency reserves provided the money supply is controlled. The role of maintaining monetary and fiscal discipline is essential. This is the reason Yeltsin and his associates have tried -- even if inadequately and intermittently -- to cut back subsidies to state enterprises, to reduce the government budget deficit, and to assume control over Russia's central bank.

In sum, the process of transforming command, nonmarket economies to market ones is both better understood and more tractable than might be inferred from much of the public debate, as well as from Mr. Reddaway's sloganeering indictment against "shock therapy" without even discussing the matter or revealing much understanding of it.

So much for the economics. I now turn to the politics, which I must precede with the warranted disclaimer that: "Of course, I'm not a political scientist."

The transformation process that I've summarized above will, as I observed earlier, inevitably impose serious political and social stresses on the systems that are undergoing the process, with attendant uncertainty about the capacity of these systems to bear these burdens. This is evident in Russia. The stresses arise from the fact that moving a command system toward a market-based economy will inevitably create losers as well as winners. Moreover, there is a perverse asymmetry to this process. The losers generally know who they are as well as what they'll be losing, whereas the winners generally don't know precisely who they are or what they will be winning. Although in the aggregate the economic gains will exceed the losses, the vigor with which the prospective losers -- communists, some (but not all) enterprise managers, much of the bureaucracy, and so on -- will resist, can be expected to be, and indeed has been, intense and bitter. The chairman of the Russian parliament, Mr. Khasbulatov, as well as Yeltsin's vice president Rutskoi, exemplify the intensity as well as the deviousness of this resistance.

All this raises critical questions about what Mr. Reddaway refers to as Russia's "political culture" and "societal attitudes," and indeed
about the feasible, let alone optimal, trajectory of economic transformation. I acknowledge the validity of many of Mr. Reddaway’s doubts and cautionary observations about the profound uncertainties connected with the reform processes in Russia, as well as in the other republics of the former Soviet Union. However, in these matters I have more (but not boundless) confidence in the judgments, forecasts, strategies, and tactics of Mr. Yeltsin and his associates than in those of Mr. Reddaway and most of his political science colleagues. To be sure, Yeltsin or his successors may be wrong in their estimates about these things, and they may pay the price if they are. There is indeed underway in Russia a process in which economic as well as political developments are increasingly gravitating away from Moscow and toward the autonomous republics and other entities that constitute the Russian Federation, and this process will probably continue regardless of Yeltsin’s own survival. Nevertheless, those like Mr. Reddaway, who profess to be so certain about such essentially difficult and elusive concepts as “political culture” and “societal attitudes,” should perhaps be somewhat more humble and tentative, and less categoric in their judgments and conclusions. They should not be quite so sure that their knowledge and judgments on these matters are superior to those of Mr. Yeltsin and his associates.

It is risky enough for some of us to offer technical economic analysis and advice because it may be incomplete and flawed. It is even riskier for others, like Mr. Reddaway, to offer political advice because the judgments and intuitions on which it is based have so often been proven wrong in the past.