

ROUTING AND RECORD SHEET DHS Review Completed

SUBJECT: (Optional)

US in Global Economy

Executive Registry

82-477

FROM:

Hans Heymann, Jr.
NIO-at-Large

EXTENSION

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NO.

DDI #2676-82

DATE

26 March 1982

TO: (Officer designation, room number, and building)

DATE

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OFFICER'S INITIALS

COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)

1.	C/NIC	DATE		OFFICER'S INITIALS	COMMENTS
		RECEIVED	FORWARDED		
		29 MAR	31 MAR		<p>Henry</p> <p>That DCT liked</p> <p>the project & wanted</p> <p>it conveyed to you</p> <p>He asked:</p> <p>"What should the</p> <p>denis?"</p> <p>any follow-up</p> <p>action from you</p> <p>would be needed</p> <p>for</p> <p>C-112</p>
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	NIO/AL - Heymann				

THE DIRECTOR OF CENTRAL INTELLIGENCE

824157

WASHINGTON, D.C. 20505

DDI #2676-82
26 March 1982

National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM : [Redacted] National Intelligence Officer at Large

STAT

SUBJECT : US in Global Economy

1. Attached is the paper I promised you, presenting an alternative, unabashedly up-beat view of US economic prospects in the 1980s. It attempts to counter what I regard as unjustifiable anxieties about the erosion of the US competitive position in the world economy. If it errs on the side of optimism, that is intentional.

2. In addition to the charts included in the paper, there is a much larger body of annotated graphic materials that amplifies many of the points made about the evolving US position in the world economy. These materials could be published separately or as an annex to the paper.



STAT

Distribution:

- 1 - DCI
- 1 - DDCI
- 1 - Ex.Dir.
- 1 - ER
- 1 - NIO-at-L/HH
- 1 - DDI Reg. w/o attachment

NIO-at-L [Redacted]



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26 March 1982

Summary

In assessing the US performance in the global economy, the following factors are often overlooked:

- o The US economic position within the industrial world stabilized during the 1970s after declining for two decades, and there is every expectation that it can sustain its present position through the 1980s.
- o During the 1970s, the United States did quite well in competing for international markets: It ran a larger cumulative current account surplus than any other developed country; it did exceedingly well in selling services and agricultural products; it even improved somewhat its share of the global market for manufactures.
- o The US had to and did put to work far more people in the 1970s than other industrial countries, a major factor that contributed to holding down the growth of US productivity.
- o The introduction of flexible exchange rates in the early 1970s has created a highly cyclical pattern in the international competitive position of US goods that reverses about every three years. The period of "non-competitiveness" of US manufactures we are now entering is more a reflection of this cyclical pattern than of fundamental factors.

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The global economy will experience a number of stresses and challenges in the 1980s, as it has in previous decades. While these challenges will be different, there is no reason to believe they will be less manageable than the extraordinary upheavals of the 1970s. The US is particularly well equipped to adjust. It enjoys:

- o A higher degree of flexibility and resilience than most other industrial countries;
- o Greater domestic energy resources and a potential for further gains in conservation;
- o A large backlog of industrial investment requirements and the only major investment stimulation program newly put in place;
- o A power of attraction to foreign investors that goes beyond present high interest rates;
- o A demographic trend that will reduce unemployment pressures and stimulate investment in labor saving capital equipment;
- o A striking competitive advantage in the dynamic service industries, particularly in the sector that integrates computers, communications and knowledge;
- o A large-scale R&D and technological innovation effort conducted across a broad range of economic activities, as well as a new-found awareness of the need to compete internationally as well as domestically.

The US Role in the Global Economy:

An Alternative Perspective

Introduction

This paper examines the performance of the United States in the world economy in the past decade and looks beyond the present recession toward the mid-eighties. The perspective that emerges is considerably more encouraging than the gloomy perceptions now gaining wide currency even among well-informed observers. In particular, it challenges the assertions often made that

- o The US is steadily losing its competitive edge in worldwide and key export markets;
- o The downward trend in US productivity growth is a firmly imbedded phenomenon; and
- o Japan's recent dramatic high-technology accomplishments foreshadow the end of US technological pre-eminence.

Not surprisingly, these and other assertions attesting to the steady erosion of America's economic strength tend to gain maximum momentum when the economy is in the trough of a business cycle. Worrisome signals emitted by adverse economic indicators -- rising unemployment, widening deficits, negative growth -- tend to focus attention on present transitory troubles and mask the significance of more favorable longer term trends. In this atmosphere, observers and forecasters tend to put the most gloomy

interpretation on what has transpired. "The US economy lost its elan during the 1970s" proclaims one prognosticator. "Productivity increases, economic growth and international competitiveness all dropped like stones." If true, this would offer a worrisome prospect, indeed. But a more careful look at the historic record reveals a relatively robust US performance in the past decade and a more favorable prospect for the mid-eighties than is generally assumed.

Specifically, this paper argues that a retrospective look at the troubled decade of the 1970s can be quite misleading if it fails to take into account the exceptional nature of the halcyon decades of the fifties and sixties that preceded it. Those were decades of extraordinary postwar growth during which the badly mauled economies of Western Europe and Japan were restored to their proper place in the world economy, closing the economic gap with the US. The high growth momentum of those decades could not have been sustained much longer in any event. A slowing was already apparent in the US after 1966. But the two OPEC shockwaves of the seventies put an extra-heavy damper on the performance of all the big capitalist economies. Real growth fell and inflation and unemployment rose in all of them.

Seen against this backdrop, the US economic performance -- compared to that of other industrial countries -- remained surprisingly strong throughout the 1970s.

The 1970s Record

Some highlights of the US performance may help put the US economic posture in better perspective.

Relative Growth:

- o US growth in real output during the 1970s exceeded or at least matched that of all other industrial countries except Japan.

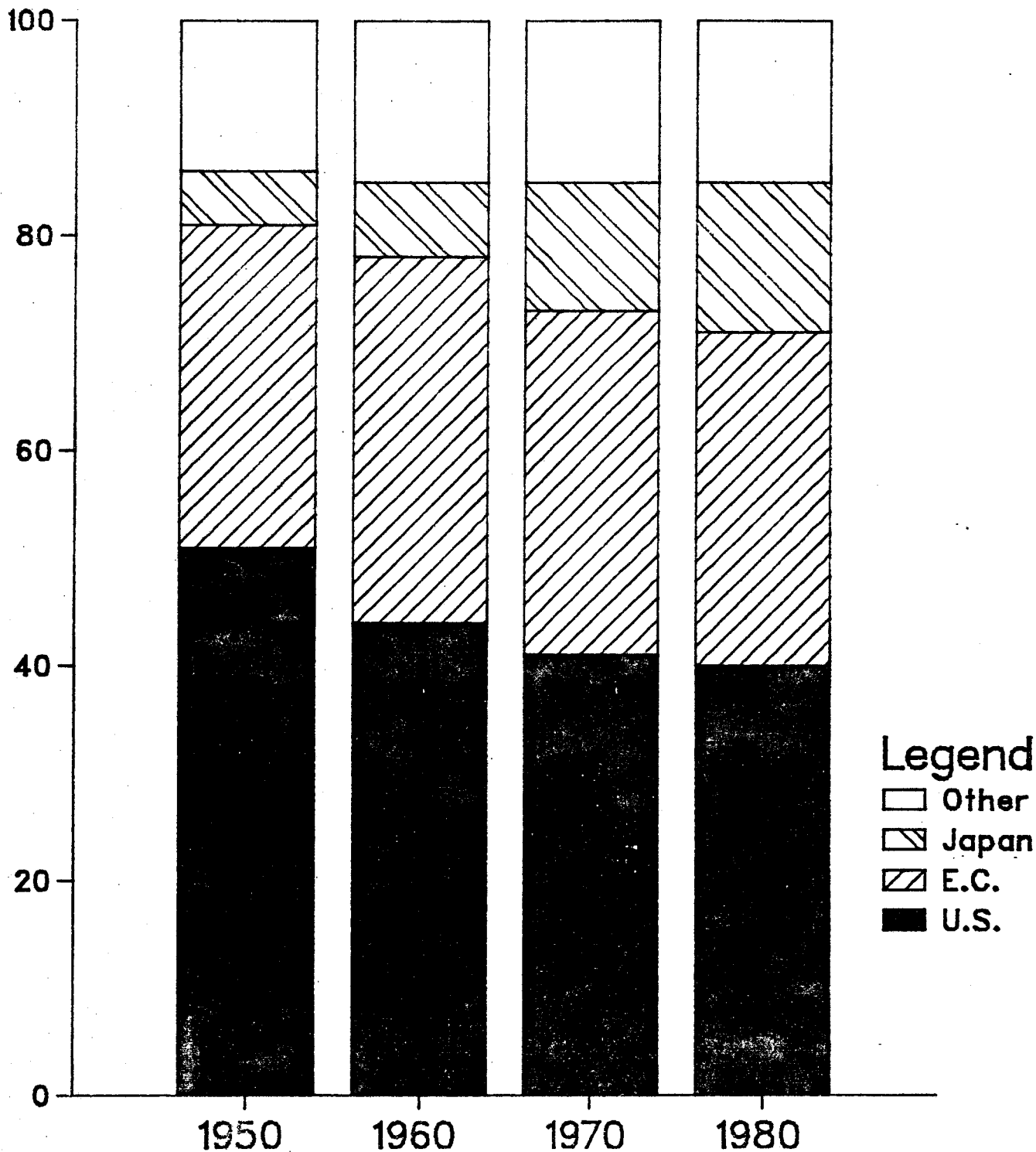
Although the growth rate of all of the OECD countries slumped during the decade, that of the US declined less steeply, thus enabling it to hold on to its 40% share of the industrial countries' collective GNP (see figure 1).

- o The sharp appreciation of foreign currencies against the dollar in the 1970s created the exchange rate illusion that other industrial countries were still gaining on the US. In fact, the exchange rates were merely catching up with the real changes that had occurred earlier. In real terms, the US maintained its relative economic power position through the 1970s.

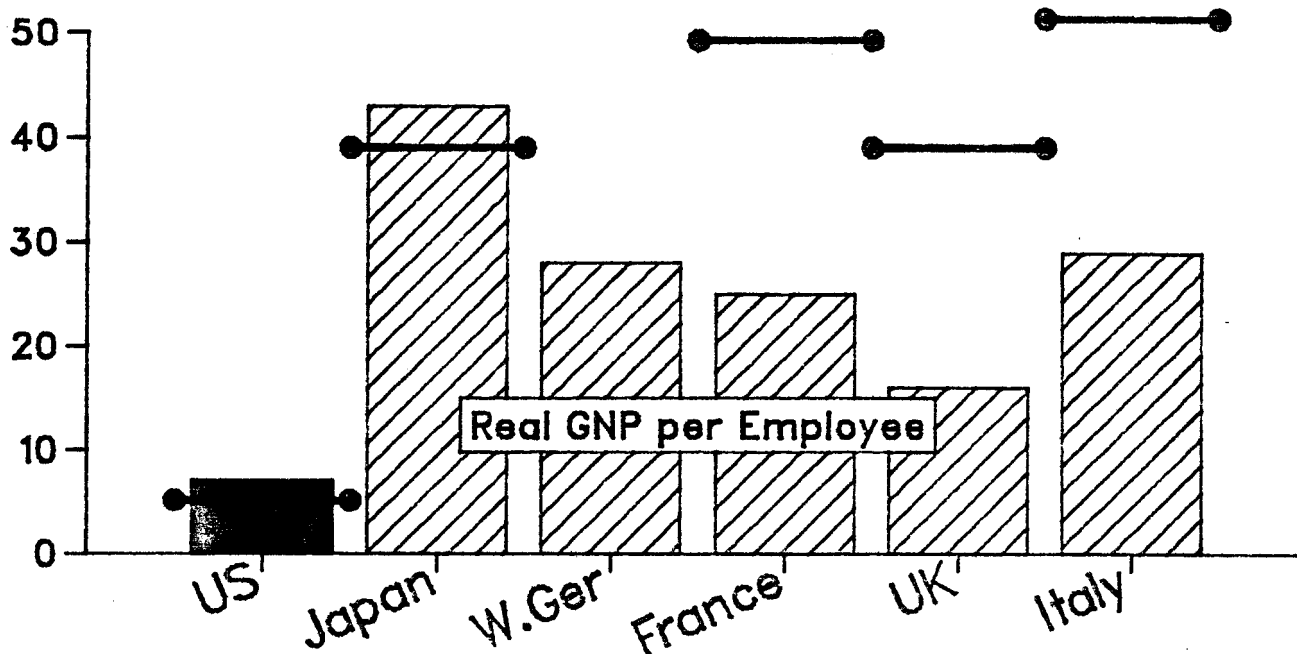
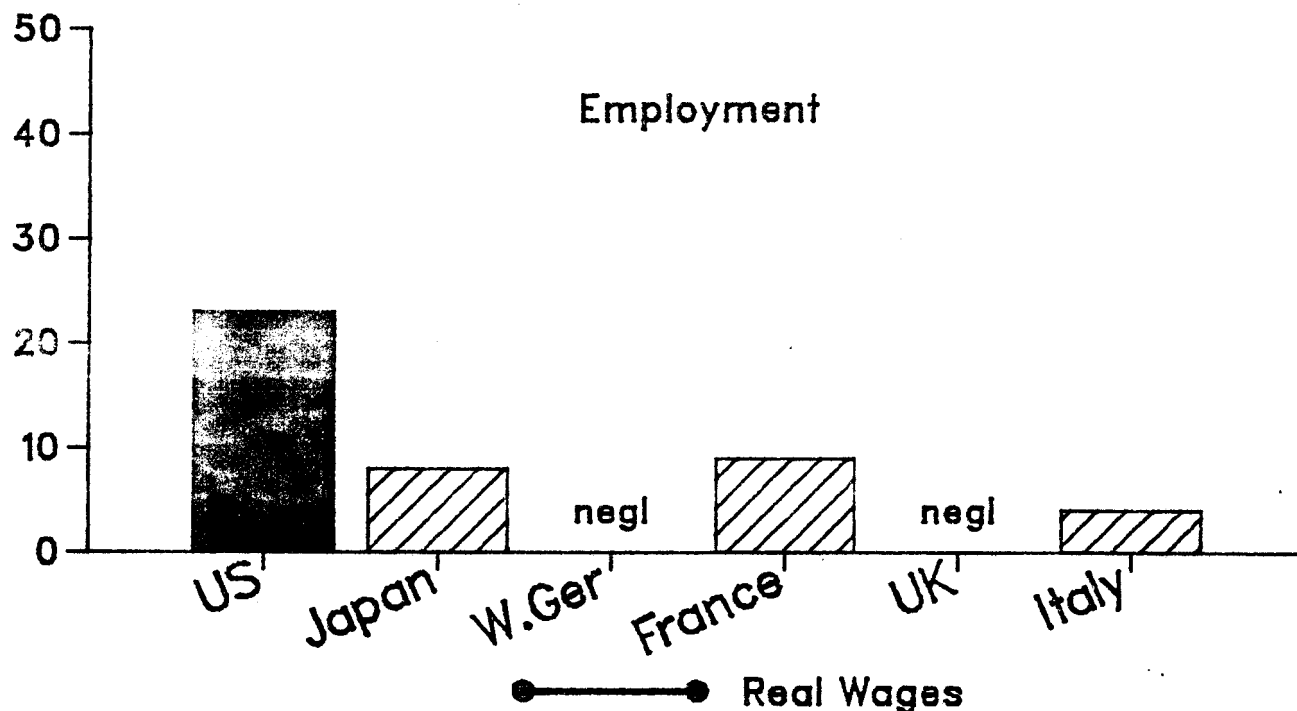
Employment and Productivity:

- o The way the US achieved its economic gains was by putting people to work rather than increasing their productivity. Unlike Western Europe and Japan, where employment grew very little, the US had to cope with a massive influx of new entrants into the labor force as the children of the 1950s baby boom shot into the labor market, along with a large new influx of women and (mostly Hispanic) immigrants. Almost 19 million new jobs were created -- a net increase in the employed labor force of 23%. With labor thus relatively cheap, it was more profitable for US firms to hire more workers than to invest in new plant and equipment (see figure 2).
- o In sharp contrast, Western European firms, in the face of a much tighter labor market and higher wage costs, placed greater emphasis on labor-saving capital investments. The results in terms of improved productivity were much better. Public pressure

Industrial Countries: Economic Power Shifts (Share of GNP in 1975 Prices)



Major Industrial Countries: Employment, Productivity, and Wages (percent change 1971 to 1980)



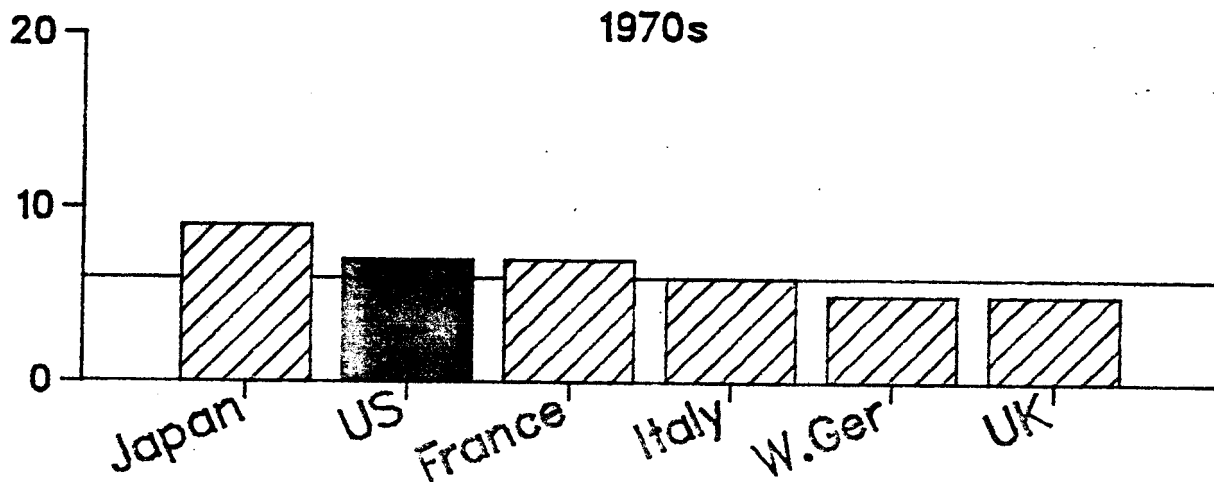
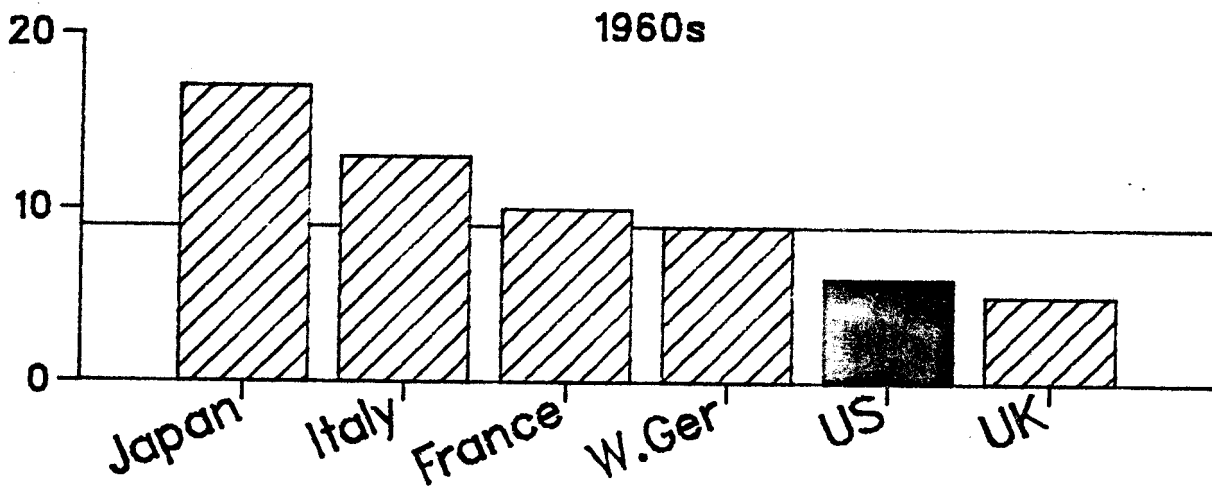
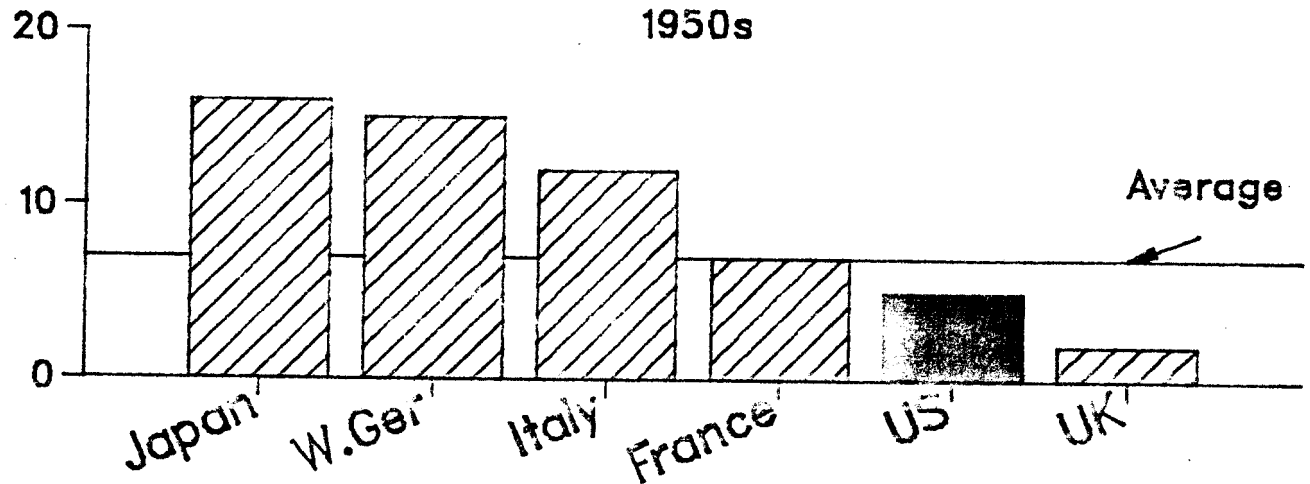
for higher wages and social welfare benefits, however, pushed up real wages beyond the productivity gains, undercutting Western Europe's international competitiveness. Europe also has been slower than either the US or Japan to move out of mechanically-based into electronically-based technologies.

- o Japan, through a high rate of investment and a remarkably adept technology development strategy, was able to achieve productivity growth rapid enough to accommodate a large boost in real wages without impairing its international competitiveness. The move toward greater labor-saving investments also reflected a significant decline in new entrants into Japan's labor force. This labor trend was the opposite of those that took place in the US and Western Europe.

Export Performance

- o Value versus Volume -- In value terms (undeflated US dollars) total world exports doubled in the 1950s and doubled again in the 1960s, but increased six-fold in the 1970s. The US share of world exports, measured in this way, declined modestly in the 50s and 60s, and fell sharply in the 70s. But again, exchange rate and price movements (dramatic changes in the value of the dollar, the huge jump in oil prices) convey a blurred image. When we correct for these elements to permit a look at the volume of exports, we find that the US share of world exports actually increased slightly in the 1970s (see figure 3).
- o Looking at manufactures alone, the volume of US exports climbed almost as rapidly as that of Japan and faster than that of our

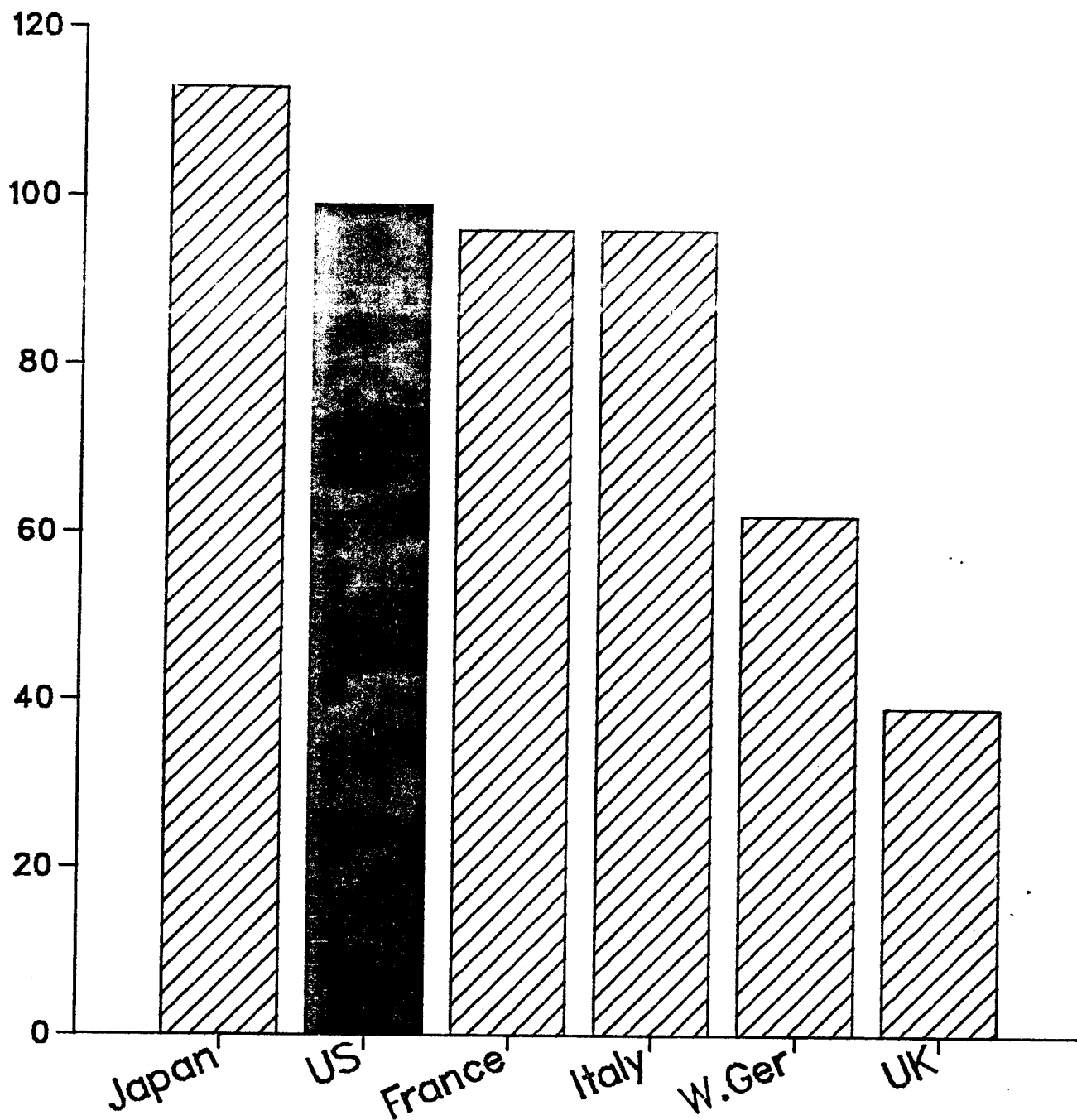
Volume of Industrial Country Exports (Average annual growth)



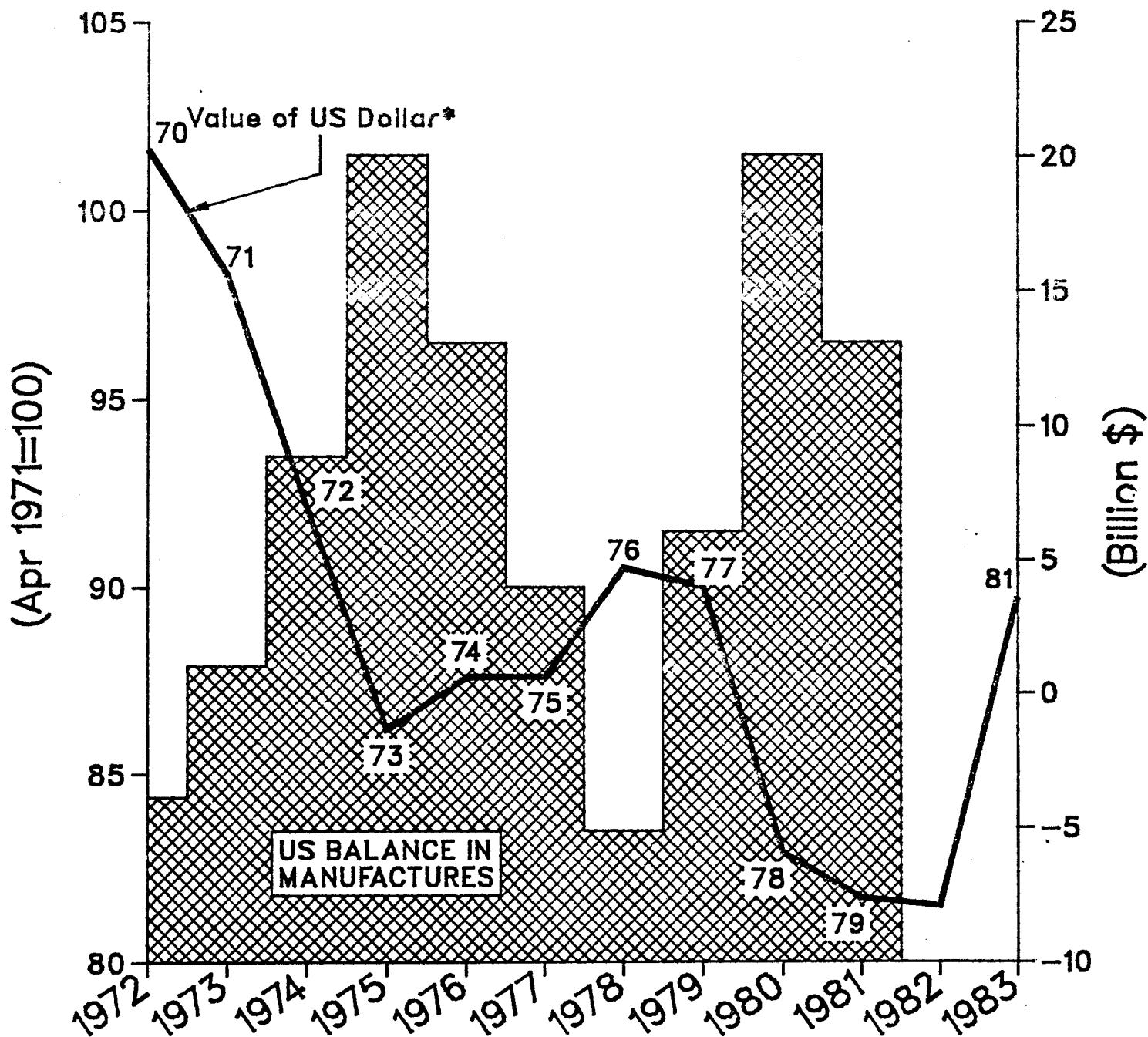
European competitors for the decade as a whole. The US share of OECD exports of manufactures thus was actually higher in 1980 than at the beginning of the 1970s (see figure 4).

- o The US share of exports of manufactures, measured in volume terms, was higher in 1980 than at the beginning of the 1970s in all markets -- Japan, Western Europe, the LDCs, and the Communist countries. Only in the OPEC countries did the US market share slip marginally, but that was largely a consequence of the Iranian upheaval. The US did particularly well in the rapidly growing markets of the newly industrializing countries (NICs) -- Mexico, Brazil, South Korea, Taiwan, Hong Kong and Singapore.
- o The influence of shifts in exchange rates, however, made the US export performance in manufactures highly erratic during the decade, with exports growing rapidly during periods of a depreciating dollar (1971-74 and 1977-80) and exports actually declining in a period of dollar appreciation (1974-77). The upswing in the value of the dollar beginning in late 1980 is now again having an adverse effect on US exports. The continuing strength of the dollar in 1982 augurs badly for US export competitiveness for the next year or so, until the cycle reverses again. The impact of exchange rate fluctuations on the US balance in manufactures for the past 12 years is illustrated in figure 5. In order to demonstrate the impact that changes in US dollar valuation have on the balance of manufactures after several years, we have plotted the two movements with a three years lag.

Exports of Manufactures (Volume) (percent change 1971 to 1980)



US Balance in Manufactures and Exchange Rate Changes



* Weighted Average of 14 Industrial Countries

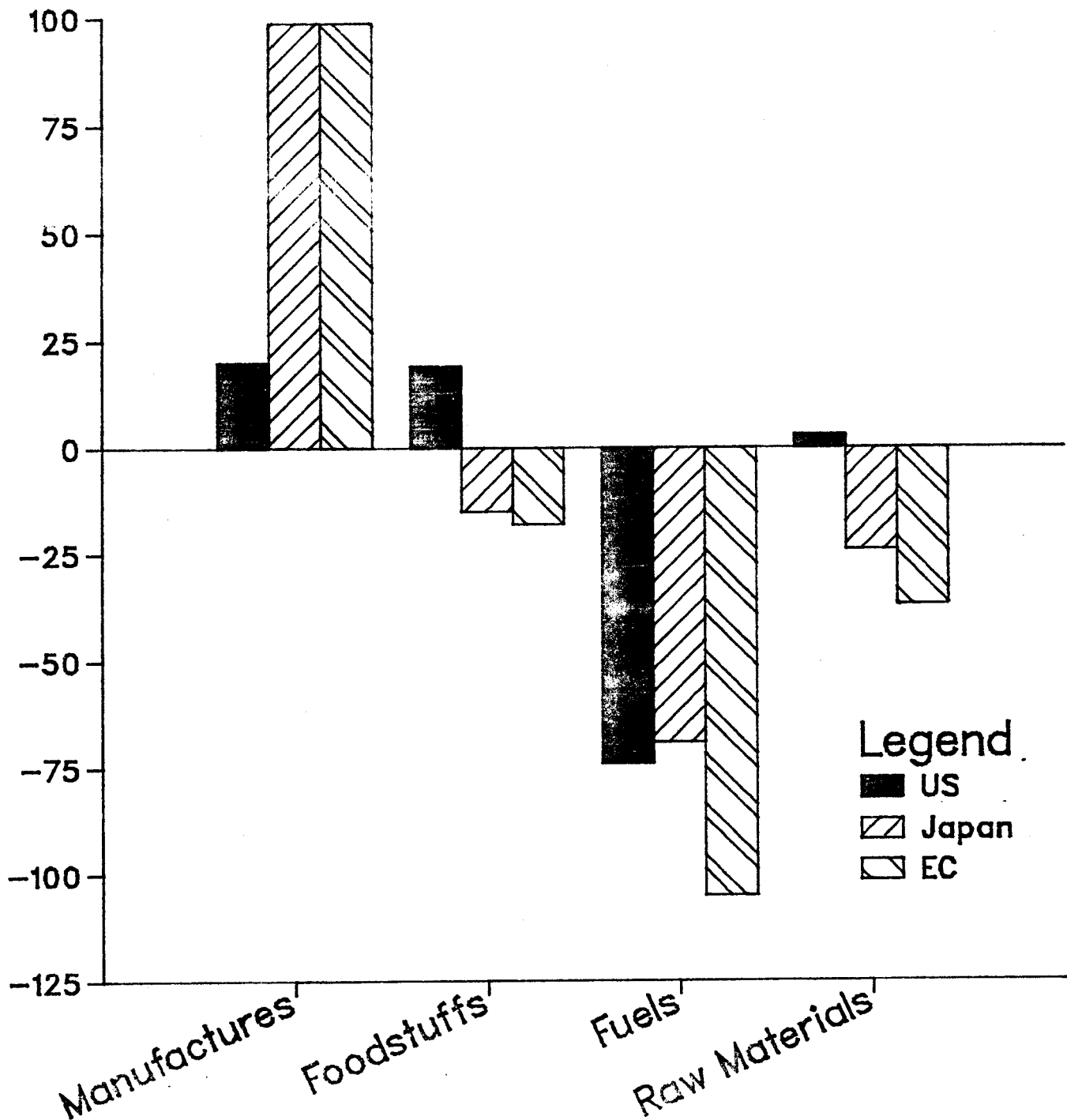
- o The structure of US trade differs significantly from that of our OECD partners. Manufactures are far less important to the US than they are to Europe and Japan in balancing the trade account. The US has had an increasingly favorable position in foodstuffs since 1973 and has run a near balance in raw materials, while most other developed countries have large deficits in these two categories. The US deficit in fuels is moderated by its large domestic energy resources and by some \$5 billion in coal exports (see figure 6).
- o Service transactions, moreover, represent a far more significant factor in balancing the US current account than is the case for any other country (see figure 7). In recent years, large US trade deficits have been more than offset by even larger surpluses on service account (see figure 8). The steady, spectacular increase in US service exports over the past five or six years, and the crucial role these now play in balancing the US current account is a widely under appreciated area of US competitive strength. Particularly significant for the early 1980s is the observation that the growth of service exports appears to be less affected than manufactures by the shifts in exchange rates that make US merchandise exports so volatile.

In sum, the US overall trade performance in the 1970s was highly creditable.

- o Its current account position was strongly positive. Over the past twelve years, the US earned far more than it paid out in its current international transactions (goods, services, return

Figure 6

Industrial Countries Trade Balances by Major Commodities* 1980



* Imports c.i.f.

Current Account Balances, 1980 Trade vs. Services (Billion \$)

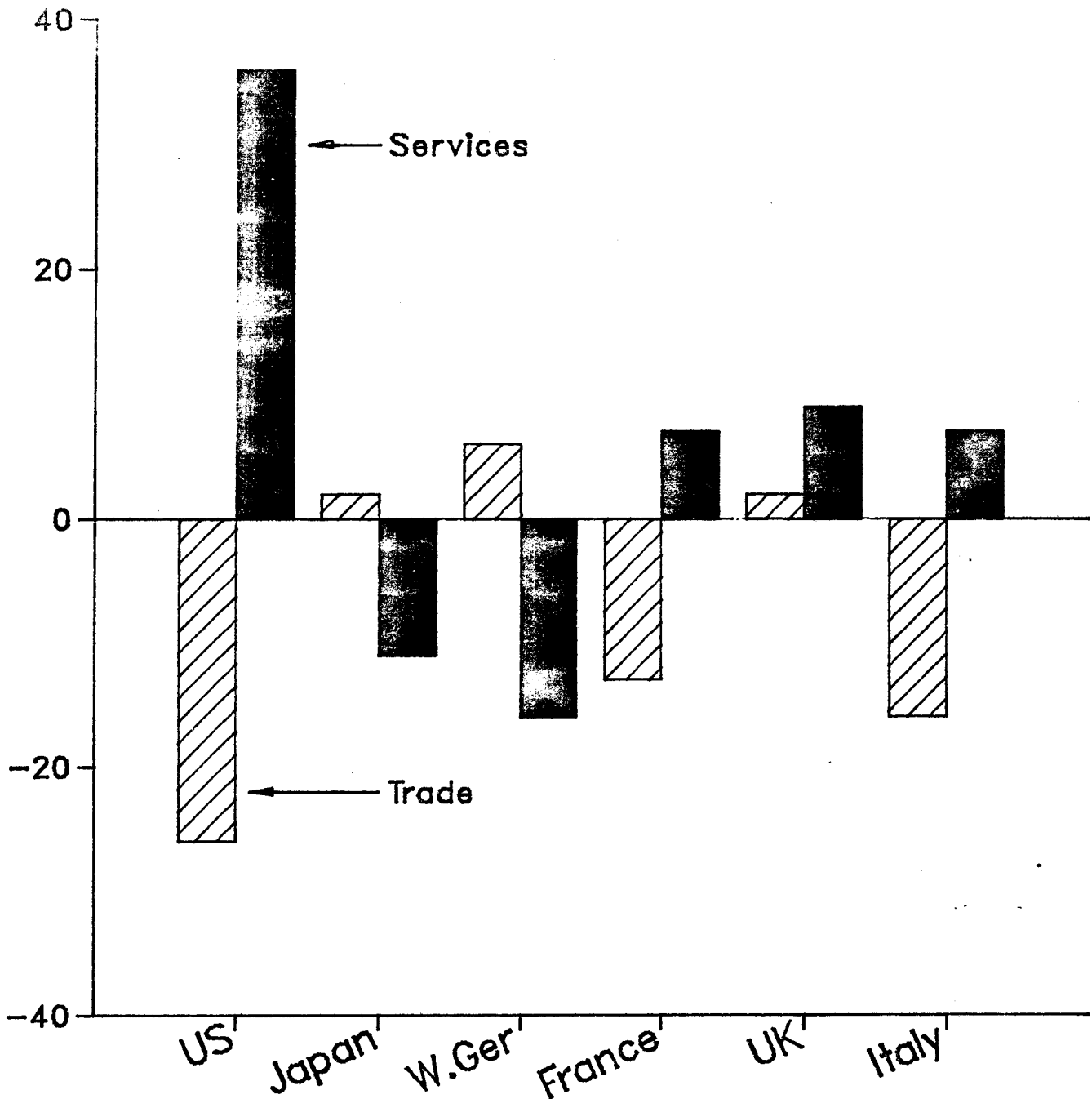
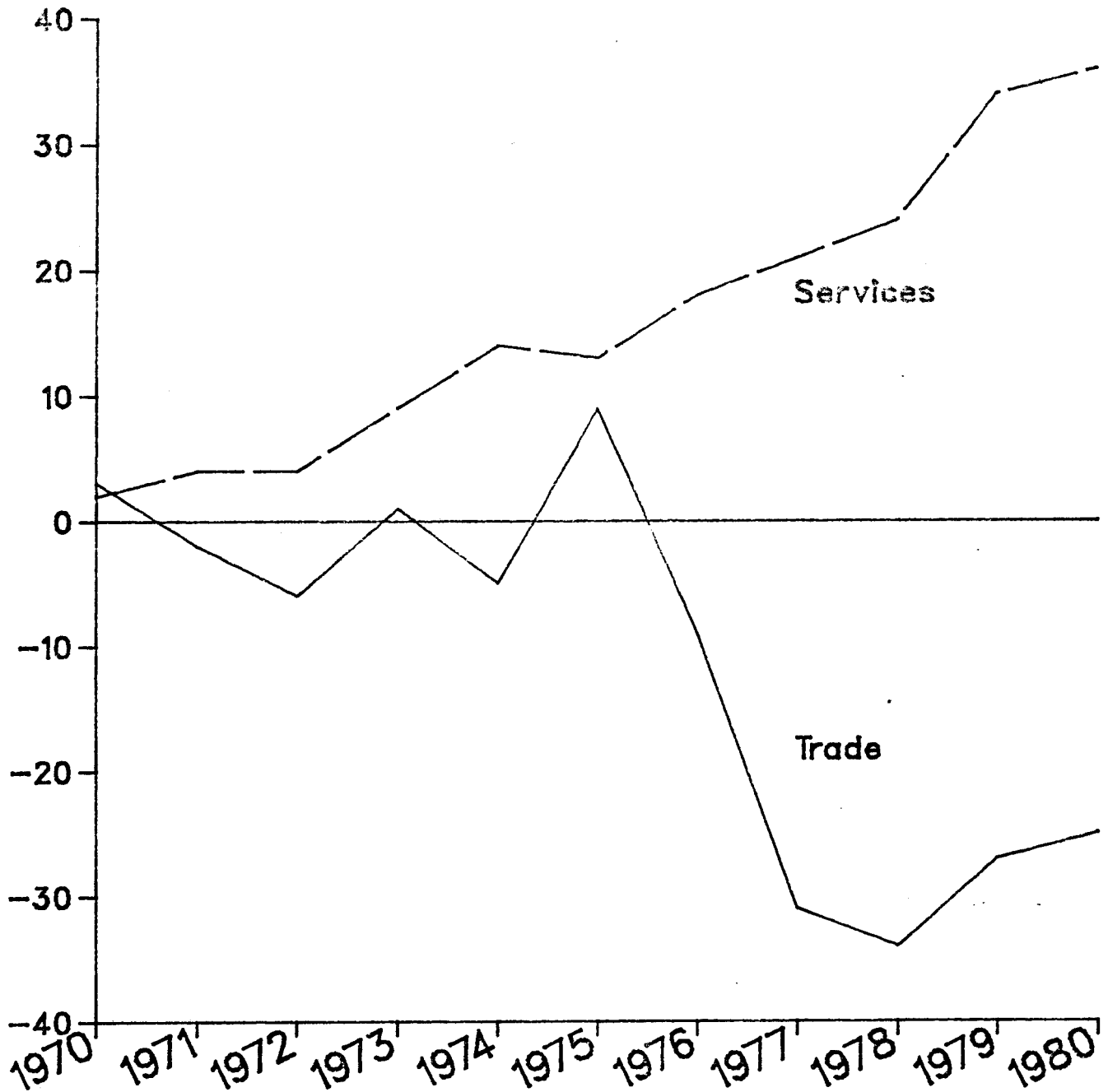


Figure 8

US: Current Account Balance Trend (Billion \$)



on capital invested abroad, and private remittances). In fact, its cumulative surpluses for the entire period topped \$60 billion, more than those of any other industrial country (see figure 9).

- o Japan, alone among the industrial countries, performed better than the US. But its penetration of world export markets is highly concentrated in a very few commodity categories. Only five categories -- road motor vehicles, steel, consumer electronics, industrial machinery and ships -- make up more than half of its exports. It is precisely this concentration that contributes to -- and also limits -- the scope of Japan's success.

Stresses and Challenges

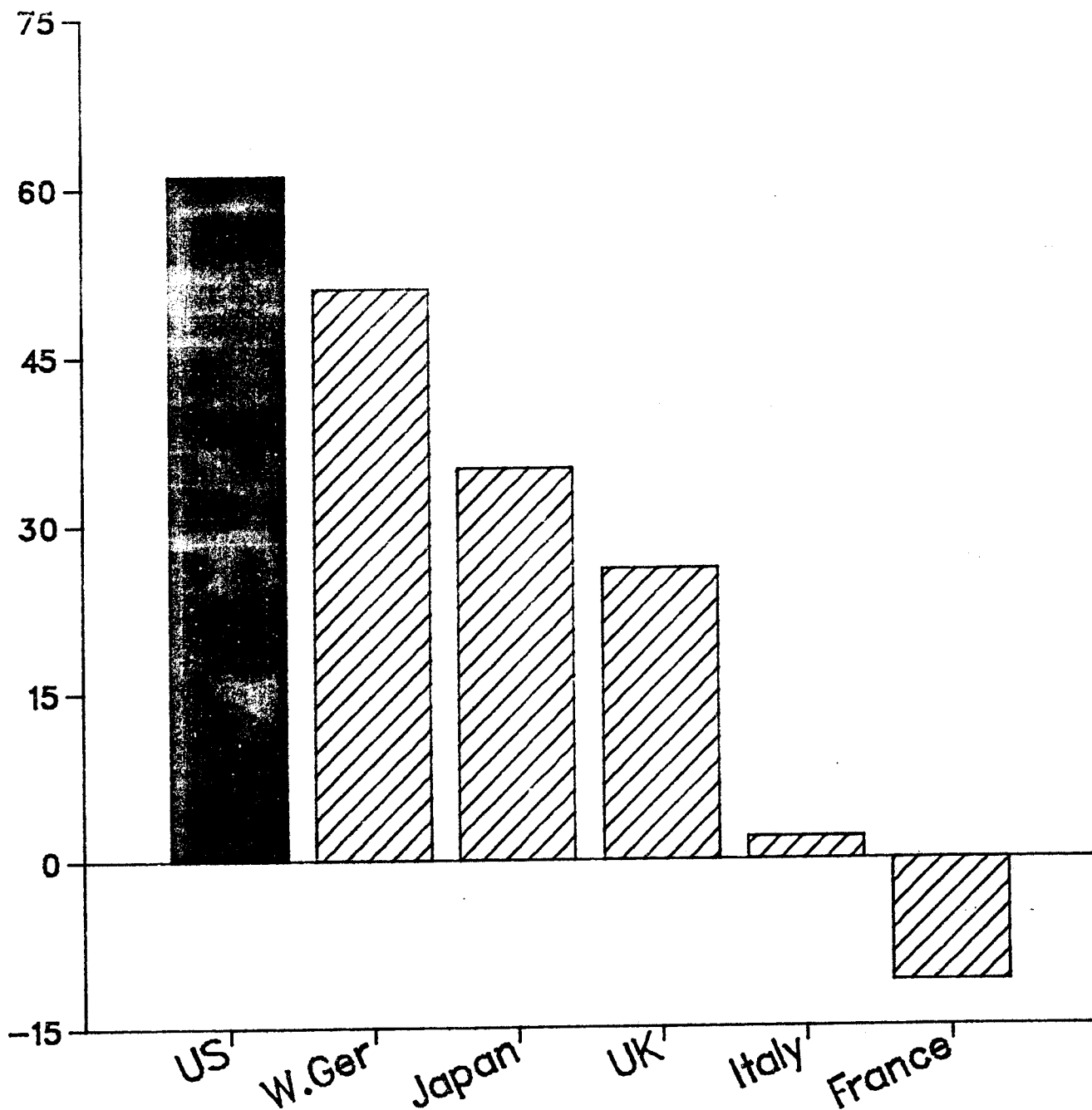
What does the relatively strong US performance during the 1970s portend for the ability of the US economy to cope with the stresses and challenges that now confront it? Some of these stresses are short term and transitory, others are structural and more enduring.

Recessionary Anxieties

It is not easy to preserve a sense of underlying US economic strength in the face of two years of sagging economic activity and seven months of full-scale recession. And yet, at some point, the downward slide will be arrested and reversed. There is now an emerging consensus among economists that the cyclical low point has just about been reached and an economic upturn will soon begin. There is much anxiety, however, about how vigorous and how long-

Figure 9

Cumulative Current Account Balances* (1970 to 1981) (billion \$)



* Includes goods, services, and private transfers

lived the expansion will be. The great fear is that growth in 1983 could be choked off by another rebound in interest rates resulting from the combination of stubbornly high federal deficits and restrictive monetary policies. But precisely because this threatening possibility has been so widely advertised, economic policymakers are likely to adjust their policy mix so as to guard against it. In any event, the long term forces at work -- described in the last section of this paper -- favor a sustained and a substantial recovery of the US economy.

The Overvalued Dollar

The most immediately troublesome issue affecting near-term US export performance is the substantial overvaluation of the dollar in foreign exchange markets (especially against the yen and the mark). The "strong" dollar has imposed a competitive handicap on US goods both in world export markets and in US domestic import-competing industries. As we have already seen, US merchandise trade performance in the 1970s was alternately boosted and dampened by cyclical changes in the value of the dollar. The current overvalued dollar -- overvalued, i.e., in terms of the underlying competitive relationships between the US and other major industrial countries -- has substantially weakened the price competitiveness of US goods and caused the US share of OECD exports of manufactures to slip beginning around mid-1981. This loss of competitiveness will almost certainly continue well into 1983. The slipping US trade performance, once it is widely recognized, will be taken as further confirmation of the already strong belief at home that US manufactures are no longer competitive and will increase the clamor for protection of US industries against foreign competition and for stronger efforts to open up foreign markets.

Two factors, however, should be kept in mind. One is the likelihood that US export performance in services will be less affected by the current dollar overvaluation, and will thus be able to attenuate, if not offset, the heavy deficit on trade account. This was certainly the pattern we have observed in earlier strong-dollar/weak-competitiveness cycles. The other is that a relatively poor US trade performance will eventually cause the dollar to depreciate against the yen and the mark. But the automatic adjustment forces may not come into play quickly or strongly: the demand-pull of high US interest rates (should they persist) and the cost-push of political uncertainty in Europe could sustain the dollar's value even though trade trends call for a depreciating dollar. The longer these two factors encourage dollar investments in the United States, the longer it will be before the US can recoup its competitive pricing position in international trade. Meanwhile, some fundamental factors influencing price competitiveness will tend to favor the Japanese and Germans. Their inflation rates have for several years been running below those in the United States and these two countries may well continue to enjoy faster growth in productivity in the manufacturing sector than the US. As a result, the longer the dollar maintains its strength, the larger will be the cut needed in the dollar's value to restore the price competitiveness of US goods. Restoration of that competitiveness, thus, may not be accomplished as quickly this time than in previous cycles.

Tilting at Japan

The most important mirror image of dollar overvaluation is yen undervaluation. But the undervalued yen is more than just a mirror image; the yen is independently depressed by Japan's fiscal-monetary policy mix, which is

the reverse of that of the US. To stimulate their domestic economy in the face of sagging demand, the Japanese are combining a tightening fiscal policy with a loosening monetary policy. The resulting low interest rates, of course, contribute to a weaker yen and to the persistent huge Japanese trade surpluses with the US. It is worth noting that every major episode of US-Japan economic friction has been preceded by a period of substantial yen undervaluation -- in the late 1960s, in the mid-1970s, and again right now. This year, Japan's current account, its overall trade balance, and its bilateral trade balances with the US and the EC will all reach surpluses of record proportions. Public outcries against Japan both in the US and in the EC will be particularly strong in the current distressed economic environment.

If past experience is any guide, the Japanese are unlikely to make significant enough concessions to disarm the rising trade antagonisms against them. This could result in an unbridled outbreak of anti-Japan protectionism that could severely undermine the integrity of the international trading system of the post-war era. Can such a development be avoided?

The fundamental problem underlying Japan's souring economic relations with the rest of the industrial world is the longstanding lack of reciprocal competitive opportunities. While the United States and to a lesser extent European firms have had to compete head-on with Japanese firms in their domestic markets and in third country markets, they have been kept out of the Japanese market. The frustrations are particularly keen because after ten years of considerable efforts by the United States and the EC to make Japan open its markets, that country still effectively shields its home market from foreign competition. US high technology firms are kept from capturing the Japanese market in an early phase of the product cycle, a move which undercuts US exports and prevents US firms from thwarting potential competitors at an

early stage. Moreover, the lack of reciprocal competitive opportunities in Japan diverts some of the rapidly growing exports of NICs to other more open markets, especially the United States.

The problems of resolving these highly caustic trade problems are particularly difficult because of significant differences that exist between Japan and other industrial countries in regard to each side's political-economic system and bargaining stance.

The Japanese political-economic system functions mainly through an informal consensus process rather than depending heavily on legal procedures as do other industrial nations. As such, Japan protects its domestic market mainly through the informal interaction of various interest groups while tariffs and other statutory trade restrictions play a minimal role. Foreign firms in Japan must deal with (1) an endless array of nuisance restrictions involving inspections and approvals handled by a highly ambiguous bureaucratic process, (2) informal cartel arrangements among major producers, and (3) unwritten guidelines under which buyers purchase goods only from Japanese firms. As a result foreigners cannot easily pinpoint where and how the restrictions are being applied.

The trade bargaining process since the late 1960s has been a highly skewed one which favors Japan. In nearly every instance, foreign governments have been asking Tokyo to give up something rather than the other way around. It has been far easier for the Japanese to resist changes in their well entrenched and highly successful political-economic system, than it has been for the United States and others to make the Japanese change. The Japanese leaders also have had an advantage because they could easily blame the problem on the competitive failures of others, and because they realize the United States is highly unlikely to use the only really effective leverage

it has vis-a-vis Japan -- close the US market to Japanese goods and/or withdraw the security shield provided Japan and its worldwide interests.

Finally the Japanese could always count on the short Western attention span for what is typically a cyclical issue. By the time the US and the EC get truly aroused by unacceptably large Japanese trade surpluses, the yen begins to appreciate again, as it almost certainly will later this year, cutting deeply into Japanese trade competitiveness sometime in the following year. Western concern with the issue then quickly dissipates.

To be successful over the long run, the trade discussions with Japan would have to be pursued on a sustained basis, perhaps with periodic summit meetings to signify the continuing high level interest in the effort. They would also have to go beyond the usual bargains (reduced tariffs, emergency imports, etc.) and attempt to get at the root causes of the trade problems, the major differences in social-cultural attitudes and modes of behavior -- a most difficult task.

Coping with Western Europe

Many of Western Europe's political-economic troubles have been building for a decade. In the past year or so they have begun to become highly visible. Until recently, the region's leaders and publics seemed to believe that they were making the adjustment to the 1973-74 energy shock reasonably well, especially when compared with the United States. In fact, in the late 1970s, when the dollar was eroding badly, there was a general mood of confidence in Western Europe and its leaders were pursuing bold new initiatives in the international arena. A crisis of confidence has descended on the region, especially in Northern Europe -- Belgium, Holland, the Scandinavian countries, and West Germany. Leaders in these countries now see

their ability to manage political and economic affairs impaired and their hold on power diminished.

Economic disabilities underly this mood of despondence. Unemployment has reached new heights with little relief in sight until the mid-1980s when there will be a sharp reduction of new entrants into the labor force. (Such a demographic trend already is underway in the United States.) West European industry has been slower than the United States to adapt to new technologies and now feels the impact on its competitiveness. Employment costs have been excessively high because of mushrooming fringe benefits and guaranteed continuity of employment. Enormous expenditures for social welfare have pushed government outlays (as a share of GNP) well above those in either the United States or Japan. Pervasive government controls also have seriously crimped entrepreneurial initiative.

In many ways, the West European pattern of having to cope with dramatic change appears to follow the US pattern of a decade or so earlier. The crisis of confidence that has struck Europe is the first step in this process of change and parallels a similar crisis period that hit the United States in the 1970s. It provides the harsh tremors needed to arouse public attention and to open popular debate on causes and cures. It could take five to ten more years and perhaps another economic recession before a new consensus develops in Western Europe on better ways to manage its affairs. During these years, economic activity will continue to grow, though probably more haltingly than in the United States. Moreover, as already can be seen, tensions within Europe will increase as dissatisfaction with its economic leadership takes divisive political forms. Lacking cohesion and confidence, Western Europe will be difficult to deal with for the next several years. US policy interests will be affected in a number of ways:

- o Trade - Protectionist forces will be difficult to contain, especially in France. Trade practices among EC members are likely to become more nationalistic, and the European Monetary System will be under severe strain as France and West Germany pursue incompatible fiscal and monetary policies. The EC, thus, will be much less inclined to negotiate new free-trade arrangements, although it will probably want to avoid any serious breakdown in established trade practices. In this last regard, the desire to maintain the basic EC structure will be among the chief factors inhibiting rampant protectionism. Each member will be forced to moderate its trade practices in the interest of maintaining the Common Market.
- o Defense - A real boost in defense spending is highly unlikely in the absence of a blantly outrageous Soviet action directly threatening Western Europe's security. Budget deficits will not subside until European states begin to trim their social-welfare outlays -- and there are no signs of any movement in that direction. The best that can be expected is for a modest increase in defense outlays on items that boost local economic activity -- manpower, manpower support, and domestically produced arms. Imported defense items -- notably sophisticated US equipment -- will be given low priority.
- o East-West Trade - While East-West trade expanded considerably during the 1970s, it still accounts for only a few percentage points of overall OECD trade with the rest of the world. Nevertheless, for Western Europe it is politically important.

Europe's economic troubles will have little impact on this market. Even if they had zero unemployment, West Europeans would continue to pursue trade with the Soviet Bloc, because they are convinced that such trade helps deter Soviet aggressive tendencies and because important European firms with a large stake in exports to the Bloc lend vigorous political support to that trade. If anything, it will be the economic troubles of the Eastern Bloc that will constrain the growth of East-West trade. While the needs of the East for the goods and know-how of the West is greater than ever, the Bloc's deteriorating hard currency position, its chronic low productivity and its newly perceived potential for internal political instability will more than likely cause this market to contract rather than expand. It seems paradoxical that an area of the world --the USSR and its Warsaw Pact allies -- that looms so large in the global defense-security arena, should play so feeble and insignificant a role in the global economy.

The Less Developed World

The LDCs were the real gainers in the 1970s -- especially, of course, the oil exporters. While the industrial countries were slowing down, the LDCs as a group maintained their real growth at rates only slightly below those achieved in the previous twenty years. A large inflow of private capital, a successful effort to expand exports of manufactures, and a string of good crop years, especially in the Indian subcontinent, helped shape their strong performance.

Since 1980, however, some of the steam has gone out of the LDC locomotive. The oil exporting countries, whose non-oil sectors were previously expanding at a torrid pace, are now faced with sharply reduced revenues because of declining real oil prices. Some of the most successful NICs, e.g., Mexico and Brazil, find themselves saddled with heavy debt burdens. Different groups of LDCs are differentially affected:

- o The oil exporting countries are having to rethink their strategies. If demand for OPEC oil continues to decline or remains stagnant for the next several years, these countries will see whatever oil power they once enjoyed evaporating. While they will still enjoy large revenue inflows and an enviable borrowing capacity, they will have to scale down their ambitious development efforts and pare many ongoing programs because the cost of maintaining them will continue to soar. Among the more populous oil exporters with depleting oil reserves -- Nigeria, Indonesia, Mexico, Iran, etc -- few are likely to develop the critical mass of entrepreneurial talent, labor skills and modern institutions required to achieve the diversification of their economies they so badly need. They will have difficulty adjusting to the erosion of their expectations of a steadily rising standard of living. They will be inclined to blame the West for their predicament.
- o The NICs will be set back temporarily by current financial stringencies and the depressed demand for their manufactured exports, but these dynamic and highly competitive countries will resume their climb up the economic ladder and continue their growing penetration of the OECD market with their manufactures.

- o The poorest LDCs -- which are also by far the most numerous -- with their stagnating economies, are least affected by global economic events. These countries, concentrated in Sub-Saharan Africa, Central America, the Caribbean, and South Asia, do not possess and are not likely soon to develop, the political underpinnings and the economic management needed to achieve sustained economic growth. Even those countries with a rich natural resource endowment, such as Zaire, fall into this category.

Meeting the Challenge

The Crucial US Role

The foregoing discussion, however sketchy, of international economic circumstances and prospects may suffice to suggest that the US economy is unlikely to receive much help from other economies in pulling the global pace of activity out of its present doldrums. In fact, the vigor and durability of the coming upturn will hinge to a large extent on what happens in the US -- partly because of its enormous weight in the global economy, but also because it is the only industrial country with a major stimulative program in place. As we have seen, neither the West Europeans, nor the Japanese are willing or able to provide the engine of growth they did during earlier upswings, and the LDCs and the Communist countries no longer offer the growth markets they did in the 1970s.

From a psychological point of view, then, the industrial world and many LDCs are increasingly looking to the United States for global economic

leadership. Given their current mood, the Europeans are much less inclined to be leaders than they were just a few years ago. Ingrained Japanese attitudes continue to prevent them from playing a role in global economic affairs that even begins to match their economic prowess.

All this raises the question of whether the US is equipped to meet the challenge. There is no doubt that the US economy, like those of all industrial countries, is confronted with powerful forces of structural change as pervasive as those it faced in the past decade, although quite different. Rapid advances in technology, sweeping shifts in consumer demand, major alterations in patterns of energy use, and significant reversals in demographic trends are all part of the dynamic process to which industrial societies must continually adjust. A display of the changing nature of these issues since World War II and a glimpse at the future is shown in figure 10. In this adjustment process, those who stand to benefit from change are forever at odds with those who stand to lose. The former seek to alter the rules and structures, while the latter want to preserve the status quo. The problem for government is how to make the needed structural adjustments politically palatable while minimizing their socially disruptive consequences.

Many Roads to Adjustment

The way a society adjusts to secular change is much less a matter of its conscious choice than it is a function of its cultural-institutional makeup. There is no right way or wrong way, no single magic formula of social organization for coping successfully with change. For the most part, we are talking not about an "industrial strategy", but a set of entrenched conditions. It may be tempting to single out some particular set of policies or approaches on some facet of a country's institutions and to present these

Figure 10

INDUSTRIAL COUNTRIES; FACTORS POSING
ECONOMIC ADJUSTMENT PROBLEMS

	<u>1950s</u>	<u>1960s</u>	<u>1970s</u>	<u>1980s</u>
<u>TECHNOLOGICAL INNOVATIONS</u>	<u>Jet engines</u> <u>Numerically-controlled Machine tools</u> <u>Petrochemicals</u> <u>synthetic fibers</u>		<u>Computers</u> <u>Satellite communications</u> <u>Micro-electronics</u> <u>Robotics</u> <u>Biotechnics</u>	
<u>SHIFTS IN CONSUMER DEMAND</u>	<u>Consumer durables</u> <u>autos and household appliances</u> <u>Services</u>		<u>government</u> <u>leisure</u> <u>financial</u> <u>Services</u> <u>information</u> <u>communications</u>	
<u>NEW COMPETITORS</u>	<u>Western Europe</u>		<u>Japan</u> <u>The 4 "Far Eastern Tigers"</u> <u>Brazil</u> <u>Saudi Arabia</u> <u>Mexico</u> <u>ASEAN</u>	
<u>PROBLEMS INHERITED FROM PREVIOUS ERA</u>	<u>Post-war reconstruction</u> <u>Post-colonial LDCs</u>	<u>Profligacy:</u>	<u>High energy costs</u> <u>Inflation</u> <u>Budgetary burdens</u> <u>US boost productivity</u> <u>W.E. revamp indus.</u>	
<u>DEMOGRAPHIC TRENDS</u>	<u>Labor turns scarce</u>		<u>Work force expands</u> <u>post-war baby boom</u> <u>women</u> <u>migrants</u> <u>New entrants diminish</u>	
<u>US MAJOR NATIONAL SECURITY CONCERNS</u>	<u>Europe</u> <u>Korea</u>	<u>Halting spread of Soviet Empire</u> <u>South East Asia</u>	<u>Third World</u> <u>Sharing of defense burden</u> <u>Protection of Persian Gulf oil</u>	

as success indicators or exemplars for other countries to emulate. But such single elements do not typically stand on their own when removed from their indigenous social context; nor do these elements lend themselves readily to modification through social engineering.

Among the elements often cited as "explaining" a country's industrial dynamism and successful adjustment to change are such things as the way government interacts with the private sector, the manner in which industry is structured, the emphasis put on welfarism, and the amplitude of the consumer savings rate. But the evidence on the separate or collective impact of these and other elements is by no means clear. All that can be said is that industrial societies differ in their institutions, approaches and policies in these matters. When they do try to replicate each other's solutions, they often find that what is good for one is not necessarily appropriate for the other. While the long term trend toward internationalization of production may well narrow the differences among countries, the differences are likely to remain substantial for some time.

The differences range over a wide spectrum. Some examples:

- o Role of government. Involvement of government with the private sector is pervasive in Japan and significant in Western Europe, but quite limited in the US. Similarly, cooperative interaction among big government, big business and big labor is extensive in Japan and well developed in most West European states while in the US the relationship among the three groups has been traditionally adversarial. Hostility, however, is beginning to break down, with the growing awareness in the US that a community of interest exists among them.

- o Industrial organization. US industrial advances and technological gains depend far more on innovations by small and medium-sized firms than in Japan, where huge, well-established conglomerates seek to play the same role.
- o Emphasis on welfarism. Both Europe and Japan are more inclined than the US toward preserving internal social stability -- e.g., by providing income maintenance -- and toward cushioning their industries against disruptive change -- e.g., by cartelizing or nationalizing enterprises in distress. European countries work mainly through regulation, such as laws that restrain layoffs, while Japan adheres to less formal practices, such as the institution of "lifetime employment". Japan's pursuit of social stability policies has also been an important factor in insulating the Japanese domestic market from foreign competition.
- o Methods of investment financing. US firms are heavily dependent for investment capital on corporate profits and equity financing, while other industrial countries -- most notably Japan -- rely more on a high rate of consumer saving as a source of investment funds. Whether the notoriously low US rate of private saving has become a serious impediment to future US growth, as is now widely claimed, is not clear. Historically, the US savings rate has always been very low.

These divergent institutional approaches and practices do not add up to any coherent explanation of why industrial countries differ in the degree and quality of their economic dynamism and adaptability. It seems, rather, that the variations among them are attributable to some quite fundamental

factors. For the US, its very high degree of flexibility rests on an uniquely broad based economy, a great diversity of political institutions and a relatively unimpeded flow of labor, capital and know-how. Japan's adaptability springs largely from its social homogeneity that permits a strong consensus among interest groups. European countries vary considerably from one to the other, but collectively their societies exhibit less resilience and greater resistance to change, largely as a matter of social culture and tradition, including lingering class hostilities and broad adherence to socialist principles.

The fact that the US economy exhibited great adaptability in coping with change during the difficult decade of the 1970s, should give some comfort that it will adjust equally well to the stresses of the 1980s. The much-touted adjustment process, however -- like the "unseen hand" of the market place -- is invisible and unpredictable. Confidence in its efficacy, thus, is essentially an act of faith. For economists and public policy activists, however, faith is a rather shaky foundation. Fortunately, there are other, more tangible factors at work that bolster the proposition that the US economy should be doing quite well by the mid-1980s.

US Economic Resurgence

The high degree of flexibility and resilience that characterizes the US economy will be bolstered by a number of developments that should help to enhance the level of economic activity. Among these are:

- o In the important energy area, the US has an enviably rich resource endowment and will be tapping these resources with unprecedented intensity. Already, as a result of technological

breakthroughs in exploration and extraction and record drilling rates, the decade-long decline of the nation's oil reserves has been arrested and, since 1980, reversed. Also, given its relatively high per capita energy use, the US has great potential for further conservation gains. If soft oil markets and sagging prices persist, these favorable developments will be slowed, but real energy costs are likely to remain high enough to maintain the momentum of development of abundant US coal resources and of conservation.

- o Capital spending, long repressed by uncertainties about future market demand, should surge once the economy turns up and interest rates decline. The tax incentives already in place could even lead to a capital spending boom.

- o The present attractiveness of the US economy to foreign investors is likely to outlast a decline in interest rates. European apprehensions about political instability, stimulated especially by events in Poland and concern over domestic economic weaknesses, are likely to sustain the present large flow of equity capital to the US. The Japanese, for their part, are already beginning to invest increasingly in the establishment of plants in the US to assure market access in the event of US trade actions. The continued flow of foreign investment capital into the US economy will benefit the economy not only through job creation but also through increased competition and enhanced absorption of innovations in technology and management.

- o Demographic trends will induce the US economy to place greater emphasis on labor saving rather than the job creation it pursued in the 1970s. A shrinkage of new entrants into the labor force is already underway and will persist through the decade. Because this decline comes earlier and is more pronounced in the US than in Europe, the US will be in a better position to reduce unemployment and increase productivity. Gains in productivity will also result from this demographic trend because the average worker will be more experienced.
- o The service sector, which now accounts for more than 70% of the US labor force and for almost 90% of its growth, is a highly dynamic factor both in the US and in the world economy. Indeed, a service transformation is taking place in the US economy, in which a new set of linkages are being established through the growth of "integrative services" that interconnect firms, units of firms, and industries at different stages of production or in different locations. The distinction between goods and service industries are increasingly breaking down, as the two aspects merge with each other. The most dramatic expansion is now taking place in this integrative part of the service sector, that combines high technology with management/marketing know-how. In this "information economy" that marries computers and communications and that includes "software" of all types and a great variety of financial and diagnostic services, the US is uniquely strong. It should be able to take excellent advantage in the 1980s of the lead it already enjoys in this rapidly expanding global market.

o The US performance on the frontiers of technology should continue to be highly creditable, even though its earlier across-the-board pre-eminence has been at least selectively whittled away, as Western Europe and Japan narrowed the technology gap. But the challenge mounted by America's major industrial competitors is not overwhelming. The remarkable Japanese technology drive in some well-selected areas has forced US high technology industry -- which had long felt secure in its dominance -- to take foreign competition seriously. Major US firms are now developing strategies to capture leading positions in new areas and to regain market shares where they have slipped. The Japanese, for their part, will find it increasingly difficult to move from imitating, improving on and applying the inventions of others to creating epoch-making developments of their own that make possible whole new industries. They will also find it extraordinarily hard to replicate their innovative successes that have been concentrated in a few areas, across the much broader spectrum of technological activity that characterizes the US. Finally, a major stumbling block for Japan will be the tough problem of moving from innovation in discrete areas of production to the integration of hardware and software into a customer-tailored service package. The 64k RAM chip success story, for example, may have been dramatic as a single accomplishment, but it represents only a speck on the large canvas of the computer-based knowledge industry.