The RAND/DIW/IFO Conference on The European Challenge and The Role of the USA

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The RAND/DIW/IFO Conference on The European Challenge and The Role of the USA

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This report summarizes and presents three key papers from a workshop/conference on "The European Challenge and the Role of the USA" jointly sponsored by the American non-profit policy research corporation, RAND, and two of the five economic research institutes sponsored by the German government, DIW and Ifo. The meeting took place in Duesseldorf, 23-24 November 1992. RAND participation was as part of a project on the International Implications of East German Economic Reconstruction. The conference was supported in part by the IKB Deutsche Industriebank AG, in whose premises it took place, by the American branches of Lufthansa and Siemens, and by the Ford Foundation.

Participants included approximately twenty German economists and others, from the sponsoring institutes, banks, other firms, and the Federal government; and approximately ten American economists and others, from RAND and other institutions. A list of participants is appended, to the summary, which attributes no views to individuals or institutions.

The overall plan is to continue and update the discussion and to disseminate the findings and policy implications to American and German decisionmakers at a second conference in Washington, DC in mid-1993.
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CONFERENCE SUMMARY

AN OVERVIEW OF THREE SESSIONS

The purpose of the original RAND project and of the two conferences is to understand, and explore certain policy implications of, the vast changes that have been brought about by the collapse of the Soviet empire, the unification of Germany, and the consequent rearrangement of Europe and of the world economy. In particular, the relationship between the United States and (then-West) Germany had long centered on their roles as the two strongest pillars in what was primarily a military structure designed to deter/defend against Soviet aggression on West Europe. The new focus remains on Germany and the U.S., but now as two of the major pillars of a world economy under strain. Germany and the U.S. must take particular responsibility for Europe, including the collapsing economies of the former Soviet Union (FSU) and East Europe; and Germany remains the keystone of European integration. Even the security and political stability of Europe, once dependent on defense, now depend much more on creating and maintaining economic stability in the eastern as well as the western portions of that continent.

With this in mind, the Duesseldorf workshop was divided into three sessions, concerning:

I Germany
II East Europe including the FSU
III The United States and the world economy.

The discussions centered on substantial concerns for the future. The fulcrum of the three sessions was the middle one on East Europe: the overall consensus was that Germany and the United States will at worst muddle through over time, but the lands east of the Oder-Neisse may not, tending instead toward increasing economic and therefore political instability. The East needs economic help—on that there was consensus but as will be noted there was no consensus on what kind of help—and
help must come from the economic powers. But the clear finding of the workshop was that both Germany and the United States are turning in on themselves--away from the problems to the east, away from the world economy, in Germany's case perhaps even away from European integration. Both countries recognize the real needs, but the ongoing spirit, so far as economic contributions are concerned is ohne mich.

In Germany, this is true in the short run because of the recession brought about at least indirectly by the enormity of the job to be done in its eastern neue Bundesländer (NBL); and the short run will blend into a long intermediate run because of the same set of problems. In the United States, the slow quasi-recessionary growth of the last few years, the budget and international trade deficits, and long-run structural fears tend--not to classic political isolationism nor even strong protectionism--but still toward a turning away from world economic responsibilities. For the U.S., however greater hope for economic as well as political leadership in the near future may be a consequence of the apparent beginning of an economic upturn and the vigor of a new administration.

The purpose of the 1993 conference in Washington will be to highlight these problems, increasing their visibility to the new administration, and to discuss possible new directions for solution.

**SESSION I: GERMANY**

Most of the reports and comments in this session were by the German participants. Specifically American contributions are noted in parentheses. The same procedure is mirrored in the report on session III, on the U.S.

**The Short Run**

The joint forecast of DIW, Ifo and the other three German economic research institutes was slightly more optimistic than the forecast of the Federal Council of Experts, but none of them predicted that Germany could break out of its recession before the end of 1993. They believed that business expectations are overpessimistic and will turn around. In
the meantime, although investment is down in the aggregate and in the manufacturing sector, it is holding its own in services. West German private as well as public investment in the NBL remains vigorous, and indeed, the latest revision (September) was upward, which is remarkable for a recessionary period. The outlook for foreign trade is not good, however; some Germans suggested that the deutsche mark might drop to 2:1 against the dollar by the end of 1993.

Underlying the forecast and the recession were three factors:

- Above all, the unexpected difficulties in reconstructing the economy of the NBL. Although this has presented great opportunities, the costs thus far have been even greater, and the difficulties in handling these costs have sent macroeconomic policy into a tailspin.

- A failure of policy leadership, as perceived by a consensus of the German participants. This was laid in particular on the Chancellor, for having forced the conversion of the ostmark into the deutsche mark too early and too high, for sweeping aside the prudent fears about the difficulties of quick reconstruction, and above all, for failing to be frank about the costs. (The Americans noted that most Germans of the political class had been overoptimistic, not just the Chancellor.) The Bundesbank too came under substantial criticism. Although the Germans did not fault the Bank’s narrow focus on price stability (the Americans did), they did feel that it had moved too slowly against the recession, and that it had not come to grips with institutional changes that affected the relationships among macroeconomic variables. For example, the adjustment of eastern prices to western, the significantly increasing holding of deutsche marks as a store of value throughout East Europe, and the changes in the form of holdings by Germans themselves, should have brought about a shift to broader monetary concepts and an increase in monetary targets.
Problems with wages, which had risen too fast, particularly in the light of the need for East German catching up. Some Germans blamed this on their system of centralized wage bargaining, but there was no consensus on that point.

Beyond the Short Run

The economy of western Germany remains fundamentally one of the strongest in the world. What happens to Germany as a whole, however, will depend at least for the next decade on the NBL, and there the prospects are far less certain.

Calculations were presented showing that for the productivity of the eastern economy to catch up to the western prices, even over a period of a decade or more, would require investment in the east so much more rapid than that in the west as to be beyond the realm of possibility. On the other hand it is not necessary for regions to catch up fully. The "Mezzogiorno" model of regional discrepancy is not likely to apply to Germany because the NBL are not restricted by the skill, cultural, and institutional barriers that have impeded the catching up of southern Italy to the rest of that country. (The Americans pointed out, however, that it took many decades after the Civil War for the southern states of the U.S. to come close to the north economically.)

The leadership failures perceived by the Germans focused on the handling of the economics of unification. Starting with the conversion of most ostmarks into deutsche marks at parity on 1 July 1990, the leadership moved too fast, and was far too optimistic. In particular, they have misled the German people, both east and west, on the difficulties of reconstruction, especially on the huge costs of reconstruction, cleanup, and subsidies to both investors and workers. Although this may have initially been in part because nobody realized the size and scope of the problems ranging from obsolescence to pollution to sudden loss of East European markets, these are realized now; but the implications have still not fully entered policy or leadership rhetoric. Nor, as one participant suggested at a later session, has anyone really admitted, let alone explored the implications of, the fact that Germany has become a country of immigration.
And finally, the Treuhandanstalt was criticized for its shifting mixture of privatization and restructuring, as result of which it has not been successful at either. A paper by one participant feared that the Treuhand might become an "Ex-GDR, Inc.," conserving the worst of the old regime rather than what little good there had been. Indeed, it was suggested that the Treuhand might end up as a German equivalent to the American S&L crisis.

(The Americans were inclined to be less critical of German policy as such, not only because such criticism is not an appropriate role for foreigners. The Americans argued that no policies could look good against the real problems of bringing an economy still mired in the Stalinist economics of the 1940s and 1950s toward the levels of one of the most productive economies of the 1990s; while at the same time creating social cohesion between what might be paraphrased from Churchill as two societies divided by a common language.)

The German participants did believe strongly, however, that wage restraint was necessary: in western Germany, for short-run recovery from the recession; in eastern Germany, for long-run reconstruction. Nonetheless, they were quite critical of centralized bargaining, and recommended that the United States avoid any move in that direction.

Due to the loss of competitiveness, it was suggested that the economy of the NBL was becoming segmented. Retail, construction, and public sectors had been doing relatively well from the start. For other industries, the main problem remains enormous competitive pressure from the West. More newly recognized, however, was the creation of a small but growing number of firms and jobs using the best of new technologies.

The germination of new technologies in the east is looked at as a hopeful sign toward a real solution. Investment in this direction, as well as in other sectors, is encouraged by a skilled labor force, by substantial federal investment subsidies, by some continuing wage differentials, and by subsidized consumer demand within the NBL. Several of the participants suggested that the fertile ground for new technologies plus proximity to markets in eastern Europe would ultimately lead the NBL to become a garden of opportunities. At the
moment, however, much investment is flowing from western Germany directly to East European countries.

To accelerate reconstruction of the NBL, the recommended policy directions included: wage restraint; and emphasis on public subsidies for investment in preference to consumption. Suggestions were made to resolve the restructuring/privatization dilemma by "as-if privatization," in which firms would be encouraged to act as if they are fully private, even while still receiving once-for-all or declining subsidies; and to encourage greater labor mobility, including from the east to the west.

Overall, however, the mood was not one of short or even intermediate-run optimism. It will take a long time to reduce and finally replace the immense overhang of production and jobs in obsolete firms and plants.

SESSION II: EAST EUROPE

What is true for eastern Germany is far more true and far more difficult for East Europe. Particularly in Russia, there is much more to be swept away and replaced. And even before the dismissal from office of Russian Prime Minister Gaidar, which took place after this meeting, the participants were not optimistic about the carrying out of what needs to be done.

Consensus was present on several points:

- The problems are deep and the hope for any kind of rapid solutions is meager. To quote from the paper presented to this session:

  Economic policy programmes devised by innumerable advisors are two-a-penny: but the fundamental political and legal conditions required if such programmes are to be realised in practice simply do not exist. Russia is in danger of sliding into a political and economic catastrophe which would pose a threat to the process of political liberalisation and the opening to the West.

  The group was also reminded that the "political and economic catastrophe," were it to occur, would happen to a state (or a
successor group of warlords) possessing large numbers of nuclear weapons.

- The three structural necessities for Russian and other eastern reconstruction are:
  -- A legal and institutional structure adapted to, and reliable enough for, a free market.
  -- Macroeconomic stability.
  -- A microeconomic system consisting of firms and managements that will respond to market incentives.
- Real wages must be sharply reduced in the first round to allow for a redistribution of income between workers and private or non-private firms. Nominal wages must be stabilized to stop wage-price spirals. Eastern European countries can only be competitive and create incentives for internal and external investors if they stop inflation.
- Some form of outside assistance will be needed.

Within these categories, however, substantial disagreement was manifest concerning:

- The ordering, by priority and over time, of the three structural necessities; in particular, whether macroeconomic stability must come before microeconomic restructuring or vice versa.
- Whether and how it may be politically possible to reduce real wages sufficiently.
- What kind of outside help could and should come from whom.

**Macro versus Micro**

Among the three structural necessities, there was general agreement on the immediate need for a system of laws and public institutions appropriate for a market economy. It was pointed out, however, that these had come ready-made to the NEL, but in themselves they provided only a the initial conditions for the huge physical and institutional task of clearing out the old and building the new.
The major controversy, in any case, was between those who contended that macroeconomic stability was a precondition for effective restructuring of the microeconomy, and those who believed that the objectives of macroeconomic stabilization could not be achieved unless a viable microeconomic structure was in place first.

The *macro-first* advocates argued that the change from a command to a market economy was in its essence a change from an economy constrained by supply (i.e., in which the central thrust is production, with what is produced decided by the producers, who will then distribute it as available) to one constrained by demand (the central thrust is consumption, which directs what is produced) but in which total purchasing power is limited by monetary policy. In order to create this change from supply to demand, to drive real wages down to the point where consumption does not exceed what can be produced, with enough left over for investment, and to create a redistribution toward capital that will incentivize investment, an adjusting shock is needed. "The 'inflation mentality' has become such a fixed component of social adjustment to rampant inflation that only a very clear signal, one pointing to a fundamental change of course for the monetary system as a whole, can be expected to produce a change for the better," according to the paper that was presented.

The required change should come about by freeing prices, which will rise rapidly, and then by using macroeconomic policy to prevent inflation, thus avoiding a concomitant increase in nominal wages which would under the circumstances lead to a hyperinflationary spiral. Workers and trade unions (new trade unions in the case of Russia) must understand and cooperate. Only when this has been done will the requisite stability exist for thoroughgoing privatization and restructuring. The IMF approach is incorrect because it tries to stabilize without recognizing the need for sharp cuts in real wages and a stabilization of nominal wages leading to improved profit expectations and low interest rates.
For Russia, unfortunately, it may be too late to begin that way. Russia has already freed prices without at the same time controlling nominal wages and the money supply; it has already entered the spiral. For that reason, the constraints desired by the IMF are too late in any case. Little discussion took place of how Russia can get to the desired initial state from the different and disastrous course on which it has already embarked.

The case for micro-first was based on the contention that without having in place institutions, firms, and individuals able to respond to market signals, the new stable low-real-wage structure can produce only bureaucratic adaptation and social unrest. The real problem is the lack of managerial skills and institutions, and these cannot be created by macro shock therapy, nor will they be available to East European states from the outside, as they were to the NBL. Given the creation of an appropriate microeconomic structure, however, IMF controls can be effective (although it was also contended that IMF cannot substitute for governmental institutions; the world cannot hide behind IMF and the World Bank).

The gradual growth of a micro structure and managerial skills in Hungary was cited by the micro-first advocates: starting with the relatively "liberal" aftermath of the 1956 revolt, the early and slow transition from a command economy through "goulash Communism" created a structure that was ready to take advantage of the 1989 turn to democratic capitalism. This was abetted by a certain amount of dollar and DM support in the later stages. (Poland, an example of macro-first shock therapy, was not much discussed, although some inconclusive discussion took place as to whether Poland is on the road to success.)

For Russia, in any case, it will all be much more difficult. Foreign assistance on a scale commensurate to that supplied to Hungary and Poland will not be forthcoming, nor will it be simple for Russia to build an appropriate structure on the ashes of 75 years of command economics. The main hope may be the small legal and illegal institutions now poking their heads above ground. It was pointed out that 35-40 percent of all basic food, and two thirds of the meat in
Russia already comes from small farms. It was also suggested (not only by the micro-first advocates) that not only the FSU, but Russia itself, could benefit from more economic regionalization.

**Reduction of Real Wages**

It was generally agreed that for all of the lands east of the Oder-Neisse, very low wages would be necessary to keep their products competitive in world markets and to attract external investment. Indeed, given existing exchange rates, much of this has already taken place. Considerable concern was expressed, however, about the political and social viability of wage levels and differentials vis-a-vis the West. The jury is still out.

In the NBL, the political and social problems are being alleviated by the substantial consumption as well as investment subsidies forthcoming from the Federal German government; even so, as discussed in the first session, the cost of these subsidies is at the core of the overall German economic problem, as well as increasing political problems. Nobody, within or outside the eastern nations, can or will provide similar subsidies to these nations; without them, political instability may prevent the required economic measures.

Such instability currently prevails in Russia and several of the other states of the former Soviet Union, with no political or economic end yet in sight. On the other hand, the realignment may be working in some of the other East European states—Hungary, Poland, and the Czech Republic. To the extent that the political constraints permit low wages over a substantial period of time, these nations may develop full market economies even faster than the NBL, where standards of living will approximate those of western Germans very quickly.

**Outside Assistance**

The participants' dilemma on this issue can be expressed briefly.
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• It was agreed that outside assistance to the eastern economies was, and would continue to be, necessary.

• There was no agreement on the form such assistance should take—what kinds of technical assistance and what kinds of financial support, nor the mix of the two.

• It was agreed, although not unanimously, that at least at the current stage, large scale financial support, were it forthcoming, could not be well used.

• It was agreed that large-scale support, at least in the form of private investment, would ultimately be needed.

• It was agreed that it would be a long time before the conditions would exist to attract such support in the form of large-scale private investment; and that large-scale government support, from Germany or the United States, would not be forthcoming in the foreseeable future.

Conclusion

Just short of hopeless, at least for Russia.

SESSION III: THE UNITED STATES AND THE WORLD ECONOMY

The United States

Although the economy of the United States is still in a multi-year period of slow growth at best, positive indicators and factors also exist, and on balance the forecast (or at least the forecasters) seemed more optimistic than was the case for Germany.

Negative factors set forth in the American presentation included:

• In the short run, unemployment remains high, and although inflation is low, the desired tradeoff between the two is more weighted against unemployment than is the case for Germany.

• Over the longer run,
  -- Surveys show long-run fears that children will be worse off than their parents.
-- The federal budget deficit seems out of control.
-- The dollar is weak (down from over 3 DM in 1984 to barely over 1.5 today), but this has not done enough for the U.S. balance of trade.
-- Savings are very low, and personal debt remains very high.
-- Long-run interest rates remain high, with a large gap between long and short rates.
-- The S&L debacle remains a drag on the budget and the progenitor of fears that the same thing may happen to banks, insurance companies, etc.
-- The real estate market is soft, and commercial real estate in particular is greatly overexpanded, particularly in California, which is 10 percent of the U.S. economy.

On the positive side, however:

- Economic indicators are beginning to turn upward.
- U.S. exports have remained strong in spite of the sluggish world economy, and stand to benefit from a resumption of world growth.
- U.S. firms have been through the wringer, and are leaner than at any time in recent history.
- U.S. productivity has been increasing faster than has been realized; in the 1980s, productivity per working-age person increased faster than for West Germany or the rest of the EC.
- Defense cutbacks, a major reason for the short-run drag, provide a source of skilled and professional and technical labor.

Tipping the balance to the positive side, at least for the short run, is the fact that the incoming Clinton administration has provided a sense of direction and engendered the belief that it is ready to come to grips with fundamental as well as short-run problems. This has been reflected in the jump in consumer confidence that has taken place,
beginning shortly before the election when it was becoming clear that Clinton would be elected.

The pure inspirational portion of the short run, however, is likely to be good for no more than six months. By the middle of 1993, the new President and his administration will have to have demonstrated that they are coming to grips with real problems, and making difficult decisions.

The central issues for the administration have to do with the large budgetary deficit: how to balance the short-run need for fiscal stimulus with the long-run need to reduce the deficit; how to reduce the deficit while paying for American "needs," particularly those that Mr. Clinton has categorized as needed public investments; how to do it all without violating the promise not to raise taxes on the "middle class"; and how to convince world markets that all this is being done, so that long-term interest rates will come down.

Another, closely-related, debate concerns "industrial policy": how to define it, with possible definitions ranging from the most general of public investment in physical and social infrastructure to government bets on specific industries; and what to do about it. And finally, as Clinton and others have made clear, virtually nothing else is possible without controlling federal and other health costs, and the debate over health costs and health care is likely to go far beyond the six months; a plan, if one is agreed on, will take a much longer time to be implemented and become effective.

Nonetheless, the perceived direction is up, with the long-run problems seeming significantly less difficult than Germany's in reconstructing the NBL, if for no other reason than the difference in generational outlook between the leadership of the two countries. This said, however, the causes for American optimism are largely internal and nationalistic; they are based on "solve-our-own-problems-first" philosophy that may not facilitate American leadership in solving world problems.
(The German participants added a number of items to both the positive and negative sides of the American lists. On the downside, they suggested that the United States:

- Paid too little attention to unequal income distribution.
- Underplayed the importance of tasks to be done within the public sector.
- Suffered severely from a short-run management outlook—-to which an American participant added criticism of the "corporate cannibalism" of the 1980s.

More positive factors included:

- The belief on the part of several Germans quite familiar with the United States that needed tax increases were more possible than the American participants seemed to think.
- The fact that the U.S. does not have centralized collective bargaining. Some Germans thought that centralized bargaining was appropriate for Germany, but none would apply it to the United States.
- American-style competition, which the Germans envied.)

The World Economy

As a result of both the natural forces of industrial development in Europe and the Far East, and shortfalls in American policy over the last decade, the United States is no longer the undisputed economic leader of the world. This is not necessarily an unwelcome development in the U.S. or elsewhere, but the difficulty is that no collective leadership has risen to fill the vacuum. That has put substantial strains on the world trading system embodied in GATT, as manifest by the current intense disagreements over the Uruguay Round. All this has been happening as world economies in general, and the U.S. relationship to other economies, in particular, have become far more interdependent.
The developed world is increasingly dividing into three blocs--Europe, North (and perhaps South) America, and Asia--and it is sometimes contended that inter-bloc bargaining would be at worst a natural and acceptable substitute for the forty-year-old world trading system, at best perhaps even preferable. The American presentation on this topic disagreed strongly, contending rather that EC, NAFTA, and whatever structure develops in Asia can be viable and useful parts of a world system continuing under GATT. At the time of the workshop, in late November, the outlook for the Uruguay round was still cloudy, but not hopeless.

The international monetary system is in at least as bad shape, having come to no new stable basis since the collapse of 1971-73. Whether as a cause or as a result, in recent years the major trading nations have become increasingly autarchic in money as well as trade. In Europe at least, this has had the apparent effect over a decade or more of slowing productivity growth and increasing unemployment, while maintaining the "social market." More recently, the inward-turning of Germany since unification, with the resulting Bundesbank policies discussed in Session I, has assisted in putting substantial economic stress on Germany's European partners and on the United States as well. As one result of all this, the proposed European monetary system has collapsed, the existing system has done so partially, and even the EC 1993 trading system is under some threat. As discussed, the United States is also turning inward. Japan was not discussed at the workshop, but it has, of course, played its own controversial role.

(It is notable, in fact, that aside from the initial presentation to this session, the world trading system as a whole received very little discussion at the workshop; the multiple crises of EC and their relation to German reconstruction even less. This was perhaps due in part to the time pressures of the last session, but it was also related to the same national inward-turning that developed as a central theme of the workshop.)
The presentation on the world economy suggested that a fundamental restructuring of the monetary system was overdue, but did not lay out guidelines. It was also recommended that with the loss of undisputed American leadership, the G-7 must take the responsibility for restoring/preserving both the trade and monetary systems, but the nature and direction of the responsibility was not set forth.

That is the note on which the workshop ended. For the conversion to market economies of Russia and the rest of the East, for the consequent political and economic stability of Europe as a whole, and for the restoration of the world trading and monetary systems, leadership is needed. Economic leadership must come from the G-7, and the leaders of the G-7 continue to be the United States and Germany. But the United States is turning inward to confront its own problems; Germany is faced with the unsolved and enormous problem of rebuilding its own neue Bundeslaender. The most hopeful notes come from the vigor of the new American administration, from the long-run opportunities that several German participants saw in central Europe, and perhaps from the observation by one that these things are always cyclical anyhow.

The conference adjourned, to reconvene in Washington in mid-1993, to discuss these issues in the light of an additional half-year of developments, research, and thought. Perhaps by the very fact of meeting in Washington in the first months of the new administration, the second conference can assist policymakers to understand and come to grips with them.
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The Economic Situation in Russia and White Russia
The Reform Process at the Crossroads

Heiner Flassbeck
1. The current situation

Political chaos and institutional anarchy are what characterise the position in which Russia now finds itself. There is no central authority able to draw up and implement credible concepts for the reform process. The government of the Russian Federation is making a great deal of noise about reform, but it lacks the necessary means to carry out reforms at all levels of social life. Economic policy programmes devised by innumerable advisors are two-a-penny; but the fundamental political and legal conditions required if such programmes are to be realised in practice simply do not exist. Russia is in danger of sliding into a political and economic catastrophe which would pose a threat to the process of political liberalisation and the opening to the West. Simple recipes, merely fulfilling a catalogue of reforms, are no answer. The current situation results from a complex mixture of transformational and macroeconomic shocks, the details of which remain shrouded in obscurity. Thus the solution can only lie in an appropriate, complex mix of political and economic "remedies". We have attempted to determine the essential elements of such an approach.

2. Urgent action: what is to be done

Effective political authority is needed if the economy is to be stabilised and reformed. If political authority is not reinstated at every level all economic programmes are condemned to failure. Given that the transformation process in Russia has already led to a substantial devolution of political power from the centre to regional government, it would seem impractical (if not impossible) to reverse this trend with the aim of pursuing a radical, centralised reform policy from Moscow. Rather, central government should adjust to the
power structures as they now are, and, together with regional and local government, establish a federalist system which prescribes the division of responsibilities. Political decision-making structures must be credible. In the situation in which Russia now finds itself, the only way to achieve this is for the central government to restrict its activities to the tasks and reforms which only it can perform; the remaining functions of the state should be left to regional and local government.

The most important and urgent areas of concern for central government are as follows.

- The creation of an uncomplicated legal framework meeting minimum requirements, based on the principles of federalism and freedom of contract; its operation must be the responsibility of an independent judiciary.

- The stimulation of competition in all sectors by removing internal barriers to market entry, by the staged, but rigorous opening of markets to the world economy, and by granting admission to foreign investors. These reforms must also apply to the energy sector. Initially at least, competition is more important than privatisation in freeing productivity reserves.

- Macroeconomic stabilisation in the monetary and fiscal spheres.

The last point, in particular, appears to throw up insuperable problems. Galloping inflation can only be stopped by the standard instruments of a restrictive monetary policy at the cost of a serious stabilisation crisis, falling output and a sharp rise in unemployment. But this would further exacerbate the already precarious position of Russian firms, weakened because of the burden of corporate debt. Moreover the social consequences of such a policy
would threaten the entire reform programme. Equally, however, if the value of money cannot be stabilised all the other steps towards reform will be to no avail, because rapid inflation renders ineffective the central steering mechanism of a market economy - the system of relative prices.

While there is no simple way out of this dilemma, a number of possible solutions can be sketched out. The origin of the above dilemma is the fact that, despite the change in market conditions, prices and wages are relatively inflexible (downwards), and firms are not constrained by cost discipline. Restrictive monetary policies consequently lead to a negative demand shock, with all its consequences for the levels of output and employment, before the price and cost levels have had a chance to stabilise. The "inflation mentality" has become such a fixed component of social adjustment to rampant inflation that only an extremely clear signal, one pointing to a fundamental change of course for the monetary system as a whole, can be expected to produce a change for the better. In the current situation such a signal can only take the form of a concentrated political effort in the course of which the central reform measures mentioned above are implemented. If carefully planned and thought out, currency reform may well help to underline the political will to make a new start.

It is a misconception, though, to believe that monetary reform alone can solve the problem of inflation. Currency reform is merely a signal. What is decisive are the measures which accompany it. The basic aim here must again be to reestablish competition on goods markets and, at the same time, to reconstitute the relationship between employers and the trade unions. New unions must be founded (or existing ones restructured) in such a way that they both represent and channel workers' interests. As far as the employers are concerned, it is an essential precondition for the success of autonomous collective wage bargaining that
firms, including state-run firms, have an interest in keeping wages in line with productivity growth. This is only likely if the state ceases to act as if it were partly responsible management failures: this would entail a thoroughgoing reduction in subsidies and the scrapping of all compensation payments and offers of guarantees for state-owned firms ("hard budget constraint").

It would be necessary to solve the problem of corporate indebtedness, which, through the practice of granting inter-firm loans, reached fantastic proportions in the first half of 1992, within the framework of currency reform. The "monetary cut" must be large enough to reduce the stock values of assets and liabilities to normal dimensions. But to stress the point once more, changes in company accounts, i.e. an improvement in stock values, are not the essential point here. What is decisive is what happens to flow values after currency reform. If wage rises continue to bear no relation to productivity growth, if competition on goods markets remains weak, fiscal policies over-expansive and monetary policy lax, currency reform will be merely a "straw fire" which will soon burn itself out, making it harder than ever to solve the dilemma of macroeconomic stabilisation.

3. Additional reform measures required in the short to medium term

Only once the necessary political and macroeconomic framework is in place can the transformation of the Russian economy into a market economy be pursued with a reasonable chance of success. This requires a number of institutional reforms to be implemented in the short term in order to improve the fiscal position, to raise the low level of productivity throughout the economy, to improve the supply of consumer goods and services (and thus public acceptance of the reform policy), and to safeguard Russia's foreign-trade position.
Despite the numerous laws passed by parliament and the decrees enacted by the president and other subordinate bodies, little has so far been achieved with regard to meeting these aims. This is because of the exceptions built into the laws and decrees, and, in some cases, the overt defiance of local and regional government, which together have meant that many of the conditions vital for the market economy to function have simply not been created. This is particularly true of the aim of reintroducing competition: sectoral analyses have revealed that administered prices, monopolistic and interventionist power structures and the dominance of state-owned firms are effectively suppressing competition in many areas of vital importance to the Russian economy. For these reasons the prices for energy and agricultural products and for transport services will have to be liberalised, and privatisation in the trade and service sectors, agriculture and road transport (small-scale privatisation) will have to be accelerated. These are important first steps which must be taken if the supply of goods and services for the Russian people is to be improved in the near future.

Productivity growth in the trade and transport sectors is also important to ensure an adequate supply of inputs for production in industry and the energy sector. Currently severe bottlenecks are hampering not only production within the Russian Federation, but to an even greater extent - trade between the CIS countries, which has degenerated to little more than barter. For this reason it is vital that a decision is reached on the future of the rouble area as soon as possible. It would be consistent both with the wishes of a number of CIS countries and with the expected variation in the pace of the reform process in different countries were the rouble area to be replaced by a system of independent currencies. Once this is in place the CIS countries can reach trade and payments agreements which will make it much easier to maintain trade within the Commonwealth.
Even if it proves possible to achieve this aim in the near future, Russia will in any case have to intensify its economic relations - foreign trade and direct investment - with western industrialised nations. It is vital that the Russian currency be made convertible at a unitary exchange rate, in order to ensure that foreign-exchange earnings are allocated efficiently and to minimise capital flight. For Russian citizens convertibility should initially be restricted to those activities which appear in the country’s current account (primarily the import and export of goods and services). For foreign nationals, on the other hand, full convertibility should be introduced immediately.

The task would then be to ensure that macroeconomic stability, once achieved, can be maintained in the longer term. Here priority should be accorded to further efforts to consolidate the fiscal position by the creation of a simple and easily implemented taxation system, together with an efficient administration to run it. Furthermore, a number of reforms are necessary on the capital market in order to separate the banks from productive firms. The aim here is to prevent a repeat of the recent excessive credit expansion. As the process of consolidating the fiscal budget develops, a social security system must be steadily built up which does not exceed the state’s financial strength. Of course, given the inevitable adjustment problems arising out of the process of transformation, such a system will have to rely on state support for the foreseeable future. Priority should be given to social insurance against the risk of unemployment, as corporate restructuring will undoubtedly lead to an increase in frictional unemployment.
4. Medium and long-term tasks

Institutional transparency and macroeconomic stability are necessary conditions for structural change. Large-scale privatisation and the creation of effective capital markets will have to be postponed until a later phase of the reform process. Full convertibility of the currency will also have to wait until the economy has been successfully stabilised. Even so, provided increased competition is created within, and brought in from outside the Russian economy, state-run enterprises will be forced to make structural adjustments from the very outset of the reform process.

5. Western aid: conditionality and effectiveness

The preconditions necessary for large-scale western aid do not obtain in Russia at present. Responsibilities are not clearly divided between the various tiers of government, the efforts of each level contradicting and blocking those of the others. The state has shown itself to be incapable of dealing effectively with corruption and thriving organised crime. Unconditional financial aid should not be given in such a situation. Any support measures under consideration must be very accurately targeted. The financial aid which has already been set aside should be used for projects which help to improve living conditions of the domestic population, promote the transformation process and improve Russia’s capacity to export. Such funds should be exchanged for roubles at the market rate and made available in the form of loans to set up new businesses or as a contribution to equity capital. Aid is most urgently required in the following areas:

- to rebuild the agricultural sector under private ownership;
- to develop new sales channels for agricultural produce and create the corresponding infrastructure (storage and refrigeration capacities, packaging industry);
- to support small-scale, artisanal enterprises serving the local community;
- to promote the production of medical apparatus and pharmaceutical products.

Outside these areas western countries should only offer technical, non-financial support. Examples include counselling, training for workers in the public administration and for accounting, help in solving constitutional and legal problems, support for the creation of an independent judiciary and for the practical application of legal norms.

In order to be able to finance imports and meet its financial obligations, the Russian economy must be in a position to earn foreign exchange by exporting goods and services. All existing barriers to trade are therefore to be removed. Western countries must open their markets to Russian exports. This applies both to the markets currently heavily regulated by the EC (agriculture, steel and aluminium for example) and also to those for technical products in which Russia is potentially competitive (e.g. the aerospace industry).

It is helpful neither to Russia nor to exporting countries when products are offered to Russia more or less free of charge in order to maintain productive capacity in the exporting countries (as has happened in east Germany via the provision of government-backed guarantees for firms exporting to the CIS). This form of price subsidy has the effect of retarding the necessary processes of structural adjustment in both countries.
6. Conditions Specific to White Russia

The body politic in White Russia has so far shown a distinct lack of enthusiasm for reform. However, the accelerating pace of economic decline is increasingly leading to economic constraints which necessitate radical steps towards reform. In principle, the objective conditions for the transformation process appear more favourable than in Russia. White Russia's point of departure is not marred, as is Russia's, by political chaos and institutional anarchy. Still, progress along the road to reform depends primarily on the willingness of political decision-makers to contemplate change. Yet at all levels White Russia's political establishment is still dominated by conservative forces.

The main tasks of economic transformation towards a market economy are the same in White Russia as they are in Russia. The most urgent need in the former is to introduce a currency of its own: without an independent currency White Russia will not be able to pursue an autonomous economic policy and so stabilise its economy in the face of Russian monetary and currency policies. Large-scale privatisation and the attendant deconcentration of the economy should be comparatively easy in White Russia, given its more favourable initial situation. Here property structures are more transparent and the conditions are such that any decisions taken on privatisation are more likely to be actually implemented.
The Role of Government in Restructuring East German Industry

Wolfgang Gerstenberger
The Role of Government in Restructuring East German Industry
By Wolfgang Gerstenberger

Introduction

1. In the ongoing discussion of alternative approaches to improving the conditions for the economic recovery in the new federal Länder (NFL), arguments in favor of an active industrial policy are advanced more often than in the past. The calls for a more active role of government in the restructuring process may be explained by the extent of the collapse of industrial production and by the dissatisfaction with the pace of the recovery.

After a brief review of the present policy approach, it will be shown that policy performance in terms of the size of capital inflows induced into the NFL and of the speed at which new/modernized production capacities are created is far better than postulated by the proponents of a more active role of government. An industrial policy at a central level (e.g. by the Treuhandanstalt) is therefore considered not only unnecessary, but would even be counterproductive on fundamental grounds. Principal objections to a centralized industrial policy include serious information problems, the risk of overtaxing public budgets if existing capacities are maintained at a level far above that justified by market demand, the risk of massive investment errors by an "Ex-GDR Inc." and the need to avoid inconsistencies in the adjustment policy. The regions, however, have no choice but to develop industrial policies.
The Official Policy Approach

2. The present policy approach to the transformation and restructuring of east German industry consists of five main elements:

   (1) Massive public capital expenditures for the modernization and expansion of the public infrastructure and massive expenditures for the training and retraining of the labor force on a large scale in order to create the necessary environment for the location of industries which are capable to produce at the standards and wage levels of advanced industrial countries.

   (2) Significant investment incentives for private investment in order to induce an inflow of capital, knowhow and management talent from the old federal Länder (OFL) and other OECD countries to the east German economy and to encourage local entrepreneurs to establish new businesses.

   (3) Focusing the Treuhandanstalt on quickly privatizing the existing east German establishments and permitting it in its sales efforts to emphasize the aspect of safeguarding/creating jobs at the expense of financial considerations.

   (4) Containing the social problems associated with large-scale restructuring by financing a cautious policy of the Treuhandanstalt concerning the closing down of unviable companies and labor market policies which emphasize retraining.

   (5) Stabilizing the export business by providing Hermes export guarantees and by granting financial and other aid to Eastern Europe and the CIS republics.

This policy approach clearly focuses on achieving the necessary restructuring of east German industry at maximum speed. It is consistent with a wage policy targeted at achieving west German wage levels as quickly as possible.
Appropriate Wage Policy

3. A wage policy aiming at an extended prolongation of existing wage differentials would neither have avoided the collapse of industrial production following unification nor significantly changed the pace of the recovery. The collapse was due to lacking competitiveness of the existing goods and services measured against Western standards and the breakdown of the Eastern markets. Concerning the speed of recovery, the present policy stance allows labor cost advantages for production in the NFL compared to the OFL at least for the next ten years. Labor cost advantages of an alternative location in Eastern Europe or the CIS could not be overcome by a different wage policy given the constraints of a unified labor market in Germany.

Therefore the main risk of the existing wage policy is that public debt limits and/or the willingness of the taxpayers to pay for unification will be exceeded, as wage policy co-determines the level of transfers to the NFL and the accumulation of debt by the Treuhand. As the external conditions for a recovery in the NFL have deteriorated (chaotic tendencies in the CIS, depressed investment activity in the OECD in view of the recession, high German interest rates because of a restrictive monetary policy), a more cautious wage policy would be appropriate. The transformation process would be enhanced by a differentiation between "Treuhandanstalt establishments" and privatized firms. The wages in the first group should be frozen or at least raised at a lower rate than those paid by private industry.
Reaction of Capital Expenditures

4. The true effect of wage policy cannot yet be measured by the unemployment statistics as employment trends in the NFL are still governed by the collapse of output following unification. The only reliable indicator is the speed at which existing workplaces are modernized and at which new jobs are created. This is inevitably correlated with the level and growth of investment in the NFL.

At present not only public infrastructure investment (communication, roads and railways, gas pipelines) is rising sharply in the NFL, yielding investment per capita and investment per GDP ratios not even experienced during the post-war reconstruction phase of western Germany. Private capital expenditures, too, are booming, which in industry are driven by direct investment primarily of west German firms. The fact that capital expenditure plans are still being revised upward despite the deterioration of the general economic climate points to a rather robust recovery in the NFL as a location of production.

Objections to an Industrial Policy: The Specific Information Problem

5. There are calls for an intensification of industrial policy in order to avoid unnecessary business closures and excessive lay-offs as well as to accelerate the restructuring process by directing more funds to industries which are believed to be competitive under the new economic conditions. Both, the avoidance of unnecessary closures and the acceleration of the restructuring process require an idea of the industries in which east Germany should specialize in the future.
It is, however, hardly possible to develop any well-founded ideas about the specific constellation of east German industry for three reasons:

(1) The industries, in which the former GDR had specialized (mechanical engineering, optical instruments, electrical engineering, electronics) and which might have comparative advantages also under the new economic regime, have lost their traditional markets in Eastern Europe and the CIS due to the frictions caused by the transformation process in these countries. Because of the political instabilities there cannot be any reliable forecasts about when effective markets will reemerge.

(2) In the core industries, the east German companies are facing great difficulties of gaining access to the western markets. Because of the recession in plant and equipment spending, competition has intensified with the traditional suppliers. Technological backwardness and the lack of established distribution channels in western markets result in minor chances for successful market entry of independent firms.

(3) Most east German companies will have to find their place in the network of intra-industrial linkages within Germany and Western Europe. Because in this area minor differences suffice to determine competitiveness, which of the integration experiments will succeed and which will fail is unpredictable.

Because of the great uncertainty and imponderabilities there is no other option than to leave the selection of the future composition of industry in the NFL to the market. The user cost of capital for investment in the NFL must be lowered as far as possible, however, to compensate for the increased risk.
Problems of a Treuhandanstalt as "Ex-GDR Inc."

6. State-owned trusts tend to stabilize capacities at levels which are not profitable in the longer run and to conserve old industries for political and social reasons. This is confirmed by past experience in Western Europe and is the reason why a trend towards privatization has emerged in most EC countries. With this in mind, a switch in the responsibilities of the Treuhandanstalt from privatization to restructuring and modernizing the existing establishments would imply unbearable financial risks for the public budgets, given the large number of people (one million) still employed in state-owned firms.

The financial risks would be increased by such a policy switch for three reasons: firstly, it would imply a higher level of (wage) subsidies than if the focus remained on privatization. Secondly, it would result in a higher volume of wasted investments, because more money would be spent on projects which would ultimately turn out to be flops. Thirdly, private enterprise would be discouraged, because private firms would have no chance in those markets targeted by state-owned and heavily subsidized firms.

The implied stabilization of existing capacities would be inconsistent with the general policy of encouraging a restructuring at maximum speed. Therefore all government support in this direction would be less efficient and/or to achieve the same effect would be even more expensive.

The Role of Local Authorities

7. Whereas central government organizations should abstain from intervening in the process of industrial restructuring for the reasons spelled out, the local authorities have no alternative. The Länder governments and their regional development associations must try to influence their industrial portfolio in order to establish the best possible foundation for the economic welfare of their regions. Toward that end they can either try to attract new industries and/or to restructure and reorganize existing plants. Under the extremely difficult conditions in the NFL the latter can include the option of becoming the owners of the establishments facing the same challenges as the private owners.
Government interventions at the local level are less problematic from the point of view of "Ordnungspolitik" because

- the allocative power of local authorities is limited by competition from and by other regions;

- their potential to protect economic structures against long-term market trends is lower due to their inability to change the rules of the game and due to the financial constraints.

A cautious use of public funds would require, however, that local authorities not be permitted to claim fresh money from the central government or within the "financial compensation scheme (Finanzausgleich) if they made poor investments."
The United States and Germany in the World Economy

Charles Cooper and Robert Levine
THE UNITED STATES AND GERMANY IN THE WORLD ECONOMY

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RAND

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1. "THE ECONOMY, STUPID!"—THE OUTLOOK FOR THE NEW ADMINISTRATION

The recent Presidential election turned by almost all accounts on voter dissatisfaction with the state of the US economy. While the economy was not technically in recession, the pallid recovery seemed like one to many Americans: unemployment at 7.5% in September was up over the 6.8% of a year earlier, industrial production was up a mere 0.2%. "Jobs" were a basic issue but not the only issue. The decline in median real wages and family incomes over the almost twenty year period since 1973 and growing income and wealth disparities were also widely remarked. Surveys confirmed that many Americans feared that children would not enjoy the same living standards as their parents. Relatively good price performance—consumer prices up only 3% in a year and under 4% on average over the last decade—was little solace; the tradeoff between inflation and unemployment is evaluated differently in the United States and Germany.

Underlying the social hardships were apparent evidence of systemic economic failures—notably a Federal budget deficit seemingly out of control, a weak dollar (down from over 3 DM in 1984 to barely over 1.5 DM today) but large and rising trade and current account deficits, and continued poor investment and savings performance. Personal savings for some eight years have run around 4-5% of personal income instead of the 6-10% normal in the 1960's and 1970's. Corporate debt has been cut back—but personal debt has been trimmed only slightly. To some extent, the shortfall in savings has been compensated for by investment from overseas, but that has raised political and economic problems of its own. The S&L debacle and strains on commercial banks seemed to confirm that the US had caught some sort of financial virus that even 3% interest rates (short-term) could not cure.
President-elect Clinton clearly has a mandate for an energetic activist economic program. Looked at more closely, however, it is far from clear that the US economy requires drastic economic measures to bring out its best. Worldwide asset deflation has claimed victims everywhere—and the US may be better placed than most to overcome its strains and reestablish a new basis for growth:

- US exports have remained remarkably strong in the face of sluggish worldwide demand and will benefit disproportionately from a resumption of growth in both developing and industrial economies.
- US firms have been through the wringer and are leaner than at any time in recent history.
- The upsurge in US manufacturing productivity has moved the United States back to the front of the class by some measures. From 1980 to 1988, for example, although the average annual increase of US productivity per employee was less than that of the EC and about equal to the FRG, the US increase per person of working age far exceeded the others.
- Only in the short-term are defense cutbacks an economic problem—as time goes on they are the source of the skilled labor and capital that a revived manufacturing sector will need.
- Nothing very favorable can be said, however, about the outlook for the commercial real estate sector, and those of us who come from California are painfully aware of the reality of geographic as well as sectoral weakspots.

The remaining problems are not going to get worse, they are part of yesterday’s problems not tomorrow’s. Tomorrow’s growth in the United States is going to have to be very different than yesterday’s. From the oil crisis of 1973 on the US has depended disproportionately on additions to the labor force, mostly new female participants (which is why the per-employee and per-person statistics are so different), to drive its growth. Capital expansion and technological change (e.g
increases in total factor productivity) have been far less crucial to
the US than to Europe or Japan. But the era of accelerated new entry
into the labor force, at least from the domestic population, is past,
and the future for the US will depend on achieving the kind of economy-
wide productivity improvements that Germany, Japan and other industrial
countries have relied upon. This is a new challenge - but the US
economy is well poised to meet it.

Three overlapping political-economic issues confront the new
administration - getting the US economy out of its present "growth
recession" and on to a more dynamic track, reducing the longer term
Federal budget deficit, and ensuring that the US retains a leading
position in those modern economic sectors that will be the source of
good wages and growth in the years ahead. Neither the relative
priorities of these challenges nor the main lines of how they are going
to be addressed is yet clear. On the one hand, Clinton-supporter Richard
Fisher (Chairman, Morgan Stanley) recommends that the new administration
focus on the longer-term problem of slashing the deficit since there are
signs that the economy is picking up and there may be no need for short-
term stimulus. On the other hand, more traditional liberals expect an
early assault on unemployment, and support for a wide range of social
programs from school lunches to extensive retraining efforts. And
consistent with either macroeconomic approach, industrial policy
enthusiasts like Ira Magaziner urge government action to encourage R&D
and support the development the "cutting-edge technologies" of the
future.

These different approaches will not easily fit together, but the
Clinton Administration is not likely to be paralyzed by the complicated
interrelations among these challenges as its predecessor frequently
seemed to be. Whatever it does will be activist in tempo and and
philosophy. Let's look at these three areas a little more closely.
Short-term stimulus

1. Will it be needed? Probably. Defense downsizing is still going on and is likely to accelerate, if anything; the corporate sector is still laying off "excess" employees; consumer confidence remains low although there has been a significant reduction in consumer debt. While economists might make the case for holding off to see whether the economy might soon turn around on its own, no activist politician is going to wait.

2. What will be the specific measures taken? The least controversial measure and the one most likely to be put in place is an investment tax credit of some sort. What remains unclear is whether it would be for all investment or only for machinery investment above some previous level. Congress in the past has been reluctant to deny the credit to any new capital outlays, and that will probably be the outcome this time as well. Whatever the case, Clinton advisers claim any ITC adopted will be self-financing over the long-run, and thus not add to the longer-run deficit problem.

The more interesting and more contentious proposal is for a large - $20 to $50 billion - public works program to be launched early in January. In the past such efforts have as often as not been counterproductive since by the time spending plans were made and the new projects actually launched the economy had turned itself around anyway. To get around this problem, one approach under current discussion is the provision of Federal funds to States or localities that have a backlog of public works programs on the shelf that have been held up for lack of funding. How true this is, and how worthwhile the backlogged programs really are, is hard to tell. If spending money were the only issue, that would not make much difference. But if the money would have to be repaid to the Federal government, how sound the projects are would make a big difference. In any event, the real issue is not how such a program is itself financed but whether it is part of a longer run strategy that the markets, particularly the bond market, will perceive as credible.
Deficit Reduction

Ross Perot's showing in the election has increased the pressure on the new Administration to put forward a credible deficit reduction program early in 1993. Since the odds are that the economy will remain soft until at least midyear, what is called for is a program that phases out the stimulus package and phases in deficit reduction as the economy strengthens. Such a program has to be both acceptable to a Democratic Congress and credible to the financial community, in particular to the bond market.

Congressional Budget Office projections make it clear that without major changes in policy, the longer term outlook is for the deficit to continue to grow. If this outlook remains unchanged there will be no possibility of bringing down long term interest rates, and if these rates do not come down achieving the high-investment high-growth high-employment economy that Clinton wants will have to be financed from abroad, by inflation, or not at all. The one saving grace is that nobody expects the deficit to be brought to heel quickly, what is expected is a credible program to bring it down gradually once a more vigorous recovery is underway.

No US political consensus exists in support of a credible deficit reduction program. Increased taxes on the wealthy (incomes over $200,000) will not begin to do the job even if Social Security payments are also made taxable for high-income earners. Moreover, experience has shown that high marginal rates generate effective political pressure for loopholes of various sorts. Higher taxes on middle-income Americans, such as a significant gas tax or a national sales tax or VAT, command little political support. Estimates made during Clinton's campaign, of how much income taxes paid by foreign investors might be increased, are far higher than can realistically be expected. Cutting the cost of entitlement programs such as Social Security or Medicare will not be popular no matter how it is dressed up as "reforming the system"; in the meantime, demographic changes will increase the bills. The defense budget offers substantially more promise for spending cuts, but what is possible here is not yet clear, and in any case, defense cuts are not likely to cover all the other increases called for.
Thus, what will emerge in the way of deficit reduction, and when, is uncertain. Although there is room both economically and politically for ducking this issue for a year or so, the problem will not go away, and sooner rather than later will have to be dealt with. When it is, the solution is likely to be found in fiscal changes far more fundamental than anything yet on the table. Many economists think that major tax reform, such as the introduction of a VAT or a much tougher inheritance tax regime, accompanied by revamped entitlements programs and restructured relations between the Federal government and states and localities, may be needed. Realistically, inflation, even as low as it has been historically, will ease some of the burden.

Industrial policy

No tenet of economic policy was more firmly held in the Bush and Reagan administrations than the idea that the government should not attempt to "pick winners and losers" among firms or economic sectors. As a result the US government self-consciously stepped back from a major role in technological research or even worker training. The Clinton administration will approach this issue on a far more pragmatic and less theological basis. While there will still be little appetite for bailing out losers there will be far more interest in government supported and funded research programs, some carried out directly by the government, others financed indirectly via tax credits. The government will be far more a catalyst for technological change than a mere observer of market forces.

Even so, the "industrial policy" pressures to make specific bets on specific sectors will be resisted. The new Administration's policies will remain far more constrained on this issue than those of France but will increasingly be hard to distinguish from those of Germany. It is likely that the Clinton Administration will play a much more active role in assisting the "conversion" of defense industries in order to preserve their unique hi-tech resources and skilled workforce. Nobody will be able to accuse them of not being able to tell the difference between a computer chip and a potato chip. The Clinton Administration as it
assumes power is likely to strike both an activist and a centrist stance. It will not be anti-business but it will be far more mindful of the social consequences of its economic policies than have recent US administrations. It is likely, on the other hand, to be less inhibited by doctrinal considerations and more pragmatic and impatient in dealing with economic issues.

On international economic matters, it will continue to support the liberal global economic system that has emerged over the last forty or so years, but here too pragmatism rather than economic theology will be emphasized.

2. CURRENT ISSUES IN INTERNATIONAL TRADE AND MONETARY POLICIES

Massive changes took place in the international economy during forty-plus years of Cold War. Dramatic decreases in the costs of transportation and communication together with the cumulative effect of forty years of trade and capital market liberalization have led to an explosion of world trade investment and capital flows that is still far from complete. The characteristics of a still evolving global economy include a reliance on telecommunications, interaction among technology, production and services, footloose manufacturing and assembly operations, and the establishment of modern industrial sectors in new countries and areas of the world. As a result of the worldwide spread of direct investment and the proliferation of transnational corporate alliances, multinational corporations today operate across national borders at all stages of the development process.

The emergence of an integrated global economy, the growing importance of regional economic arrangements, the end of U.S. economic dominance, and the slow realization that the few rich and the many poor must seek to achieve their aspirations together in an increasingly crowded world, have changed the international economic agenda. But although the agenda has changed, the necessary policy and institutional adaptations have not yet taken place. A globalizing world economy has placed new strains on GATT and on international monetary arrangements, and has revealed serious institutional and doctrinal weaknesses.
Unfortunately, multilateral stewardship has not yet developed to the point where it can play the role formerly played by the United States.

In the summer of 1992 two major nonpartisan national study groups, the Carnegie Endowment Commission on America and the New World and the CED Subcommittee on a Global Economic Strategy for the United States, issued reports calling attention to this issue. The Carnegie Commission, for example, noted that: "The outlook for world economic growth ... over the next few years is clouded. Today there is no locomotive, no large country that is growing and willing to accept a large increase in its imports and a sizeable deterioration in its trade balance. And policy cooperation among the major countries is so ineffectual that it offers little promise of concerted action that might soon stimulate world growth. The rapid pace of change in the global economy threatens to overwhelm existing multilateral arrangements."¹

Both reports urged the United States to take the lead in energizing more effective international economic cooperation. Both also pointed out that a different kind of U.S. leadership was required. They stressed that while the present liberal international system owed its existence and effectiveness to U.S. leadership beginning in the early postwar years, the necessary adaptations could only be brought about by the joint efforts of the world's leading industrial countries. The CED description of the U.S. role as a "rallier of nations" aptly characterizes the new kind of U.S. leadership that was being urged.

Underlying the change in the nature of U.S. economic leadership are changes in the U.S. economy that preclude it from being the sole steward of the international economic system. One central development is the narrowing gap in productivity between the US and other industrial countries. EC per capita income rose relative to that of the US from 29.4% in 1960 to 66.3% in 1990, and that of Japan from 29% to 80.7% (purchasing power comparisons). While economic convergence is a natural, even inevitable, economic process, which has slowed down, just as naturally, in the last decade, strikingly low U.S. savings rates bode ill for the future.

Equally significant is the change in the role of foreign trade in the U.S. economy. As a continental economy rich in natural resources and with few internal barriers, the United States remained less involved in foreign commerce than other industrial nations through the 1960’s. This has all changed. In a single decade the U.S. economy was transformed by the increase in trade relative to GNP from 12.7% in 1970 to 25.0% in 1980. The increase in the importance of trade since 1960 is much greater for the U.S. economy than either Japan or Europe as a region. Increasingly the United States and the EC are coming to resemble each other as U.S. involvement in the global economy grows and internal barriers to trade in Europe continue to fall.

While the emergence of a global economy is the subject of editorials and commentary, the world economy remains dominated by trade within and among the three regions of OECD Europe, North America, and East Asia. Regionalization is growing in importance, stimulated in part by EC-92. Indeed, the Single European Act agreed to by EC governments in June 1985 and designed to bring about a barrier-free Europe by the end of this year can be seen in retrospect as marking not only a revolutionary political transformation of Europe but a new stage in the evolution of global economic geography.

As the movement of goods across borders has increasingly been accompanied by movements of capital and technology, regional arrangements have been viewed as better suited than complicated multilateral negotiations to harmonize the wide variety of administrative and regulatory practices that separate markets. For both EC-92 and the US-Canada Free Trade Agreement (FTA), regional agreement was needed to catch up with the problems associated with a prior expansion of trade and investment. Overt trade barriers such as those conveniently dealt with in GATT were by definition not even a factor in the case of EC-92.

A successful conclusion to the Uruguay Round will not by itself bring multilateral surveillance fully in line with the rapid pace of change in the international economy, but by extending GATT supervision to agriculture, textiles, services, trade-related investments and
intellectual property it would take a significant step in that
direction. New issues regarding financial services, foreign direct
investment, public procurement, technical standards and tax policies
are on the post-Uruguay Round GATT agenda, while growing conflicts
between trade and environmental concerns and between trade and
competition policies are already being heatedly debated. Were the
Uruguay Round to fail, such issues would not disappear, they would
simply be taken up through bilateral and regional negotiations.

Some observers argue that this would be no bad thing. The
principles of non-discrimination and national treatment that underlie
GATT negotiations are seen by them as inappropriate to emerging trade
issues, many of which involve intruding on what has until recently been
considered solely matters of internal policy. It is argued that
cumbersome multilateral negotiations on such matters cannot be expected
to succeed and that regional negotiations offer more promise.
"Reciprocity" rather than non-discrimination would be the outcome.

A major problem with this line of reasoning is that the stronger
trading nations would be able to take care of themselves, the weaker
would not. GATT offers the only hope for inclusiveness and the best hope
for giving all countries a stake in the system. For a global trader such
as the US has become, sweetheart deals among the few are no substitute
for an open global system. Giving up on the multilateral system could
open the way for regional groupings to deteriorate into hostile blocs.
Regional trade and investment agreements are not necessarily
inconsistent with a GATT-centered trade policy. Indeed, they can play
an important role as the cutting edge of integrating national markets,
but the multilateral system cannot be allowed to lag too far behind or
it will be outrun. In this regard, further development of the EC
will be welcomed by the United States provided that it continues to
occur within GATT guidelines and the EC continues to demonstrate
willingness to negotiate multilaterally in areas where others feel their
interests are affected.
The US-Canada FTA, while controversial politically in Canada, is an economic success. Its extension to include Mexico in a North American FTA reflects the radical change in Mexican economic policies under the Salinas government that has for the first time opened up the prospect of a prospering Mexico as a US neighbor. As a consequence, a number of studies have shown that NAFTA can reasonably be expected to generate many more jobs through additional exports than would be lost to additional imports. Congressional approval is expected early next year, although additional understandings regarding environmental protection and the treatment of labor, and effective worker adjustment provisions, may be needed.

What is less clear is what happens next. The Bush Administration considered opening discussions with Chile as a further step towards a possible Western Hemisphere free trade zone. If multilateral trade talks remain stalled, or if bilateral issues remain contentious, possible further steps by the Clinton administration towards this end are likely. Moreover, it would then be likely that the US would intensify discussions regarding some sort of trans-Pacific regional arrangement. It is even conceivable that there would be renewed efforts to construct some sort of US-Japan trade arrangement.

With the end of the Cold War, international political constraints on US trade policies are no longer as compelling as they were. If multilateral progress is stalled, the US could easily become even more aggressive in negotiating trade problems on a bilateral basis outside of GATT than it has in recent years. GATT’s weakness in dispute settlements and enforcement actions and the creeping irrelevance of GATT rules to real world trade complaints and grievances contribute to this possibility. Countries such as the US, the UK, and Germany, with a strong interest in the maintenance of an open world trading system, should recognize how big the stakes are. Sooner rather than later this will undermine the multilateral system and lead to a more politicized trade environment. Not only is an early successful outcome to the Uruguay Round needed, but the pace of multilateral trade negotiations will have to pick up immediately after this is achieved, since the system already lags economic realities.
The stakes of what is involved in trade negotiations have also been raised by the realization that for strategic industries where economies of scale are critical, and where "learning by doing" is essential in developing a particular technology, early government support can determine who will get what gains. There is no simple answer to the dilemmas involved in developing adequate multilateral provisions regarding such programs. Domestic programs to encourage R&D and support new technologies become simultaneously essential and internationally contentious. Such programs exist in many countries and are likely to be adopted in some form in the United States by the new Administration. Multilateral rules providing for nationality-blind government procurement policies and R&D subsidies can help in defusing the problem but some degree of tolerance for others' domestic efforts to support key industries will be required.

If the international trade system has reached a critical juncture, the international monetary system seems to have reached an impasse. The collapse of fixed exchange rates in 1971-73 has not led to the elaboration of durable international understandings regarding exchange rates, international liquidity, policy responsibilities of debtor and creditor nations, or even policy cooperation to alleviate the pains of recession. The present ad hoc regime is not one chosen and implemented out of conviction. Rather present arrangements are seemingly tolerated in the absence of agreement on something more coherent. As a result it has proved impossible to establish an effective oversight role for the IMF or any other institution.

US officials of virtually all political persuasions see the urgent global problem as one of restoring more vigorous economic activity and reducing unemployment in most industrial countries. Attempting to slay once and for all the dragon of inflation by imposing a stringent monetary environment seems to have gone much too far. Recent experience with the political fallout from 10% unemployment in Europe is sobering.

Only briefly during the recent Europhoria of 1988 and 1989 did EC members appear able to generate adequate numbers of new jobs. For most of the last quarter-century, the contrast with the US has been striking.
From 1963 to 1988, US employment increased by 47 million, as jobs were generated for 94% of the increase in the working-age population. For EC over the same period, employment increased by only 8 million, with jobs generated for only 26 percent of the increased working age population. After the brief period of Europhoria, Europe appears to have slipped back to its longer-term trend of high unemployment and slow job growth. This may be a recipe for high productivity, and for a strong balance of payments, but it is not a recipe for a strong European or global economy. No fully persuasive explanation of why European employment has for so long been anemic exists. Intuitively the answer would seem to lie in a combination of generous social policies, high wages and monetary conservatism. This recipe evidently attracts public support, but whether it can be followed in the face of blistering international competition attendant with a global market remains to be seen.

From a longer-run global perspective, present monetary and financial arrangements are unsatisfactory in other dimensions as well. Once the pace of economic activity picks up, there will be a danger of a global capital shortage and high real interest rates that would be particularly painful for developing countries to the south and to the east, and doubly so if world savings were again being channeled to industrial countries "to sustain private consumption or public sector deficits or sometimes both" as a B.I.S. report noted last year. On the brighter side, the substantial progress made in reducing inflation and dampening inflationary expectations, is an important accomplishment that has not been easily achieved. It confirms that an opportunity may be at hand for putting in place cooperative policies among major industrial countries to encourage broad participation in an expanding global economy.

Present institutional arrangements for international monetary cooperation do not easily lend themselves to the development of such policies. The IMF today has little influence on the financial policies of the major industrial countries, while the G-7 as an institution, with a kaleidoscopically changing cast of characters and virtually no institutional memory, has only intermittently and ineffectively tried
to do so. Looking to a possible future of three major currency blocs, a renewed commitment to developing and enforcing a more defined operational doctrine regarding international monetary cooperation, exchange rate management, and policy coordination is needed.

The Carnegie Commission in its report urged that steps be taken to strengthen the G-7 as an effective facilitator of such monetary cooperation and policy coordination. This conclusion reflects sentiment that is widespread in the US policy community where many feel that the G-7 should be drawn into a wider range of issues, including trade strategy and assistance to developing countries and the transitional economies of East Europe and the CIS, in order to "manage" the global economy.

The argument emerging in policy circles in the United States for a fundamental overhaul of the present system may be put roughly as follows:

The policies, institutions and arrangements of the present international economic system were put in place over forty years ago at a time when the United States was in a position to steward its operations effectively. This is no longer the case. As a result, growing difficulty in elaborating and enforcing multilateral rules governing international trade and finance threatens US economic prospects as well as our political interests.

The inability to bring the Uruguay Round to a successful conclusion in spite of the awareness of all parties of the contribution this would make to trade prospects and the global economic environment is an alarming example of this development. An increased level of trade protection in industrial countries, the growth of regional arrangements, and the inability to develop norms of good conduct in the realm of monetary policies and exchange rates are other examples. There is a risk that the present system will founder and eventually be replaced by ad hoc arrangements among powerful regions and blocs. There will be no winners if this happens, but there will be many losers.

Even if this worst case is avoided, the best to be expected from a business as usual approach is more muddling through. The future seen from late in a recession frequently seems gloomier than it turns out to be. Still the prospect of more years of desultory trade negotiations that never quite catch
up with what is needed, continuing high real interest rates and financial stringencies for both industrial and developing countries, episodic and inadequate encouragement of reform in developing countries, economic hardship and political crises in East Europe and the CIS, and reactive rather than creative responses to global problems generally is simply not good enough.

It is now widely accepted that the United States cannot by itself lead the way to a stronger international economic system. Stronger leadership is required but it must be collective leadership of the world’s major industrial democracies. What is needed is a G-7 capable of establishing effective multilateral stewardship of the international economic system through agreed commitments, strategies and institutional arrangements to replace U.S. stewardship which is no longer feasible or desirable. Since expanding global markets are seen as key to US recovery, the new US administration is likely to pursue this objective with considerable urgency and vigor.

What remains to be seen is whether domestic strains will permit the major industrial countries of the world to agree on a common approach to the demanding international agenda. In this regard, domestic pressures in the US and Germany, the two major industrial countries (along with the UK) most closely associated with liberal trade and financial market policies are not encouraging. The current impasse over the Uruguay Round could be a harbinger of worse to come.

3. THE AMERICAN AND GERMAN ROLES

For different reasons, neither Germany nor the US has emerged from the Cold War with a domestic political-economic base solid enough to encourage it to exert effective international economic leadership.

The domestic base for US international leadership has eroded severely. The plight of American cities and the strains on American families suggest this may be a long time coming. Although the United States is very unlikely to relapse into the kind of historical political "isolationism" that many Europeans fear, a move toward Western Hemisphere economic autarchy would be an inevitable result of the
collapse of the GATT negotiations. In any case, US overseas public expenditures will be severely limited, at least in the near future.

With the collapse of the Soviet Union and the end of the Cold War, the American public’s preferred agenda for US foreign policy is aggressively self-interested and assertive. With little domestic consensus on the fiscal reforms needed at home, there is even less support available for a statesmanlike foreign policy. Foreign trade is seen by many Americans more as threat than as opportunity, and a decade of stagnating incomes has led to a pessimism about the economic future which permits little concern for developments elsewhere in the world. Europe is seen as capable of managing its own affairs after years of prospering under an American security shield, Japan is seen as part of the economic problem, and developments in the former Soviet bloc and in the world’s poor countries call forth massive indifference. A restoration of economic progress and optimism at home is a precondition for American leadership abroad.

Thus, the outlook for an early turnaround is not particularly encouraging. If Clinton’s economic policies can restore production and job growth, and increase personal incomes and the national sense of wellbeing, however, that can lead over time to an improvement in America’s international outlook.

For Western Europe as a whole, the liberal international economic regime that has been in place since WWII has been reasonably effective in dealing with most of the challenges it has faced - restoring world trade, supporting postwar economic recovery, establishing an effective international monetary regime and adapting it to changing circumstances, transferring resources from rich to poor countries and encouraging the latter’s economic development. These jobs could no doubt have been done better, but the international regime has not flunked any of its assignments. Until now. It has not proved up to the job of supporting the transition to market economies either with advice, resources or access to markets.
Germany is a special case, and a dominant one. As has been discussed at the earlier sessions of this workshop, the drag of unification shows few signs of abating for the foreseeable future. The transition from Communist to productive market economies is proving far harder, more costly, and more time consuming to bring about than expected. Thus overburdened with the costs of unification, Germany has understandably little tolerance for accepting additional international responsibilities. Belated attempts to achieve a domestic "solidarity pact" with respect to sharing the costs of unification have had only marginal success. There is still no consensus on who will pay either through higher taxes or restraints on wages, social programs and subsidies. The Bundesbank has felt compelled to step in to squeeze out resulting inflationary pressures, with the unfortunate side effect of choking off economic activity at home and deepening and prolonging recession elsewhere in Europe. The United States has been better insulated, but if Germany wanted to provide a friendly assist to the takeoff of the Clinton administration, a significant rate cut would be a major contribution.

A political product of the repercussions of German monetary rigidity has been the creation of uncertainty over the future of European integration (beyond EC-92 which remains relatively unscathed). It is no longer clear as a result of the October 1992 turmoil in financial markets and the UK's temporary change of course whether European Monetary Union and the adoption of common European defense and foreign policies are still realistic goals to be achieved this century. If "deepening" no longer has any well defined content, the question of "broadening" the EC is even more up in the air. Unfortunately, developments in the East are even more unsettling. The horrors of what is happening in Yugoslavia do not permit any complacency concerning the discouraging economic and political developments in Russia and the other successor states of the FSU as well as in East and Central Europe. The impression left on any informed observer is one of beleaguered governments barely hanging on to democracy while economic hardship creates sullen publics and smoldering ethnic and national tensions.
Let us make clear, however, that we do not view Germany’s economic problem primarily as a failure of policy — by the Federal government, the Bundesbank, or any other German institution. True, the dreadful condition of the economy of the GDR, and in particular the gap between East and West German productivity, was woefully underestimated; and some of the political/economic decisions made in 1990 were, in retrospect, jumps that carried half of the way across a wide chasm. Nonetheless, the chasm is there, and nobody has figured out how to cross it.

The chasm lies between: on the one hand, the economic difficulties and costs of equalizing productivity between the 1990 economy and one firmly based on the Stalinist shibboleths of the 1940s; and on the other hand, the social intolerability of leaving one part of a nation to gradually climb out of a 1945 standard of living, while the other part progresses into the 21st century. Such a chasm would exist even if the ostmark had been converted at 5:1 and if Eastern wages had been frozen at 1989 levels. It may be made worse by the strong German version of the European social market—the economic structure that, as has been suggested above, has constrained Europe from creating jobs at the same rate as the United States—but it is based more on differences of capital stock, accumulated shortages of market-related skills, and industrial organization than on differences of social policy.

As this workshop has discussed, an even wider chasm lies between Western Europe and Eastern Europe including the former Soviet Union. Nor can the economies of the West be isolated in their stability much better than the West German economy can be protected from the East; or the social politics of population pressure now being experienced by Germany be prevented from spreading. And, worst of all, the spectre of former Soviet warlords armed with nuclear weapons renews, on a more random and perhaps more dangerous basis, the fears we thought we had ended with the end of the Cold War.

It is our hope that this workshop, and the follow-on conference in Washington, can help provide an understanding among Americans of the depth of the German and European problem, and an understanding among Germans of the effects on the world economy of their attempts to cope
with it. Such understandings do not provide ready-made solutions, but they are a necessary first step.