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A New Foreign Economic Policy for the United States

C. FRED BERGSTEN

The United States faces a series of intense challenges, acute threats, and promising opportunities from its interaction with the world economy. These challenges, threats, and opportunities confront both the US economy, as it seeks to sustain growth and stability at satisfactory levels, and overall US foreign policy and the country's place in the world. Some are immediate and require urgent response. Others reflect structural changes in global economics and politics that will play out over a number of years and even decades.

A number of the threats are immediate. The most important and most likely is the substantial economic adjustment that will be required to correct the unprecedented and rapidly growing US current account deficit. If this includes a crash of the dollar within the next year or so, when the US economy is nearing full employment and full capacity utilization, the result could be a sharp rise in US inflation and interest rates along with a rapid fall in trade surpluses and economic growth in other countries. These events could produce a very hard landing for the US and entire world economies.

A second major risk is even higher energy prices. The global price of oil could return to the late-2004 level of $55 per barrel and climb even further to $60 to $70 per barrel. Sharp disruptions in global energy supplies could make the situation even worse. Such developments, especially if they were to occur simultaneously with a sharp fall of the dollar, would add to

C. Fred Bergsten is the director of the Institute for International Economics.

the likelihood of both higher inflation and economic downturn (as well as carry wide-ranging repercussions for US foreign policy).

A third risk is a retreat from globalization and trade liberalization, driven mainly by domestic opposition to these trends within the United States. Such a retreat would severely affect US economic interests, over both the short and longer runs, by disrupting a major source of US income enhancement and productivity growth. In light of the widespread international identification of globalization with the United States, such a retreat would have major adverse consequences for US foreign policy as well.

Beyond these immediate threats, a second set of major foreign economic policy issues relates to profound changes in the structure of the global economy that are altering the framework within which the United States will operate for the foreseeable future. Completion of the process of European unification has created an economy roughly equal in size to the United States, with a single money (the euro) that provides the first potential competition to the dollar since it became the world's key currency in the early part of the 20th century. China is rapidly becoming a third global economic superpower and, in some vital senses, an even larger driver of the world economy than the United States. Regional economic cooperation in East Asia, in both the trade and monetary arenas, is likely to create over time an even more powerful entity in that part of the world. These developments could usher in a three-bloc global construct that would carry major national security as well as economic implications for the United States, requiring wholesale reconsideration of the United States' basic foreign policy as well as economic strategies.

International economic issues must be viewed in the context of overall US foreign policy as well as overall US economic policy. Events of recent years, including the Iraq war but going well beyond it, have raised fundamental questions in many parts of the world (and much of American society) about the posture of the United States with respect to international, especially multilateral, cooperation. A restoration of strong US relations with many of its disenchanted friends and allies will obviously require new US policies outside the economic realm. Given the high(est) priority that virtually all countries attach to their international economic interests, however, the stance of the United States on those topics will go far to shape attitudes toward the United States across an array of issues far broader than the economic agenda itself. For foreign policy as well as economic reasons, unilateralism is simply not an option for the United States in the 21st century.

This book concludes that the United States needs to undertake, with considerable urgency, a series of major policy initiatives to head off the immediate international economic risks just cited. As is usually the case with foreign economic policy, those responses must start at home. The United States will need a credible program to substantially reduce its budget deficit over the next few years, and then to return it to modest surplus over time, to help correct the current account imbalance, and to sustain confidence in US economic policy and the economy's long-term prospects. It will need an effective new strategy to cut US energy consumption and boost domestic production. It will need much stronger and more effective assistance for US workers who are now hurt by globalization, or fear that they will be in the future, so that they will become able to take advantage of that phenomenon rather than feel victimized by it, restoring in the process a more stable domestic foundation for a constructive international economic policy.

Each of these steps must be complemented by important initiatives in other key countries. The other major economies, especially China and elsewhere in Asia, will have to cooperate in achieving an orderly adjustment in the exchange rate of the dollar to avoid a subsequent crash and resulting hard landing. The countries that will experience declines in their trade surpluses to accommodate the correction in the US trade deficit, especially the largest ones in Europe and Asia, will have to stimulate growth in domestic demand to maintain their own and global prosperity. Oil-importing and oil-exporting countries must come together to work out a global energy regime that will support rather than constantly jeopardize the world economy. Rich and poor countries must cooperate to further open international markets, via both multilateral and regional trade agreements, to obtain the huge benefits that are available from additional globalization, including its enormous payoff for reducing poverty in developing nations.

These initiatives must be launched promptly but will take some time to implement and to produce the desired results. At best, it will take several years to correct the US external and internal deficits and to install new domestic and global energy regimes. Hence the reforms proposed in this book constitute a medium-term strategy that will have to be pursued with perseverance as well as vigor over a prolonged period. Moreover, none of the suggested measures will be costless. Their adoption will be strongly in the national interest of the United States, however, and they should be pursued as matters of very high priority.

Our proposed strategy rests on this volume's clear conclusion that the prosperity and stability of the United States depend heavily on events and activities that take place outside its borders and over which it has limited control. The share of international trade in the US economy has almost tripled over the past 40 years and now exceeds the same ratio for the European Union or Japan. The United States must attract about $4 billion of foreign capital inflow every working day to finance its current account deficits and outward foreign investments.[1] It relies on foreign sources for

1. The current account deficit exceeds $600 billion per year and US capital outflows have been averaging about $300 billion per year. Both must be offset by capital inflows to balance the international books. There are about 240 working days in a year.

more than half its oil supplies and, even if it could cut that ratio substantially, would still depend on prices set largely abroad for the world's most important commodity. The United States has long since passed the point where economic isolationism would be feasible despite its continuing status as the world's largest national economy.

Another clear conclusion of this study must also be emphasized at the outset: that the United States benefits substantially from globalization and can reap large additional benefits from the further spread of that phenomenon. As estimated conservatively in chapter 2, the US economy is now richer by about $1 trillion per year as a result of its further integration with the world economy since 1945. This translates into higher average incomes of about $9,000 per year for every American household. The average US citizen is thus about 10 percent more prosperous as a result of globalization. Indeed, well over 10 percent of Americans' income gains over the past half century have resulted from the country's increased internationalization. All income groups, and small and medium-sized enterprises as well as larger firms, share in these benefits.

These economic gains could be increased by at least $500 billion annually for the entire country, and another $4,500 per year per household, by adopting wholly free trade on a global basis, and it should be feasible to move a considerable distance in that direction over the coming years. Some of the other policy proposals in this volume, such as limiting the volatility of world energy prices and reducing their long-term average toward levels that would prevail under more market-related conditions, would also bring large benefits for the US economy. Still others, such as achieving gradual rather than abrupt correction of the country's huge external imbalances, would prevent sizable costs that could otherwise subtract substantially from its well-being.

In addition, US foreign policy and indeed national security gain enormously from the benefits of globalization to *other* countries. Major economic and trading partners have not gone to war with each other for over half a century. No country has ever achieved successful economic development without integrating with the world economy, a historical fact of great importance as we seek to combat the security (including terrorist) implications of mass unemployment in poor countries and failed states around the world. At this point in time, with relations between the United States and many of its traditional (especially European) allies so frayed by disagreements over Iraq and "US unilateralism" more generally, successful new international economic cooperation even could help restore America's overall international ties to an important extent.

To be sure, there are costs to globalization as there are for any dynamic economic process. Chapter 2 suggests that these costs total only a small fraction, perhaps 5 percent, of the gains from globalization to the overall US economy. But some workers—perhaps 100,000 to 200,000 annually in recent years out of a total labor force of 130 million and annual net job creation that averages at least 1 million to 2 million (chapter 2, Baily and Lawrence, forthcoming)—become unemployed as a result of changes in trade, most for temporary periods but a few more permanently. Manufacturing workers dislocated in trade-impacted industries also experience average wage declines of about 13 percent in their new jobs (Kletzer 2001), losses that may be offset only partially by the lower prices they pay for imports. Chapter 3 concludes that globalization has also added modestly to the increasing income inequality that has characterized the United States over recent decades, increasing the dispersion of American incomes at the same time it raises both their mean and the income *level* of all groups.

A major theme of this book is that the *foreign* economic policy of the United States must embrace a wide-ranging set of *domestic* measures to address the costs of globalization. Its overall benefits for the United States, both to date and prospectively for the future, are far too important to roll back or forgo. Those gains are indeed so large that the United States can readily afford to deploy a modest fraction of them to effectively address the costs of globalization and to help the losers both cushion their transition periods and become qualified to take advantage of the opportunities it provides. Despite the need for aggregate fiscal tightening, it will be essential to do so if the United States is to maintain a sustainable domestic base for the conduct of an effective foreign economic policy over both the shorter and longer runs.

Short-Run Agenda

The United States and world economies were advancing smartly as this book was completed in late 2004. Global growth approximated 5 percent in 2004, its fastest pace in over 20 years. Continued if somewhat less rapid expansion seemed likely for 2005. The world's two chief locomotives, the United States and China, continued to lead the advance despite modest slowdowns in both.

The breadth of the global expansion has been impressive as well. Japan, after a decade of stagnation, has been a major "upside surprise" with growth exceeding 4 percent in 2004. East Asia outside Japan is expanding at 7 percent. Regions with small economic impact but sizable populations, including Africa and Latin America, are recording their best performance in two decades or more.

Can this synchronized global expansion continue? Many of the underlying portents are promising. Inflation and interest rates remain low almost everywhere. Productivity continues to rise rapidly in the United States. China could experience another decade or two of impressive growth. India may become a new source of major expansion. Many emerging-market economies have adopted floating exchange rates, sharply reducing the risk of crises à la Mexico, East Asia, Russia, and Brazil that derailed large parts of the world economy during the 1990s.

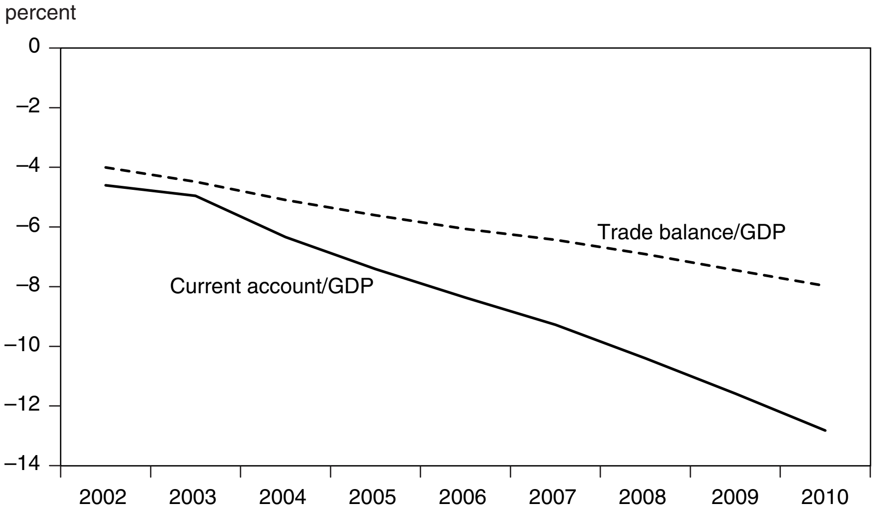
Unfortunately, there is a substantial possibility that this scenario could be shattered by a combination of five international economic developments within the next few years. Three of these risks center on the United States itself but are substantially exacerbated by their extensive international dimensions: renewed sharp increases in the trade and current account deficits, requiring an early and substantial reversal that may include a crash of the dollar; a rising budget deficit; and a retreat from open trade policies. A fourth relates to the other growth locomotive, China, where a sharp slowdown due to its recent overheating is likely and a hard landing is possible. Fifth, oil prices could climb to $60 to $70 per barrel, or much more in the event of a major political or terrorist disruption, and stay there for a while. Any one of these events could substantially reduce US and world growth. A combination of two or three of them, let alone all five, could radically reverse the prospects and bring a sharp turndown at home and abroad.

There remains time to head off each of these risks. Preventive policy actions could avoid at least their worst consequences and preserve a positive outlook. Hence the United States, in its own self-interest, must address them effectively as a matter of urgency. Moreover, the United States has an enormous international responsibility to act constructively in light of its sizable share of the world economy and its central role in, if not responsibility for, most of the global problems. But each of these issues has major worldwide components and cooperative international action will also be essential. US policy over the next year or so must be devoted both to making the necessary policy changes at home and to providing international leadership to forge their essential international complements.

The most alarming prospect is renewed sharp deterioration in the US trade and current account imbalances. These deficits have been growing again since early 2004 and already exceed annual rates of $600 billion, well above 5 percent of the economy. As a result, America's net foreign debt has reached $2.5 trillion and the country must attract about $4 billion of foreign capital every working day (to finance the current account deficits and America's own foreign investments). These present levels are almost certainly unsustainable. New scenarios by Institute senior fellow Catherine L. Mann, moreover, suggest that the current account deficit could now be rising again by a full percentage point of the economy per year (about $100 billion annually) as it actually did in 1997–2000. If this were to occur, the deficit would rise well beyond $1 trillion per year and 10 percent of GDP by 2010 (figure 1.1).[2]

2. There are five reasons for this dismal prospect. First, the fall of the dollar from its peak in early 2002 through 2004 amounted to a trade-weighted average decline of only 15 percent, taking only about $150 billion off the annual imbalances that would otherwise exist and being swamped by the other factors cited here. Second, the current US baseline is highly un-

Figure 1.1 Current account versus trade balance (assumes no further dollar depreciation)



Source: Figure obtained from Catherine L. Mann. Data are from Macroeconomic Advisers.

This prospect poses three major risks for the United States and other countries. One, to be discussed shortly, is a further escalation of trade protectionism in the United States. Dollar overvaluation and the huge external deficits it spawns have traditionally been the primary precursors of such domestic political swings, which would carry large costs for both the US economy and foreign policy.

The second major risk is a disorderly crash of the dollar. If this were to occur in late 2005 or beyond, when much of the slack will probably have disappeared from US product and labor markets as the economy approaches full employment, inflation pressures would shoot up and standard macroeconomic models show that US interest rates could hit double digits (Baily 2003). The stock market would almost surely tank in response. Economic growth would drop sharply and perhaps fall into recession.

favorable: Merchandise imports are now almost twice as large as merchandise exports, so the latter have to grow about twice as fast as imports grow, an unprecedented relationship except in the late 1980s after the trade-weighted dollar had fallen by over 30 percent during 1985–87, just to halt the deterioration. Third, US economic growth is likely to be faster than growth in its major markets, even on conservative assumptions for the United States and optimistic assumptions about the others. Fourth, the income elasticities of trade are much higher for merchandise imports in the United States (about 1.7) than in the rest of the world for American merchandise exports (1.0). Fifth, the large debtor position of the United States means that its net investment income payments to the rest of the world will probably be increasing steadily, especially as interest rates rise. See Mann (2004a).

The third risk stems from the negative impact on other countries from correction of the US deficits, especially if triggered by a sharp fall of the dollar. As described by Michael Mussa in chapter 6, their trade surpluses must decline as a counterpart of the US improvement and their economic growth would fall correspondingly unless they could reorient their policies to generate offsetting increases in domestic demand. In some surplus countries, this would call for expansionary fiscal policies. In others, including some of the largest such as Germany and Japan, long overdue structural reforms would be required. Lower interest rates would be in order virtually everywhere although Japan cannot cut rates below zero, where they have stood for several years, and the European Central Bank resisted much easing despite a rise of 40 percent in the euro against the dollar by late 2004.

The difficulties of achieving the needed global response, especially if the dollar's fall is precipitate and the foreign adjustments need to take place quickly, suggest that the results could be very costly for world growth. The United States would also be hurt by the slowdowns elsewhere (though it would benefit from a declining current account deficit over a period of several years). The situation would be worse if future increases in energy prices and the US budget deficit push in the same direction of higher inflation and interest rates, and then slower growth or even recession.

Fears of a hard landing for the dollar, and for the US and world economies, are of course not new. It is certainly true that the United States derives short-run benefits from the additional consumption and investment permitted by its current account deficit, and surplus countries like the job creation that results for them, creating considerable resistance from both sides of the imbalances to any substantial reduction of them (Mann 2004a). Even if further substantial dollar correction eventuates, moreover, it could do so in a gradual and orderly manner as in fact occurred throughout 2002–03 and when the decline resumed in late 2004.

The unsustainability of the situation is much more ominous now, however, because of the record levels of the current account deficit and America's international debtor position, and the high probability of further sharp deterioration in both. The risk of renewed escalation of world oil prices at the same time suggests a parallel with the dollar declines of the 1970s, which were associated with the two oil shocks of that decade and subsequent stagflation, rather than the 1980s, when a sharp fall in energy costs (and thus inflation) cushioned dollar depreciation.

It is impossible to foresee when this renewed deterioration of America's international financial position might produce a sharp fall in the dollar. The deficits have already been in uncharted terrain for several years, and US economic performance may be sufficiently attractive to keep the foreign capital coming in at the requisite levels at current prices for a while longer. Foreign monetary authorities could step in to keep the dollar from falling much (or at all) against their currencies, as several of the major Asian countries did through much or all of the period of dollar decline in 2002–03. This is where the two other US-centered risks enter the picture: the budget deficit and a retreat from open trade policies.

Objective projections score the US budget deficit at $5 trillion over the next decade. Even they, however, ignore possible or even likely future increases in overseas military costs and homeland security expenditures, further extension of the recent tax cuts and necessary fixes for the tax system (especially concerning the alternative minimum tax), and proposed new entitlement increases. The retirement of the baby boomers that begins in five years will make the picture much worse over succeeding decades by steadily increasing transfer payments to the elderly. It is not difficult to foresee a budget deficit that also approaches $1 trillion per year. Yet there is little serious discussion in the United States of how to restore fiscal responsibility let alone an agreed strategy for reining in the runaway entitlement programs, especially Medicare (Peterson 2004).

The budget and current account deficits are not "twin" in any rigid sense. The budget in fact improved dramatically throughout the 1990s, moving into surplus in the early part of this decade, while the external imbalance soared anew. But additional increases in the fiscal shortfall, with the economy nearing full employment, will further reduce national saving in the United States and intensify the need for foreign capital. Hence such increases will promote further increases in the current account deficit, increasing the prospects of a dollar crash. Former Federal Reserve Chairman Paul Volcker predicts with 75 percent probability that America's internal and external imbalances will produce a financial crisis within five years (Peterson 2004).

Former Secretary of the Treasury Robert Rubin has also stressed the psychological importance for financial markets of expectations concerning the medium-term trajectory of the US budget position (Rubin and Weisburg 2003). If that deficit is viewed as likely to rise steadily and substantially, confidence in America's financial instruments and currency could crack. The dollar could fall sharply as it has about once per decade over the last 40 years (in 1971–73, 1978–79, 1985–87, and 1994–95). Market interest rates would rise immediately and the Federal Reserve would probably have to push them higher to limit the escalation of inflation. Given the timing, such risks are exacerbated in this case by the presumed change in leadership at the Federal Reserve Board in early 2006, inevitably creating new uncertainties after 25 years of superb leadership by Volcker and Alan Greenspan. A very hard landing is not inevitable, but neither is it unlikely. Preventing it, through decisive action on both the budget and the exchange rate, must rank very high on the overall US policy agenda and head the agenda for foreign economic policy.

The third risk to US economic and foreign policy interests is a retreat from open trade policies. The risk at present takes new as well as traditional forms. The spate of trade actions already initiated against China represent traditional protectionism, with greatest impact in the historically sheltered sectors of textiles and apparel but extending as well into color television sets, furniture, shrimp, and other products of declining US competitiveness (Hufbauer and Wong 2004). So did the hike in steel tariffs in 2001 and the new subsidies included in the 2002 farm bill. Sugar managed to win total exclusion from the United States–Australia free trade agreement (and minimal quota increases in other FTAs).

The hubbub over outsourcing, however, has led to a "new approach": proposals to deter foreign direct investment by altering the taxation of foreign income accruing to American multinationals (Hufbauer and Grieco 2004) and to limit government procurement (at both the federal and state levels) from companies that "offshore." The tax bill passed by Congress in late 2004, in addition to much unrelated pork, cut tax rates on "domestic US production" in an effort to strengthen American competitiveness. The US move to launch a World Trade Organization (WTO) case against Airbus, after 25 years of acceptance of its subsidies, may reignite transatlantic trade conflict.

The trade policy problem could come to a head in early 2005 when Congress will vote on at least three contentious bills. It must extend Trade Promotion Authority (TPA) to 2007 or neither the Doha Round of multilateral negotiations in the World Trade Organization nor any other meaningful international trade talks can be completed. It must address the mandated five-year reauthorization of US membership in the WTO. And it will have to vote on the FTAs that have already been negotiated with Central America and the Dominican Republic, and with Bahrain, the former of which will almost certainly produce a pitched battle over how to treat labor and environmental standards in all US trade pacts.

The projected escalation of the external imbalance would also make it harder to bring the Doha Round to a successful conclusion and pilot it through Congress. Failure of the Round, or even a substantively minimal outcome, could halt the momentum of trade liberalization and further open the door for protectionism and mercantilism. Under contemporary circumstances, such outcomes would also be likely to further accelerate the negotiation of new bilateral FTAs and regional economic blocs, especially in East Asia, and hasten the advent of a potentially dangerous three-bloc world. All this would place the current multilateral trading system in extreme jeopardy.

These trade policy concerns add further to the case for strong and urgent action to correct the US fiscal position and the currency misalignment. Indeed, it was domestic political rather than international financial pressure that induced previous US administrations (Nixon in 1971, Reagan in 1985) to aggressively seek dollar depreciation to avoid severe disruption of the global trading system. These concerns also underline the case, to be developed shortly, for a major effort by the United States to restore the momentum of trade liberalization by ensuring a successful outcome to the Doha Round.

The fourth global economic risk centers on China, the second locomotive of the present and potential global expansion. Nicholas Lardy notes in chapter 4 that it became the third largest trading nation in the world in 2004, has already become the second largest importer of a wide range of commodities from cement to oil, and accounted for over 20 percent of the entire increase in world trade during 2000–03. China's worldwide impact derives not only from its size and rapid growth but also from its openness to the global economy; its ratio of trade to GDP is double that of the United States, European Union, or Japan, and its ratio of inward foreign investment to GDP is even larger by comparison.

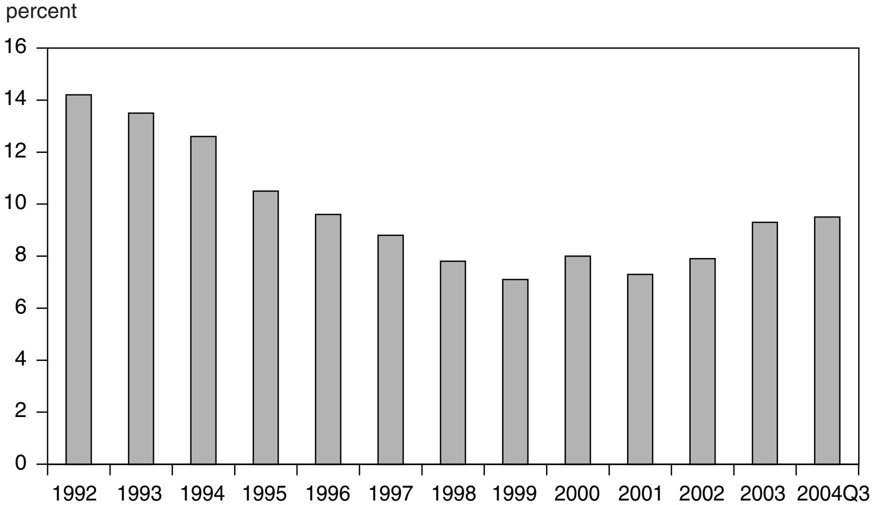
It is thus of great global consequence that China faces the risk of a substantial slowdown of its own economy. The country must rein in its recent runaway credit expansion and unsustainable levels of investment, with growth slowing as a result. The new political leadership that took office in late 2002 refused to address the problem for more than a year. It finally did so via a peculiar mix of market-related policies, such as higher reserve requirements for the banks and modest interest rate increases, and traditional command-and-control directives such as sectoral ceilings on increases in bank lending.

Under the best of circumstances, China's growth will have to drop for a while from the 9 to 10 percent pace of recent years. When the country cooled its last excessive boom, after 1993, the rate of growth declined for six straight years (figure 1.2). A truly hard landing, due to the delay in addressing the problem and the half-measures initially adopted, could be much more abrupt and severe. Either outcome will dampen growth in all of East Asia (including Japan) and, via commodity markets and other trade effects, significantly affect the rest of the world.

The fifth threat to US and global prosperity and stability is energy prices. The rapid growth of world demand, lagging investment in new production, shortages of refining and other infrastructure (particularly in the United States, due partly to its environmental requirements and other regulatory decisions), and fears of new supply disruptions have vastly outstripped any possibility for increased production from either Organization of Petroleum Exporting Countries (OPEC) or non-OPEC sources in the short run. Hence prices rose steadily throughout much of 2004 and hit record highs in nominal terms before falling back at the end of the year. The global economic effects are extremely significant since every sustained rise of $10 per barrel in the world price takes $250 billion to $300 billion (about half a percentage point) off annual global growth for several years, of which about one-third occurs in the United States.

Philip Verleger concludes in chapter 7 that this lethal combination could become much worse before it gets better on a lasting basis, pushing the price into the range of $60 to $70 per barrel over the next year or two and

Figure 1.2 China's GDP growth, 1992–2004Q3



Source: China Statistical Yearbook 2003, 57, National Bureau of Statistics of China, www.stats.gov.cn.

reaching the previous record high of 1981 in real terms, even without any political or terrorist events to actually impede production for a prolonged period in the Middle East, the former Soviet Union, or elsewhere. Both the likelihood of this outcome and its costs increase significantly as the US and world economies move closer to full employment and full capacity utilization. As Chairman Greenspan frequently reminds us, the three largest postwar recessions were triggered by sharp increases in the price of oil.

The more fundamental problem of the global energy system, however, is the oligopolistic nature of the world oil market. The OPEC cartel in general, and dominant supplier Saudi Arabia in particular, restrict supply in the short run and output capacity in the long run in order to preserve prices far higher than would occur under market conditions. Recent prices of $40 to $55 per barrel compare with production costs of $15 to $20 per barrel in even the highest-cost locales. These problems also look likely to get worse before they get better as OPEC has talked openly about increasing its target price range from the traditional $22 to $28 per barrel to $30 to $40 per barrel or even higher. The lack of "surge capacity" exhibited by OPEC in 2004 suggests that such a hike might indeed be viable for some time unless explicitly countered by consuming countries. Whatever the short-run outcome, this could dampen global growth substantially for some time.

OPEC and Saudi Arabia do not always succeed in controlling the energy market. Indeed, they have suffered several sharp price falls over the past three decades. They have been unable (due to their lack of additional capacity) to counter the recent price rise. But their actions would violate most national antitrust laws if they occurred within countries and should be totally unacceptable to both the United States and the international community.

The United States must address these five problems, three of which are largely homegrown but all of which (including the budget, because of its impact on the external imbalance) carry substantial international dimensions, urgently and decisively. They alone justify elevating foreign economic policy to the top of the overall national agenda. They also emphasize the need to consider the international aspects of seemingly domestic issues such as the budget and gasoline prices.

As important as these immediate problems are, however, they understate considerably the salience of the world economy for US policy over the coming years. Structural changes both at home and abroad underlie the more immediate problems and intensify their impact on US society. Responses to the short-term agenda require an understanding of these more fundamental underpinnings.

Domestic Foundations of Foreign Economic Policy

The foreign economic policy of every country of course derives from its national interests, which attach high priority to the success of its own economy. These interests include the creation of stable and well-paying jobs, the maintenance of reasonable price stability, the achievement of maximum economic growth, and the presence of social safety nets to provide "shock absorbers" against the inevitable disruptions that occur in all economies.

In a highly interdependent world, these national goals can seldom be achieved unless the global economy as a whole is functioning effectively. This requires the foreign economic policy of each country to take serious account of both the international repercussions of its own policies and the impact on it of developments emanating from abroad. Such considerations are particularly crucial for a global economic superpower, certainly the United States, since the external effects of its own initiatives (e.g., large tax cuts leading to larger trade deficits and ultimately a sharp fall in the dollar, as in the mid-1980s and prospectively again now) can come back to affect its own economy with great force.

The domestic political base for foreign economic policy is nevertheless shaped largely by popular perceptions of the impact of the country's international involvement on the key domestic variables, which may or may not accurately reflect objective reality. Here too there has been a sea change in the United States over the past couple of decades, producing an unprecedented paradox. As the globalization of the US economy and the benefits from it have expanded dramatically, so too has the backlash against globalization. Both phenomena reached their postwar zeniths in the late 1990s: Just as US productivity growth and thus economic prosperity surged, importantly due to the gains from globalization, the negative reactions surged as well due to the increased adjustments that it required. Hence much of US foreign economic policy stalemated just when the issues it addresses reached the high degree of salience outlined earlier, significantly complicating the ability of the administration and Congress to effectively promote American interests across the entire range of global economic topics.[3]

The gains to the US economy as a whole from globalization are clear and impressive, as noted earlier and explained in detail in chapter 2. These gains have been achieved through two main channels. On one side of the trade equation, increased imports—and the competition they have levied on domestic producers—have reduced costs and increased variety across a wide range of goods and services to American consumers and American firms using imported inputs. On the other side, increased exports have expanded total US output in sectors where it is most efficient and competitive, greatly expanding economies of scale and producing real wages for American workers that are 15 to 20 percent above the national average.

The sharp increase in US economic growth over the past decade owes a great deal to these benefits of globalization. The acceleration of US output growth derived directly from the sharp pickup of growth in labor productivity, which jumped from 1½ percent during 1973–95 to 2½ percent in 1996–2000 and to 4 percent in 2001–04. When the normal annual expansion of the US labor force (about 1 percent) is added to the likely future course of these numbers, the result is that US output potential is now probably rising by at least 3 to 4 percent per year. This (or more) was indeed the rate of realized growth in the late 1990s and again in the second half of 2003 and 2004, when the unemployment rate dropped below 4 percent for a prolonged period and back down to 5.5 percent, respectively—well below the "full employment" floor of 6 percent that was thought to exist before the productivity boom set in. This is an impressive performance for a rich and mature industrial country like the United States and will continue as long as productivity continues to expand at anything like its pace of the past decade.

3. The most dramatic examples were the three failures to win congressional support for new trade negotiating authority (1994, 1997, and 1998) and the tiny margins (majorities of one and three in the critical House votes in 2002) when TPA was finally restored. Congress also significantly delayed passage of new International Monetary Fund (IMF) funding legislation (1997–98) at the height of the Asian financial crisis.

The increase in US productivity derives largely from the interaction between widespread adaptation of the new technologies, particularly in information and communications, across much of the economy and the simultaneous globalization of those technologies. It is difficult to disentangle these two closely related developments, but as much as half of the jump in total productivity may stem from their globalization alone. For example, globalization of the information technology (IT) hardware sector in the 1990s is estimated to have reduced the costs of such products by a further 10 to 30 percent and thereby added a full 0.3 percentage points per year to US economic expansion. Going forward, similarly sizable benefits—leading perhaps to further acceleration of overall US productivity growth—can be anticipated from the globalization of IT services and software that is now under way. Major sectors that have not yet globalized much, such as health care and construction, along with small and medium-sized enterprises more generally, could reap substantial benefits from greater internationalization and thereby provide a further boost to US productivity and overall economic growth (Mann 2003).

A hypothetical elimination of all remaining barriers to international trade in goods and services would provide substantial further benefit to the US economy and to American citizens. Such "completion of the globalization process" could perhaps add another $500 billion (or roughly 5 percent) to the annual level of national income. This would amount to an additional $4,500 annually per household. Hence US policy should continue to seek liberalization of the sizable remaining barriers to world commerce. Such liberalization would help the United States more on the export side of the trade equation than the import side because it has already eliminated most of its own import restrictions while many other countries, especially some of the rapidly growing large economies of the developing world (such as Brazil and India), retain much higher restraints.

As with any dynamic economic change, there have been costs to the extensive adjustments required by the globalization process. That process has created losers as well as winners among individual workers and firms. The salience of these costs has become greater in recent years for three reasons: the overvalued dollar and growing trade deficit have greatly exacerbated the breadth and intensity of the adjustment problems; the increasing pace of globalization has forced more rapid change on all those affected; and the final barriers to be eliminated are, by definition, those maintained in sectors that face the most difficult adjustment burdens (e.g., apparel in the United States).

The number of Americans adversely affected by increased US trade is modest but not insignificant. Kletzer (2001) estimates that there are perhaps 100,000 workers per year who lose jobs due to increased imports *and* whose replacement work reduces their pay by 30 percent or more. (There are perhaps twice as many workers who also lose their jobs due to imports but find new work at the same or, in many cases, even a higher wage.) These numbers of course cumulate over time and, even more importantly from a social and political standpoint, instill concerns across a much larger share of the labor force that "there but for the grace of God go I." A recent summary of polling and other public opinion data shows that American workers are in fact evenly divided over the results of further globalization even though only a small minority are adversely affected themselves (Scheve and Slaughter 2001). Hence the United States must devote priority attention to this domestic adjustment problem, especially as the magnitude of the national gain from globalization is so large as to easily provide adequate financing to do so.

The United States, unlike most rich industrial countries, has relied primarily on market forces to manage this problem. To be sure, rapid growth and relatively full employment provide the best possible environment within which displaced workers can find remunerative new jobs. But growth is not always rapid and employment is not always full, and neither workers nor their unions are willing to rely on such benign circumstances. Moreover, there are important disconnects between the skill mix of the American labor force and the job opportunities that are created in the United States as globalization continuously pushes the economy toward the high-skill end of the spectrum. The concern over outsourcing is the latest case in point: The expansion of trade in IT services and software will almost certainly create more jobs than it exports, indeed jobs that pay considerably better, but it is not clear whether Americans with the requisite skills will be available to assume these positions (see chapter 9).

Hence two types of policy responses are required, both to deal with the real problems of adjustment and to provide a stable new political foundation for a constructive foreign economic policy for the United States. One is the creation of adequate social safety nets to cushion the short-term transition periods faced by displaced workers. The second is better education and training programs to equip US workers to take advantage of globalization rather than feel victimized by it. Both steps will be crucial in forging a new domestic consensus in support of further opening of the world economy: The polls and worker surveys show that the ambivalence over the issue yields to a substantial proglobalization majority when the government is perceived as providing effective adjustment programs, and that every year of additional education for the labor force as a whole adds a full 10 percentage points to the share of the population that supports further opening (Scheve and Slaughter 2001).

Since 1962, the United States has taken tepid steps in both directions through the program of Trade Adjustment Assistance (TAA). As outlined in chapter 10, however, TAA—despite steady improvements over the past four decades, most notably in the TPA legislation in 2002—remains too small, too restrictive, too unimaginative, and too poorly administered to achieve either purpose effectively in substantive and thus political terms.

The needed reforms will clearly have to broaden the scope of eligibility for TAA to include the services sector and perhaps entire trade-impacted communities and sectors (such as apparel); substantially increase benefit levels, especially for training programs; provide the innovations of the 2002 legislation, wage insurance and a health care tax credit, to all eligible workers rather than a restricted subset thereof; develop further innovations, such as homeowner insurance and a human capital investment tax credit, to address more effectively the practical problems of displaced workers; and administer the program aggressively to bring its benefits to as large a number of trade-impacted workers as possible.

The US government must embrace this wholly domestic program as an integral component of its foreign economic policy. If it fails to do so, there is a severe risk that much of its effort to maintain an open and constructive stance toward the rest of the world will fail for lack of internal support. Such a specter was already raised to a large extent in the late 1990s when, despite the strength of the economy, domestic resistance to further globalization produced a political stalemate that denied the president new trade negotiating authority and thus blocked any substantial new initiatives. The debacle at Seattle in 1999, when the United States failed to convince WTO members to launch a new multilateral trade round, occurred largely due to doubts that the United States would be able to reduce any of its own remaining trade barriers in the future and hence was simply seeking one-sided concessions from other countries. It will be essential to sharply expand and improve TAA as part of any successful new foreign economic policy in the United States.

The New Global Context

Just as the domestic foundations of foreign economic policy have been changing dramatically, so has the international context within which that policy must be pursued. Fundamental shifts are occurring in both the composition of global economic power and the distribution of global economic performance—sometimes (as with China) in the same direction, sometimes (as with the European Union) in opposite directions. The United States must reprioritize its international economic ties and institutional commitments at the same time that it reforms its policies at home to provide a firm foundation for those international linkages.

Throughout the postwar period, the United States could safely assume that the other major players in the world economy were essentially like-minded: Western Europe, Japan, Canada, and a few others on specific issues. To be sure, there were often bitter and prolonged disputes (especially with Japan). But the similarities dominated: All the major players were market-based high-income economies and political democracies that had huge stakes in a flourishing world economy and were dependent on the United States for their security. Hence, in a crunch, they could usually be relied on as dependable supporters.

The composition of the global economic elite for the next few decades looks likely to be quite different. The United States is no longer the world's dominant economic entity in view of the creation, and now expansion, of the European Union. Europe's new single currency (the euro) is the first potential rival to the dollar's global financial dominance in the century since the dollar replaced the pound sterling as the world's key currency.[4] European attitudes toward basic economic and social preferences may increasingly diverge from those of the United States (Baily and Kirkegaard 2004). As the dispute over Iraq has displayed so brutally, much of Europe is no longer the reliable US ally of Cold War days.

Even more dramatically, China has become the new growth pole and chief driver of global trade expansion. As described by Nicholas Lardy in chapter 4, China has already become the world's third largest trading country and provided the largest stimulus to world trade of any country (even the United States) during 2000–03. Its economy has expanded ninefold since its adoption of outward-oriented economic reforms in 1978 and, with exchange rates measured at purchasing power parity, it is already the world's second largest economy. (With currencies converted at market rates, it ranks sixth but will move up to fourth—after only the United States, Japan, and Germany—within the next couple of years.) Its trade *increase* in 2003 was more than double India's total trade *level*. It accounted for almost half the increase in total global demand for oil in 2002–03. It already has the third largest stock of inward foreign direct investment (FDI) in the world, surpassing the United States as the leading destination for such investment flows in 2003 and amassing an inflow in that year alone larger than the cumulative flow of FDI to India since its independence in 1947.

China, however, differs radically from the United States on at least four counts. First, it remains a poor country and will still be relatively poor, with per capita incomes one quarter of the United States' or less, even if it again becomes the world's largest economy by the middle of the century. Second, the privatization of its economy has proceeded only part way, and the state is likely to play a much more central role indefinitely than in any of the "western" countries including Japan (though China's remarkable openness to the world economy and conscious strategy of globalization are likely to align it with the United States on a number of international trade and other issues). Third, political democracy, while making limited strides at the local level, remains a distant dream in Com-

4. This development is likely to be beneficial, if occasionally painful, for the United States as the euro makes it more difficult for the United States to fund and thus run excessive external and internal deficits. See Posen (forthcoming).

munist China, and one-party government seems likely to prevail there for the foreseeable future. Fourth, far from being an ally, China is viewed as a potential threat by many Americans, and the view from the Chinese side is clearly reciprocal; the uneasiness of the present (albeit substantially improved) relationship provides a far different foundation for economic cooperation than the close cultural, historic, and ideological ties that have underlain US relations with the rest of the G-7.

An additional possibility, which is still far less important but whose potential nevertheless merits consideration, is India. With its rapid population growth and consistent economic expansion of 5 to 6 percent over the past decade, which could rise to China-type levels of 8 to 10 percent for the next decade or so with the adoption of plausible if difficult additional reforms (Srinivasan and Tendulkar 2003), India is projected by some to become the world's third largest economy by 2050 (Goldman Sachs 2003). Like China, it too would remain a poor country even with such an impressive aggregate. It would be a more market-oriented economy, however, with a vibrant democratic polity. Though not an ally of the United States, it carries none of the threatening implications of resurgent China—and its inherent rivalry with China naturally orients it toward the United States in a world where both Asian giants are becoming important players. India is unlikely to become nearly as large a global economic factor as China, because of the relatively closed nature of its economy, but could still become a very important player on the world scene.

The situation in Asia, whose economic growth is likely to remain the world's most dynamic at the same time these huge changes in relative positions are occurring, will also be affected by the decline of Japan. Demographics alone point to a continuing reduction in Japan's global role—the country never assumed much international leadership even during its miracle growth period—even if it proves able to restore a reasonable degree of economic progress as now seems likely (Posen 2004).

Major differences in current and prospective economic performance further intensify the complexities of these tectonic changes in the structure of global economic power. America's closest traditional partners in Western Europe and Japan, while still the wealthiest countries in the world, have been laggards for the past decade and could maintain that dubious distinction for the foreseeable future. There are a few exceptions to this generalization: the United Kingdom has fared far better than continental Europe; a few of the smaller Europeans (notably Ireland, the Netherlands, and Scandinavia) have done better than the "big three" (France, Germany, and Italy); Canada has led the G-7 in growth in some years; and there are a few bright spots in Latin America (notably Chile and Mexico).

The world's best economic performers, however, except for the United States itself, have been largely elsewhere: especially China, India, and others in East and Southeast Asia. If the United States wants to align itself with the changing pattern of world trade and investment expansion, it is likely to be pulled in very different geographical directions than over the past five or six decades.[5]

Some of the world's new economic powerhouses, including China and India, will nevertheless remain developing countries for the foreseeable future. Moreover, virtually the entire net increase in world population during the years ahead will occur in the poor countries. Despite dramatic reduction in both global poverty and inequality over the past two or three decades (Bhalla 2002), half the world still lives on less than $2 per day. Much of the African continent has experienced deterioration in its economic conditions in recent years. Many of these poor countries, in part because of their poverty, represent security threats to the United States because of their susceptibility to becoming safe havens for terrorists, drugs, and crime. The United States will therefore also have to strengthen its commitment to address development issues as a priority within its overall foreign economic policy.

These shifts also carry potentially profound institutional implications. It is already clear that the G-7 must either alter its own membership or give way to the relatively new G-20 (or some other more representative group) as the chief steering committee for the world economy (Bergsten 2004a). The creation of the "non-G-5"—including Brazil and India along with the European Union, the United States, and Australia—which restored life to the Doha Round and thus the WTO in 2004 is already a step in that direction. But the United States must prod the formal multilateral institutions to alter their ways as well if they are to become more effective and thus continue to serve US interests. The entrenched incumbents in the International Monetary Fund (IMF) and World Bank, especially from grossly overrepresented Europe, have fiercely resisted the wholesale reallocation of "chairs and shares" that will be needed to reflect the objective changes, and has thereby undermined the legitimacy of those organizations (see chapter 5).

The United States will need to reorient its foreign economic policy priorities accordingly. It will need to further develop and nurture special ("G-2") relationships in at least four directions: with the European Union, the world's largest economy and home of its other key currency; with China, the other chief locomotive of the world economy and the leader of a potential East Asian economic bloc; with Japan, to provide a counterweight to China and ensure its ties with a central player in any new Asian grouping; and with Saudi Arabia, because of its continued dominance of the world energy picture for at least the next couple of decades.

5. Henry Kissinger ("America's Assignment," Special Report in *Newsweek,* November 8, 2004) has recently concluded that "China's renaissance, the rapid growth in India, and the globalization in every corner of the world . . . [will] bring about massive issues of policy that can be postponed only at peril to the world economy. . . . These issues must be addressed with great urgency by the newly elected president—in concert with directly affected trading and financial partners."

Some of this essential evolution has already begun. The United States and the European Union have maintained a functioning "G-2" on trade policy for several decades. The United States and Saudi Arabia have conducted a "special relationship" that includes oil for even longer, although its orientation has focused on "security of supply" rather than price. The United States and China have for some time had intergovernmental committees on economic and monetary issues, but their meetings have been largely perfunctory, and most serious business, like WTO entry, has been pursued on an ad hoc basis. On the multilateral front, the United States played a major role in the creation of the forward-looking G-20 of finance ministers and central bank governors in the late 1990s and, in a much earlier period, took the lead in engaging Japan in the global leadership structure in an effort to avoid repeating the tragic historical errors through which new economic powers in earlier periods (especially Germany during the late 19th century) were held at bay.

The United States, however, has not to date adopted a strategy that recognizes, and responds to, the fundamental changes in both economic structure and economic performance just outlined. The case for new initiatives is clearest with China, which is rapidly becoming a global economic superpower (despite maintaining an inconvertible currency) as well as the world' s leading growth pole. But the European Union, especially with enlargement and the inevitable expansion of the global role of the euro, must be viewed as an essential partner due to its size and wealth and—with China and the possible emergence of an East Asian bloc—as a continuing ally in a tripartite global system. The complexities are even greater with respect to Saudi Arabia, but its central importance to the global energy picture, and the critical importance of that picture to the entire world economy, are so great that the major initiatives proposed later in that issue area will require an intensification as well as reorientation of the traditional relationship.

These new international requirements for US foreign economic policy will of course interact extensively with the need for new domestic foundations for that policy as addressed in the previous section. Increasingly close cooperation with China, for example, will be a tough sell for workers who view it as a threat to be confronted rather than an essential collaborator. Explicit links with Saudi Arabia may run counter to other US foreign policy goals in the region as they have in the past. Tighter ties with "old" as well as "new" Europe may be disparaged in some quarters, perhaps more thoughtfully for Europe's recent lack of economic dynamism than for its disagreements with other aspects of US foreign policy. Presidential leadership will be required on a consistent basis to reconcile these potential conflicts and maintain the priority attention that the issues deserve.

With both the domestic and international contexts in place, it is time to lay out a "foreign economic policy for the next decade." These proposals are directed most immediately to the administration and Congress that assume office in early 2005. They address deep problems that will take some time to resolve, however, even under the best of circumstances. They also hope to set out an agenda for at least the medium term, given their incorporation of underlying forces both at home and abroad as well as the immediate focus that will be required of any government. A major challenge will be in choosing priorities from the list of issues already noted and the even longer list addressed in subsequent chapters of this book.

Proposals for Policy

Five issues would seem to deserve priority attention for US foreign economic policy over the coming period:

- restoring the *US current account and foreign debt positions* to levels that will be sustainable in both international financial and domestic political terms;
- conducting a *trade policy* that will both preserve the enormous gains that globalization has already brought to the United States and pursue the substantial further benefits that are clearly available;
- constructing and implementing a comprehensive program of *domestic supports* to cushion the losses that some Americans will suffer from continued and further globalization of the economy, through substantial improvements in both social safety nets and education/training programs;
- creating a new strategy for *energy policy*, combining major changes in domestic consumption and production patterns with a fundamental reorientation of our international approach to the issue; and
- making further improvements in *development policy* to support growth and poverty reduction in the poorer countries of the world.[6]

Correcting the Current Account Deficit

The highest priority for foreign economic policy—and perhaps overall US economic policy—must be to correct the large and rapidly growing

6. The foreign economic policy of the United States will of course have to address a number of issues that are not addressed in this book, for reasons of both space and priority. The most notable omission is probably international environmental policy, which the Institute has considered previously in Esty (1994) and Cline (1992). Other exclusions include sanctions policy, which has been covered extensively by Hufbauer, Schott, and Elliott (1982, 1990, and forthcoming 2005), and the important role of US government corporations in foreign economic policy (see Hufbauer and Rodriguez 2001 on the Export-Import Bank and Moran 2003 on the Overseas Private Investment Corporation).

deficits in the US current account and international debtor positions. Those imbalances are already far above previous record levels and on a trajectory that will take them increasingly into even more clearly unsustainable territory. It would be risky to the point of irresponsibility to base policy on a hope that a sharp adjustment can be avoided over the next four or five years.

An effective response to this problem has both short-term and long-term dimensions and must be supported by other countries though the United States must of course take the lead. The goal should be to cut the US current account deficit roughly in half, to 2 to 3 percent of GDP. Depending on how fast the adjustment can be achieved, this could stabilize the country's net international investment position ("net foreign debt") at about 50 percent, an uncomfortable level but the *best* the United States can hope for at this juncture. By contrast, Mussa shows in chapter 6 that current account deficits even holding at the present level of 5 to 6 percent of GDP would take the net foreign debt ratio beyond 50 percent in five to eight years and reach a clearly unsustainable 100 percent in less than 20 years.

The most constructive remedy in the short term is a three-part package that includes credible and sizable reductions in the US budget deficit, expansion of domestic demand in major economies outside the United States, and a gradual but substantial realignment of exchange rates. The key initial step would be a commitment by the United States to achieve sharp reduction in its budget deficit over the next few years. By reducing the dissaving of the federal government, such a US step would reduce the savings/investment imbalance that requires huge capital inflows, strengthens the dollar, and is thus a key underlying cause of the US external deficit. By compressing the growth of domestic demand within the United States, it would make room for improvement in the trade balance without generating higher inflation and interest rates. By restoring confidence in US fiscal management and the country's economic outlook, it would enhance the prospect for an orderly currency adjustment.

This is not the place to provide details of the needed US budget correction. The goal, however, should be a reduction of the deficit by at least 50 percent over the new presidential term. That progress will need to be sustained thereafter and preferably extended to the achievement of a surplus so that the federal government would begin to make a positive contribution to the abysmally low national saving rate.[7]

7. There are several possible steps to help correct the budget deficit that would also be quite helpful, or even essential, in pursuing US foreign economic policies that will be discussed later. Sharp cuts in US agricultural subsidies might provide $5 billion to $10 billion annually in budget savings while making a major contribution to the Doha Round negotiations. A substantial increase in carbon or gasoline taxes, a necessary ingredient in any serious new US energy policy, could contribute importantly to higher revenue levels. The substitution for

As outlined by Mussa in chapter 6, however, budget correction will not by itself restore a sustainable US current account position. A decline of about 30 percent in the trade-weighted average exchange rate of the dollar from its peak at the outset of 2002, implying a fall of another 15 percent or so from its level at the end of 2004, will be required to achieve that outcome. It is vital that this depreciation occur in a gradual and orderly manner, at the rate of the decline of 10 to 15 percent actually recorded in 2002–03 or even the additional 5 percent in October–November 2004, to avert the risk of a crash landing.

The euro, Canadian dollar, and a few other unmanaged floating currencies will need to appreciate further to permit this adjustment to take place. Their rates rose substantially in 2002–03, however, and they have thus already made a substantial contribution to the necessary outcome. A major part of the remaining dollar correction needs to take place against the currencies of the East Asian countries (Bergsten and Williamson 2003, 2004). Their surpluses and foreign exchange buildups are the chief counterparts of the US deficits and debt buildup. Moreover, their rapid economic growth enables them to "afford" modest reductions in their trade surpluses more than the sluggish Europeans.

To date, however, these countries have permitted very little appreciation of their currencies. China is the key because its continued peg to the dollar means that its currency has actually depreciated, by a trade-weighted average of more than 10 percent over the past three years, as it rode the dollar down and further increased the competitiveness of one of the world's most competitive countries. This has blocked direct US adjustment against the world's fastest growing economy and second largest holder of currency reserves. It has taken virtually all of Asia largely out of the international adjustment process because other countries in the region, from Japan to India, are very reluctant to countenance losses in their competitiveness against China and hence resist letting their currencies rise against the renminbi and perforce against the dollar. It violates China's international obligations to avoid manipulating its currency for competitive purposes, as analyzed by Morris Goldstein in chapter 12.

China should revalue its currency by 20 to 25 percent, while maintaining its fixed exchange rate system and capital controls for the time being,[8]

direct taxes of new indirect taxes, which would be rebatable at the border and thus help correct the current account imbalance, could also contribute to budget correction if their rates were set at levels to increase revenues. Elimination of the deferral of US taxation on overseas profits of US companies until they are repatriated, as proposed by Senator John Kerry in the 2004 presidential campaign, could also contribute a modest amount of revenue to the budget (Hufbauer and Grieco 2004).

8. The US administration, the G-7, and the IMF have mistakenly asked China to adopt a floating exchange rate and progressively eliminate its capital controls. These are worthy goals for the longer run, which China has adopted long ago. They are totally infeasible for at least the next several years, however, because of the continued weakness of the Chinese

for both internal and external reasons. Such a move would simultaneously promote all three of its priority domestic economic goals: slowing its growth rate to 7–8 percent by cutting demand for its exports; reducing inflation, which has been rising rapidly and now exceeds 5 percent, by cutting import costs directly; and halting the inflow of speculative capital, which has made it more difficult to control the expansion of the monetary base. On the international side, a substantial revaluation would be by far the most effective response to the protectionist measures that are escalating so rapidly against China in the United States (and will rise in a number of other importing countries as well if their currencies have to accept a disproportionate share of the counterpart appreciations against the dollar's correction because China and other Asians continue to resist doing their part).

A substantial Chinese revaluation would enable the other Asian surplus countries to let their currencies appreciate by at least a large fraction of the Chinese move. The main contributions need to come from Japan, Korea, Taiwan, Malaysia, Singapore, and India. All these currencies are nominally floating, but their authorities have intervened heavily in recent years to resist market pressures for appreciation. If they were all to move more or less simultaneously against the dollar, along with China, the appreciations in their own trade-weighted average rates—which is what counts for trade and economic impact—would be substantially mitigated. If the other Asians moved by 10 to 15 percent in response to a Chinese move of 20 to 25 percent, the US current account would improve by an estimated $50 billion to $60 billion per year (Goldstein 2003, Hufbauer and Wong 2004).

The contours of this short-term adjustment package are broadly similar to those worked out in the Plaza Agreement of 1985, which sought to correct the previously largest international imbalances in history through a coordinated realignment of floating exchange rates among the G-7 countries. The main question, now as then, is how to implement the required changes. The best outcome would be a continued gradual dollar depreciation in the markets, as occurred in 2002–03 and again in late 2004, *and* a willingness by all the important surplus countries (especially in Asia) to permit that adjustment to play out against their currencies. In the absence of such a fortuitous development, the dollar decline could either stall out far short of completion, storing up even larger problems for the future, or accelerate into a free fall with very adverse effects on the US and world economies.

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banking system and hence the risk of capital flight. Indeed, early Chinese acceptance of the US/G-7/IMF proposal could produce a substantial capital outflow due to portfolio diversification by Chinese investors and thus lead to a *weaker* renminbi, which would *intensify* the international imbalances and protectionist problems. See Goldstein (2004).

Hence the United States should take several policy initiatives to ensure the necessary correction. The most important, as already noted, is early initiation of a credible program to reduce its own budget deficit substantially over the next few years. With respect to implementing the currency adjustment, there are two basic options. The preferable course would be a "second Plaza Agreement" through which the world's major economies, including China and several of the other key Asians, publicly announce that they would promote a substantial realignment.[9] They would presumably then indicate their readiness both to intervene in the markets to achieve such an outcome (in the case of the Asians, beginning with a cessation of interventions to prevent it) and to implement measures to expand their domestic demand if needed to offset the adverse impact on their (and thus world) growth of the induced cuts in their trade surpluses.[10] There is ample justification for launching such an international initiative in light of the clear-cut manipulation of their currencies by China, Japan, and other Asian countries in violation of their obligations under the IMF's Articles of Agreement—which the United States, the G-7, and the IMF itself have to date conspicuously failed to insist upon (see chapter 12).

The United States could achieve at least some of the impact of such a multilateral agreement by indicating unilaterally that it wanted to see a weaker dollar. Such a US declaration (or simply leaking of such an intent), reversing the "strong dollar policy" of the past decade, would have considerable impact on the foreign exchange markets (see Fratzscher 2004 on the effectiveness of "oral intervention"). However, the results would be much less certain than under an agreed international compact. Moreover, the effect on world growth would be much more problematic given the absence of any commitment by the surplus countries to make appropriate adjustments in their economic policies to cushion the global impact.

In addition, some countries in Europe as well as in Asia might seek to counter such a unilateral US move by intervening directly or indirectly

9. A more modest variant of this idea would be an "Asian Plaza Agreement" in which the Asian countries, perhaps prompted by the United States, agreed to stop intervening to block dollar adjustment and worked out to some extent the relative appreciation of their respective currencies and thus the trade-weighted change in each. China, once it has decided to revalue the renminbi, might want to lead such an initiative to make sure that it had company in the region. However, the Asians would justifiably want to know what Europe, Canada, and other major countries were planning to contribute to the overall global adjustment, so an agreement with broader participation would be more likely to succeed.

10. It is of course quite possible that such an initiative would be "too successful" and that the dollar's fall would become too rapid and/or overshoot on the downside at the conclusion of its adjustment. If such outcomes were appearing to eventuate, the cooperating countries could then intervene on the other side of the market to stop it—as the G-7 in fact did with its Louvre Agreement in 1987 when the correction agreed at the Plaza threatened to become disruptive (Funabashi 1988).

(e.g., via monetary policy) to block substantial dollar depreciation—thus triggering "currency wars" that would make the global financial situation worse for a while. Hence the United States might have to employ aggressive tactics to achieve the needed currency correction: threatening to sell dollars in the currency markets, as it actually did after the Plaza Agreement and as recently as 1998 against the yen and 2000 against the euro, or to impose new trade barriers against noncooperating countries as done by the Nixon administration with its import surcharge in 1971.

With a US budget commitment and international agreement to realign exchange rates, the other major countries would be much more likely to adopt the measures needed to offset the resultant declines in their trade surpluses by expanding domestic demand.[11] The precise nature of these measures should be left to the individual countries though they would be expected to adopt some combination of more expansionary macroeconomic policy (especially monetary policy, taking advantage of the anti-inflationary impact of their currency appreciations) and needed structural changes (especially in Europe and Japan). Indeed, the need to expand domestic demand in these countries to offset anticipated currency appreciations should have the desirable effect of strengthening the prospects for successful implementation of the policy reform efforts already undertaken by some governments (à la Schröder in Germany). Domestic political resistance, which has blocked such efforts, might be overcome in the new circumstances and especially if they were part of an international compact worked out with the United States, China, and other key countries.

Dollar depreciation, while essential to the needed correction, will nevertheless provide only a temporary (albeit prolonged) respite for the external financial problems of the United States. Excessive current account deficits have consistently reappeared despite repeated and sizable dollar declines. Prior to the sharp pickup in productivity growth and robust US output growth over the past decade, many analysts believed that the United States faced fundamental problems of international competitiveness. With that strong pickup in economic performance in recent years, the puzzle is even greater.

A substantial part of the underlying problem is clearly macroeconomic, centered on the low national saving rate (since it would be foolish to cut investment spending on a lasting basis to resolve the external deficit problem). Hence the United States should aim to run budget surpluses in prosperous economic periods to contribute positively to the domestic availability of capital. Serious consideration should likewise be given to measures that promote private saving but, since all manner of tax and

11. China, which has set an official goal of reducing its overall output growth to 7 to percent from 9 to 10 percent in order to cool recent overheating, would not need to take such measures. It should simply let the cut in its external surplus translate into a cut in total output growth for at least the next couple of years.

other incentives have been attempted and failed, this would probably require mandatory savings requirements à la Singapore.

Foreign economic policy could pursue at least two major initiatives in this context that would strengthen the US current account position over the longer run and thus reduce the need to rely on periodic depreciations of the dollar.[12] One would be to alter the current international trading rules that permit most other countries to rebate their indirect taxes on exports and impose those taxes on imports, while prohibiting the United States from doing so on its direct taxes. In theory, these across-the-board differences in tax systems between the major trading countries should be neutralized by changes in exchange rates. In practice, the dollar has experienced prolonged periods of overvaluation during the past 50 years (as at present) rather than the undervaluation that would be needed to counter the trade impact of the tax differences. Hence the United States should seek a change in the global tax rules in future multilateral trade negotiations and be prepared to make offsetting concessions (for example, in its implementation of antidumping duties) to win foreign acceptance thereof.

Alternatively, or as a lever to promote such international agreement, the United States could reform its own tax system to comport with the existing international rules. Possibilities include a national retail sales tax or a corporate activity tax (CAT) to replace the corporate income tax for this and other purposes (Hufbauer and Grieco, forthcoming). Such a shift could improve both the efficiency and simplicity of the US tax code, and the new tax could reasonably be set at a level that would raise additional revenue as a contribution to cutting the budget deficit. Such a tax would clearly be rebatable at the border under the current international rules, so the United States could either match other countries' practices or, without then having to offer any quid pro quo, much more easily negotiate a cessation of all border rebate practices.

The US current account position could also be improved by further increasing US emphasis, in international trade negotiations, on liberalization of other countries' barriers to imports of services. The United States runs a sizable surplus in its trade in services, which partially offsets a huge gap in merchandise trade. Moreover, it appears that foreign income elasticities of demand for US services exports are higher than the US income elasticity of demand for services imports—the reverse of the Houthakker-Magee phenomenon that applies to merchandise trade (Mann 2004b).

Liberalization of their services sectors by other major trading countries, especially the rapidly growing developing countries, would have doubly beneficial effects for the United States. On the one hand, the share of ser-

12. To do so on a lasting basis, they would have to contribute to a reduction in the underlying savings/investment imbalance. Both strategies proposed here would achieve that goal by boosting corporate profits and thus business saving.

vices in these countries' overall economies would grow more rapidly; those shares remain very low by international standards and, though they will inevitably rise to a dominant position as in all other mature high-income countries, an acceleration of that trend would be very helpful for US exports. At the same time, reduction of those countries' barriers to services imports, including domestic regulations that have such restrictive effects, would enable the United States (and other competitive exporters) to secure a growing share of a rapidly expanding market. Some studies of the future gains to the US economy from moving to global free trade indicate that three-quarters of those benefits would accrue in the services sector (Brown, Deardorff, and Stern 2003).

The US current account deficit and external debt are macroeconomic problems that require primarily macroeconomic responses, notably a sizable and lasting increase in the domestic saving rate and a competitive exchange rate for the dollar. Import restrictions would be an ineffective and indeed counterproductive policy response because they would impair American productivity and trigger retaliation and/or emulation by other countries. But it is perfectly appropriate, indeed imperative, for the United States to seek long-run improvement in its export performance by adding reform of the international tax rules and liberalization of foreign services markets to its priority goals in international trade negotiations, especially multilateral talks in the WTO like the current Doha Round. Trade policy can thus play a helpful role in reinforcing US efforts to restore stability to the country's economic and external financial positions over both the long and short runs.

International Monetary Reform

There is one other implication for US foreign economic policy of the major problem, and potential crisis, surrounding the current account deficit and overvaluation of the dollar. This is not the first time that such a situation has confronted the United States. Indeed, it is at least the fifth cycle in the postwar period with similar characteristics: a sharp rise in the dollar leading to a substantial deterioration in the current account, producing in turn domestic protectionist pressures and growing fears of a dollar crash, resolved via more or less disorderly realignments of exchange rates and ad hoc policy measures among the major countries. Such patterns emerged in the early 1970s and led to both the first serious protectionist threats in the postwar period and the termination of the Bretton Woods system of fixed but adjustable exchange rates, in the late 1970s surrounding double-digit inflation in the United States and elsewhere, in the mid-1980s with such an outbreak of US protectionism that the United States had to seek international help to weaken the dollar via the Plaza Agreement, and more mildly in the mid-1990s leading to the all-time lows for the dollar in 1995.

The international monetary system has nevertheless stubbornly resisted any reforms that would reduce the prospect of repeated misalignments among the major currencies. The entire debate over strengthening the "international financial architecture" in recent years has centered on problems surrounding emerging-market economies, which were indeed the chief systemic problem in the second half of the 1990s,[13] while ignoring the countries and currencies at the center of the system (and the large increase in the imbalances among them that was building up while this debate transpired). It should be a major goal of US foreign economic policy in the coming years to develop, propose, and negotiate improvements in the international monetary system to reduce the likelihood that huge misalignments and imbalances will continue to recur, with the adverse effects on the United States seen so many times over the past 30 years.[14]

Trade Policy

As noted earlier and elaborated in chapter 2, the United States has gained enormously from the dramatic reduction of its own and other countries' trade barriers over the past 50 years. The total benefit to the US economy totals about $1 trillion, or almost 10 percent of GDP, per year. The annual standard of living of the average US family is about $9,000 higher as a result. Complete elimination of all remaining barriers, at least those that can now be identified and quantified, would augment these aggregates by perhaps another 50 percent.

There is of course no prospect of moving to completely free world trade in the near future. However, US policy has been approaching that ultimate

13. A number of highly desirable further reforms with respect to these issues are analyzed and proposed by Morris Goldstein in chapter 12.

14. One possibility would be to install at least a weak version of the target zone idea (Bergsten and Williamson 1983, updated in Bergsten and Henning 1996), perhaps the "monitoring zone" variant recently developed by John Williamson (Williamson 1998, 2000). Such an approach would seek to keep currencies from deviating too far from equilibrium levels, thus producing sustainable current account positions over the longer run in both financial and trade policy terms. The key countries, probably initially through the G-7 (or its successor) and institutionally through the IMF, would agree on the ranges for their currencies that would meet the "sustainability" test. They would then agree to take no actions that would push their exchange rates away from those levels or keep them from moving toward those levels, such as intervening in the markets either financially (as Japan, China, and others have done in recent years to block appreciation of their currencies against the dollar) or rhetorically (as the United States has done in recent years to support continued overvaluation of the dollar). If experience with such an approach proved to be effective and useful, it could subsequently be strengthened to incorporate explicit cooperation to stop rates from moving away from their equilibrium levels and even to push rates toward their equilibrium levels as with the Plaza Agreement in 1985. The chief policy instrument would be sterilized intervention in the currency markets, which has been shown to be a successful tool in numerous episodes over the past 20 years (Fratzscher 2004, Kubelec 2004).

goal via three channels of negotiation: bilateral FTAs with individual countries or small groups thereof, megaregional FTAs with Latin America (and, though only rhetorically so far, with the Asia Pacific), and multilateral reductions to trade barriers at the global level through the WTO (currently via the Doha Round). The strategic underpinning of this threefold approach is the concept of "competitive liberalization," under which negotiations at each level create new incentives and pressures for nonparticipating countries to join the process (Bergsten 1996a, 1996b; Zoellick 2001). For example, US FTAs with Central America and the Andean countries create new discrimination against the South American countries in some of their important markets; this should help induce them to agree to a continentwide Free Trade Area of the Americas (FTAA), which generates important new discrimination against the Europeans and Asians throughout this hemisphere; this in turn should pressure the non-FTAA participants to agree to a substantial global reduction of all barriers via the WTO. The shoe can of course be on the other foot: A meaningful free trade pact between the European Union and Mercosur (Mercado Común del Sur, or the Southern Cone Common Market) should quicken US willingness to complete an FTAA, and the creation of an East Asian Free Trade Area, like the steady movement toward a single market within Europe before it, could represent an enormous inducement to others to reach ambitious multilateral agreements to reduce barriers at the global level.

The chief objective of US trade policy over the next few years should be to implement this strategy in a way that will most effectively promote US economic and foreign policy interests. This will require several changes in both the substance of the US negotiating agenda and the list of countries with which talks are conducted.

As noted earlier, three major changes in the US approach to trade negotiations would advance US budgetary as well as trade objectives. One is a complete elimination of agricultural protection by all countries, which would enable the United States to cut $20 billion in farm payments from its annual budget as well as eliminate distortions that severely limit world trade in this sector and hence lift 200 million people out of poverty in the poorest countries (Cline 2004 and chapter 13). Such a goal is unrealistic for the Doha Round because of the continued resistance of the European Union, the world's largest farm subsidizer, and others (including within the United States). But the United States should redouble its efforts in this direction in Doha, by offering to reduce its own trade-distorting subsidies as close to zero as reciprocity from others will permit and by continuing to pursue the ultimate objective in megaregional and future multilateral negotiations after the Doha Round is completed (presumably in 2007).

Second, the United States should raise worldwide liberalization of barriers to services trade to the top of its priority agenda. US comparative advantage is both clear and particularly constrained by policies in other countries in many services sectors. Hence substantial services liberalization might make an important contribution to reducing the US current account deficit, especially over the longer run, as well as generating a large number of high-paying domestic jobs.

Such negotiations on services will not be easy, however. Most of the offending policies derive from domestic regulatory regimes in other countries, rather than tariffs or other border measures, and are thus harder to identify and negotiate away (as the long-running US efforts with Japan through the 1980s and 1990s demonstrated so vividly). Moreover, the United States would presumably have to liberalize some of its own barriers to imports of services as part of such a deal. Some of these—as on maritime services (including the venerable Jones Act) and especially on labor services, which will almost certainly be demanded by some of the developing countries whose services markets the United States is most eager to pry open—would entail domestic adjustment that would be politically if not economically painful. The potential payoff is nevertheless substantial and should be pursued aggressively at all three levels of negotiation.

A third, more radical, addition to the future global agenda would be to tackle the WTO rules governing the relationship between taxes and trade. The current rules discriminate badly against the United States (and the few other countries that rely on direct, mainly income, taxes as revenue sources) in favor of countries that use indirect (including value-added and sales) taxes. Those rules permit indirect taxes to be rebated on exports and added to imports but bar similar treatment for direct taxes. The theoretical offset to this structural difference via changes in exchange rates obtains only over the very long run, if at all, and the persistent overvaluation of the dollar (in trade terms) throughout the postwar period suggests that this particular component of the invisible hand is nowhere to be seen.

The United States can counter this particular distortion in two ways: join 'em or fight 'em. The United States could convert its direct taxes to indirect taxes, perhaps a national retail sales tax or corporate activity tax for the key corporate sector, for revenue as well as competitiveness reasons (Hufbauer and Grieco, forthcoming). It could then emulate the border adjustments of other countries and subsequently negotiate from an equal starting point to end that entire practice.

However, it may be difficult to reform US tax policy in this direction. Objections would be raised to the allegedly regressive effects (and sizable transition costs) of the proposed changes and, for some variants of the approach, to "letting companies go tax-free," and to relations between the US federal and state governments. Hence the United States may want to pursue the alternative course of seeking elimination of the archaic distinction in the WTO rules. This would carry a very high payoff for the United States, along with services liberalization probably bringing the biggest benefit it could obtain from multilateral trade negotiations.

However, most other countries would stoutly resist such a reform since the current rules favor them so substantially. Hence it would probably be impossible to add it to the agenda for the Doha Round at this late date, when major efforts will be needed simply to achieve the goals already agreed (in principle) for that initiative. The United States should thus use the next few years to try to alter its tax code to conform to the WTO rules and, if that route fails, seek to place the issue on the agenda for whatever multilateral trade negotiation follows Doha.

In addition to these modifications in the US agenda for future multilateral trade negotiations, changes are needed in the regions and countries with which it is pursuing the other components of the "competitive liberalization" strategy. In particular, new approaches are needed with respect to Asia, and particularly northeast Asia, the largest gap in the network of trade agreements that have been pursued in recent years (Baucus 2004). Another reason to devise new strategies toward that region is that the East Asians are contemplating major new trade (and financial) agreements among themselves, ranging from bilateral deals between significant pairs like Japan-Korea and China-ASEAN (Association of Southeast Asian Nations) to a full East Asian Free Trade Area (including ASEAN, China, Japan, and Korea), which would carry substantial trade (and perhaps foreign policy) diversion costs for the United States.[15]

The United States faced similar issues in the late 1980s and early 1990s, when Asia was booming and Prime Minister Mahathir bin Mohamad of Malaysia attracted considerable attention with his proposal for an East Asian Economic Group. The United States responded firmly against "drawing a line down the middle of the Pacific," in Secretary of State James Baker's memorable phrase, and insisted on full membership in the new Asia Pacific Economic Cooperation (APEC) forum that was originally contemplated as an Asia-only grouping (Funabashi 1995). The United States and others were subsequently able to use the initial APEC summit meeting in 1993, which raised the prospect of a potentially huge Asia-Pacific trade bloc, to induce the European Union to agree to a successful conclusion of the Uruguay Round and creation of the WTO after they had stalled for three years and threatened total failure of the exercise (Bergsten 1994).

After a promising start in the mid-1990s, however, APEC has achieved very little actual liberalization. It did lead the negotiations toward the eventually global Information Technology Agreement in 1996, which freed $500 billion of trade in high-technology goods and services, but its subsequent pursuit of the agreed goal of "free and open trade and investment in the region by 2010 (for its developed members) and 2020 (for its developing members)" has stalled out. The group's private-sector arm, the

15. Scollay (2001) implies that US exports would decline by $25 billion annually as an immediate effect of the creation of an East Asian Free Trade Area.

APEC Business Advisory Council, attempted to restart the process in 2004 by proposing serious study of a Free Trade Area of the Asia Pacific (FTAAP) that, like all other FTAs, would extend its liberalization only to members of the group. APEC has never explicitly confronted the need to proceed on such a preferential basis, which is obviously essential to win domestic support for the idea in the United States and indeed virtually all member economies, opting instead for vague calls for "open regionalism" that implied extending the benefits of its liberalization on a most-favored-nation basis to nonmembers.

The United States should strongly support this initiative. It is the best way to head off the risk of Asia-only regionalism that could severely hurt US economic and foreign policy interests. Building on APEC's halting but promising results to date, it would begin to forge serious institutional ties across the Pacific that could over time emulate the enormously successful (if currently frayed) transatlantic ties that have been so vital to the United States for half a century. It would enable the United States to engage directly with the most dynamic economies in the world.

From the perspective of trade policy, US participation in the credible launch of an FTAAP would represent the most potent next step in the "competitive liberalization" process. Brazil and the other Latin American countries would realize that their potential megaregional agreement with the United States, the FTAA, had a serious and potentially more lucrative rival for US attention. The European Union and other non-APEC countries would immediately see the huge trade diversion they would suffer if an FTAAP were to eventuate and would almost surely "sue for peace" by making sure that the Doha Round, and perhaps early successors in the WTO, reasserted the centrality of global liberalization. APEC might never need to actually create an FTAAP if it offered a credible prospect of doing so in the near future. Such an arrangement could also be viewed, however, as a potential fallback in case the Doha Round were to fail or even produce a disappointing result (Bergsten 2004b).

Perhaps in addition to an FTAAP, or certainly if it failed to proceed because other APEC members resisted the idea, the United States should pursue comprehensive bilateral FTAs with key countries in the region, especially Japan and Korea. The reasons are similar to those just noted: to preempt discrimination from the FTAs those countries are working out among themselves and with others in the region, to engage directly with some of the world's largest and most rapidly growing economies and traders, and to apply meaningful "competitive liberalization" pressures to others. Moreover, FTAs with larger countries of this type would attract substantial political interest in Congress (Baucus 2004) and the business community (US Chamber of Commerce 2003) and thus provide support for an open trade policy that is sorely needed. Agriculture would of course have to be fully included for these FTAs to achieve this purpose, and indeed for them to be acceptable to Congress.

A refocus of negotiating attention on larger countries should go well beyond East Asia (Schott 2004 and chapter 8 in this book). Many of the smaller agreements pursued in recent years have been of limited economic or even foreign policy benefit to the United States, and their pursuit diverts the limited trade policy resources of the US government from more important targets. In addition to Japan and/or Korea in East Asia, two other candidates offer the most promise.

The most intriguing possibility is India (Lawrence and Chadha, forthcoming 2004). A US FTA with India would link the world's two largest (by population) democratic states and offer major foreign policy benefits in a crucial and difficult part of the globe. It could also induce meaningful liberalization in a country that may be the world's next economic superpower, after China, but that remains highly protected (on investment as well as trade). Just as a US offer to negotiate free trade with Japan or Korea might be enough to induce those countries to finally overcome their agricultural protectionism, given its enormous payoff to them in foreign policy as well as economic terms, such an offer to India might enable a reform-minded government there (such as the current regime) to strengthen the economy on a much broader scale.

Another candidate would be Egypt (Galal and Lawrence, forthcoming 2005). FTAs with Jordan, Morocco, Bahrain, and possibly Oman and the United Arab Emirates in the near future are useful beginnings toward a trade agreement with the entire Middle East, which would be of great value in overall foreign policy and national security terms. Egypt, however, is both by far the largest country in the region and the center of influence on many far-reaching issues. It has also been pursuing economic reform, albeit fitfully, and encompasses a substantial number of reformers in key positions (in both government and business) who could use an FTA negotiation with the United States to promote such an agenda. Success in those efforts would have important spillover effects throughout the Middle East, in terms of both economic policies and the benefits from working closely with the United States.

US trade policy for the next four years should thus pursue a multiple agenda as at present but with significant modifications. Highest priority should continue to be attached to a successful conclusion of the Doha Round in the WTO because of its large economic payoff to the United States ($164 billion in the aggregate per Brown, Deardorff, and Stern 2003), its major foreign policy benefits (especially with the developing countries), and its huge systemic significance (by restoring confidence in a multilateral system that is more important than ever in a world of accelerating regionalism). But the United States should substantially amend its agenda for those talks to give priority to reducing agricultural subsidies and barriers to services trade as much as possible. Second priority should be given to the megaregional possibilities, especially the addition of an FTAAP as well as renewed efforts to complete the FTAA. Large changes should also be made in the determination of potential partners for bilateral FTAs: Japan and/or Korea should head the list as part of a new lineup that also includes India and Egypt.

To achieve any of these goals, the US administration and Congress in early 2005 will have to surmount several legislative hurdles:

- to extend Trade Promotion Authority through June 2007;
- to remain a member of the WTO;
- to replace the WTO-illegal Byrd Amendment, under which US firms that file successful antidumping petitions receive the duties collected as well as the protection they afford; and
- to approve the Central America and Bahrain FTAs.

Extension of TPA is imperative to permit pursuit of any of the new initiatives proposed in this section or indeed continuation of any of those now under way. Continued membership in the WTO is obviously also essential. Both would therefore seem to be routine exercises for Congress and that may indeed turn out to be the case. However, the shaky political support for further globalization in the country and the renewed escalation of the trade deficit, especially if economic growth and job creation were to slow, could jeopardize the ease of passage. It might then become necessary, as well as desirable substantively, to link improvements in the TAA program—as discussed in the next section—to the legislation to win its passage, the same formula that was utilized in Congress in 2002 to obtain TPA in the first place.

Passage of the pending FTAs and rectification of the remaining WTO finding against the United States are less critical but nevertheless quite important in terms of the administration's posture on trade in both international and domestic terms. The specifics of the Central America agreement, in particular, will set the framework for future FTAs for at least the next four years on such key issues as the links between trade and labor or the environment. Likewise, continued failure to bring US laws into compliance with WTO obligations will increasingly erode US credibility in the global trading system and its ability both to use the WTO to contest violations by other countries and to pursue its broader negotiating interests—in addition to the mounting economic costs of foreign retaliation that will undoubtedly start soon in the absence of credible congressional movement on the Byrd Amendment. The administration and Congress thus face a very large and quite urgent trade policy agenda.

Domestic Adjustment

None of these international economic initiatives will proceed very far, or rest on a sustainable basis of internal support, unless the United States substantially improves its domestic support system for those elements of US society that are adversely affected by globalization and may be hurt by further trade liberalization. Globalization and further liberalization carry very large benefits for the United States but, like any dynamic economic change, generate costs as well as benefits for those who experience their impact. There are losers as well as winners.

There are at least three reasons why policy must explicitly address those costs and losers. One is simple equity: When portions of society are harmed by policy choices taken in the general interest, there is a strong case for providing equitable compensation. The second is economic: It is wasteful for national resources to remain unemployed or underemployed when there are good reasons to believe that, with practical assistance, they can contribute more productively to society. The third is political: The domestic backlash against globalization has become so powerful, especially over the past decade, that it has severely limited US foreign economic policy throughout that period. The case for mounting an effective program of domestic assistance to workers, and perhaps entire communities, disadvantaged by globalization, is very strong.

The United States can clearly afford such a program. We have estimated that the benefit to date from internationalization of the US economy over the past half century totals about $1 trillion per year. Current governmental spending for Trade Adjustment Assistance amounts to less than $1 billion per year and would rise only to $1.5 billion to $2 billion annually under the reforms adopted in 2002. Despite the need to bring the federal budget deficit under control, it would be the height of fiscal foolishness to jeopardize the national payoff from globalization through an unwillingness to deal fairly and effectively with the downsides of the phenomenon. Total US government spending for worker assistance programs totals $8 billion to $23 billion, depending on what is counted. Even these numbers are quite small relative to some other advanced industrial countries, as shown in chapter 10. Moreover, these programs bear no direct relationship to dislocation linked to globalization and never seem to have had any mitigating impact on antiglobalization concerns.

Indeed, a case can be made for broadening the traditional program of *trade* adjustment assistance to address the problems of workers who are dislocated from their jobs for *any* reason. There is a strong intellectual argument for such a response: It is very difficult to disentangle globalization from other factors, especially technological change, in assessing the cause of any particular dislocation. Multiple causality is virtually always present, especially in today's economy where technological change and globalization interact in almost every industry and reinforce each other's impact. The worker anxiety that produces backlash against globalization does not of course make neat causality distinctions and, even if globalization plays a minor role in most cases as shown by virtually every study on the topic, will continue to resist further international opening unless the corrective domestic programs are substantially improved. A very practical reason for harmonizing TAA with the rest of the US worker dislocation programs (such as unemployment insurance) is that it is now an "orphan" in the Department of Labor and has never been implemented very vigorously; treating trade-impacted workers like all other dislocated workers in the country would increase the attention as well as benefits they receive.

The attitudes of American workers, and especially of their chief labor union organizations and political supporters, will be critical for the future evolution of these issues (Baldwin 2003). For the past decade or so, the AFL-CIO and its proponents in Congress (and sometimes the administration) have conditioned support for new trade agreements on their incorporating requirements for stronger labor standards in other (especially developing) countries. Such standards would clearly be desirable but, even if they could be widely agreed and implemented, would produce very small benefits for American workers in terms of job security and levels of pay (Elliott and Freeman 2003). Moreover, most of the low-income countries that are the target of such efforts are hostile, viewing labor standards as a thinly disguised cover for traditional protectionism, and the chances of negotiating major commitments in this area are negligible.

Hence it would seem far more sensible for US labor to put its political weight behind substantial improvements in domestic assistance programs for trade-impacted (and perhaps other) dislocated workers. The AFL-CIO endorsed the initial TAA concept in 1962, when President Kennedy launched it as the domestic component of his Trade Expansion Act that produced the Kennedy Round, and indeed maintained its traditional support for trade liberalization through that period. But organized labor subsequently soured on TAA, understandably in view of the parsimonious implementation of the legislation, and indeed came to label it as "burial insurance" for its members. The union movement then turned against almost all further trade liberalization, a stance that it maintains today. The administration should pursue a "grand bargain" with labor that would encompass a shift by the AFL-CIO from emphasizing international labor standards to TAA, along with its support for future trade agreements, in return for governmental adoption and effective implementation of a dramatically improved and broadened TAA program.

Despite the lack of enthusiasm of organized labor, TAA has maintained a surprising degree of political traction. Supporters of trade liberalization have insisted on expanding the program in virtually every important trade bill over the past 40 years since Kennedy instituted the idea. Senate Democrats insisted on a major expansion, which proved decisive when the bill returned to the House for final passage as well, when passing TPA in 2002. The reforms of 2002 in fact set the stage for the next, much more generous and far-reaching expansion of the program that is essential if a firm domestic foundation is to be restored for US trade policy and foreign economic policy more broadly.

When the public, including American workers, are asked whether they "favor free trade" if the US government has "programs to help workers who lose their jobs," the 50-50 split on the simple "yes/no" question becomes a comfortably favorable two-to-one majority (Scheve and Slaughter 2001, 96). The obvious requirement is to beef up the TAA program so that it will become, and be seen as, effective in addressing the needs of disadvantaged workers. Two sets of issues are involved: an adequate safety net that cushions the transitional impact of job dislocation, with income supports and continuation of key benefits such as health insurance and pension rights, and empowerment of workers to find new jobs with decent wages through basic education and training/retraining along with job search and relocation assistance—especially to achieve skill upgrading and better matching of skills to jobs. Both programs need to include all workers directly and indirectly dislocated due to changes in international trade and investment patterns, and to provide benefits that are both generous quantitatively and effective qualitatively in achieving the short-run and longer-run objectives of the policy.

Kletzer and Rosen suggest many of the specific components of such a program in chapter 10. The key additions to current legislation would include

- identifying "import-impacted" industries and automatically qualifying all workers in those industries rather than requiring groups of workers to apply individually;
- eligibility for services workers, especially in light of the growing role of services in total US trade and the present debate over outsourcing in that sector, since only manufacturing workers are now covered;
- restoration of eligibility for affected communities as well as individual groups of workers;
- eligibility for workers displaced by plant relocations to all countries rather than only countries with which the United States has FTAs;
- technical corrections in the new wage insurance and health care tax credit programs to enhance their utilization;
- substantial increases in funding, especially for the training component of the program;
- a human capital investment tax credit, to induce US companies to sharply expand their own training efforts (see chapter 9 and Mann 2003);
- extension of the wage insurance concept to cover other assets that are important to workers, notably their homes (Richardson, forthcoming); and especially

- further reforms in the basic K–12 education system in the United States, which is the fundamental underpinning for all American workers but which continues to underperform both its own potential and its counterparts in many other countries.

Until quite recently, the annual budget costs of TAA were running at only $200 million to $300 million per year. The amount has increased to an estimated $800 million for 2004 and will probably rise to $1.5 billion to $2 billion per year when the reforms of 2002 are fully implemented. Adoption of all the reforms proposed here would take the total to about $3 billion. All of these numbers are obviously very small, and readily affordable, compared with the $1 trillion per year that the US economy already gains from globalization and the potential future benefits of another $500 billion annually from moving to global free trade.

The biggest policy issue in this area, as noted, is whether to extend these programs to cover all dislocated workers whatever the cause of their difficulty. There is a strong case for such reform on moral, economic, and political grounds. The estimated annual budget cost would be $12 billion, only four times the cost of the trade-only program and an even tinier fraction of the benefits from permitting continuation of the dynamic changes that fuel the overall US economy. From the standpoint of foreign economic policy, on the other hand, de-linkage from the international agenda would probably reduce the political benefits of the program in achieving congressional support for future trade bills.

Whether the narrower or broader routes are taken, passage of the proposed reforms should rank very high on the agenda of the US government in the period ahead. One early possibility would be to link at least the more technical parts of the needed legislation to one or more of the trade bills that Congress will be addressing during the first half of 2005, as discussed earlier. More extensive changes could then be included in bills that will be needed to implement a successful Doha Round, in late 2007 or early 2008, especially if that legislation includes (as it should) a renewal of TPA for future negotiations. If a future administration and Congress were inclined to overhaul the totality of worker dislocation benefits, presumably including unemployment insurance, that would be a natural vehicle to incorporate such changes.

Energy Policy

Energy policy is another issue area, like correcting the current account imbalance and reaping further gains from trade liberalization while rebuilding domestic support, that requires a skillful blend of internal and international initiatives. Perhaps even more so than those topics, energy policy will require full integration with the rest of US foreign policy since a number of other countries, both importers and exporters of oil, will need to be intensively engaged at a time when some of them are at odds with the United States on a range of other topics.

The international focus for the US energy policy recommended here is twofold. First, the United States needs to reopen the NAFTA discussion with Canada and Mexico on their roles as producers of energy resources, as described by Schott in chapter 8. Both have large reserves of both crude oil and natural gas, which could substantially increase and diversify world (as well as US) supply if they were willing to permit the needed investments (including by foreign-based companies) to realize that potential. Delicate political sensitivities constrain such policies in both, and the United States may have to offer concessions on other issues, including immigration policy for Mexico (as discussed by Gordon Hanson in chapter 11), to win their agreement. The payoff is so important, however, particularly in terms of boosting output by large amounts in relatively secure locations, that the United States should be willing to do so.

Second, the United States needs to launch a major international effort, conducted in close cooperation with the other key (developed and developing) oil-importing countries, to counter OPEC's (and especially Saudi Arabia's) long-standing manipulation of the world oil market. The payoff from restoring global energy prices to levels that bear at least some resemblance to the underlying economics of the commodity would be enormous: probably on the order of $500 billion a year for the world, of which perhaps $150 billion to $200 billion annually would accrue to the United States. Any US administration or indeed the world as a whole could not envisage a more effective "jobs program."

Such an international effort will only be feasible, however, if the United States implements a series of new domestic energy measures. The chief reason is that the United States remains the dominant global consumer of energy, accounting for about 25 percent of world demand.[16] Serious efforts to put downward pressure on global energy prices for the longer run, and thus to strengthen the negotiating position of the demand side of the market, are thus possible only if the United States takes serious actions to restrain its appetite. In addition, the United States needs to rein in its gas-guzzling sport-utility vehicles (SUVs) and other excessive consumption of energy products if it is to obtain a sufficiently high moral ground to enable it to lead such an international effort.

The domestic component of the new energy policy should also be twofold, primarily addressing the consumption pattern but covering pro-

16. This number is sometimes compared with the US share of world population of about 5 percent, suggesting huge unfairness in the US consumption total. As indicated in the text, US consumption of energy does indeed need to be significantly reduced. But the United States also produces about 25 percent of global economic output, a much more relevant comparator that suggests that US energy demand is not disproportional in the global context.

duction as well. For the longer run, and especially if the United States can succeed in reducing the cartel's pricing power and thus cut world prices toward a market-related level of about $20 per barrel, the key step would be a significant gasoline tax (at about $1 per gallon, legislated promptly and phased in over several years during the next downward phase of the price cycle to both minimize economic disruption and maximize political feasibility). Such a tax could also provide a significant source of revenue to help reduce the budget deficits, or alternatively be rebated through cuts in other taxes to have a neutral effect on the overall economy while achieving the desired cut in energy usage (and environmental damage).

Even more immediate needs relate to the refinery and other infrastructure bottlenecks that have contributed substantially to the recent run-up in prices, as described in detail by Philip Verleger in chapter 7.[17] New environmental rules, with respect to the sulfur content of oil products, have precluded the usual resort to imports of refined products to meet the surge in demand and need to be relaxed at least temporarily. Competition policy decisions by the Federal Trade Commission have required merged oil firms to sell parts of their refining capacity to smaller companies, which have been unable to expand (or even maintain) output levels due to their weaker financial positions, and should not be repeated. The administration should stop buying for the Strategic Petroleum Reserve when the price is high and rising.

On the supply side, there is no risk of "running out of oil" (let alone carbon fuels more broadly, like coal) à la David Malthus or the Club of Rome or their more recent successors. But OPEC has substantially limited its output levels (as have non-OPEC countries, including Canada and Mexico). The needed private investment is deterred by high political risks in many producing areas, restrictive energy policies in many of those countries, the economic risks stemming from periodic price plunges, and the endemic instability of the current energy regime itself. Hence Congress must also break the logjam that has blocked new US production. A serious program to expand renewable energy sources is vital as well.

None of this can have much impact in the short run, however. The only available policy measure to bring prices down quickly would be large sales from the Strategic Petroleum Reserve (and similar governmental stocks in other importing countries). These reserves are now sufficiently large, at almost 700 million barrels in the United States and 1.4 billion barrels worldwide, to have a considerable impact on prices for quite a while.

17. These recent increases, beyond say $40 per barrel, *cannot* be blamed on OPEC except in the sense that the cartel's unwillingness to increase its capacity over time precluded its having the ability to expand output to a level that would have enabled it to moderate the price surge when it wanted to. Part of the latest surge relates to the insecurity of supply in Russia (highlighted by the Yukos case), Nigeria, and Venezuela as well as the Middle East, where it of course relates as well to broader political and security issues.

Verleger estimates in chapter 7 that an administration announcement of its willingness to exchange 100 million barrels of light crude for 100 million barrels of heavy crude over a 90-day period could reduce severe refining constraints and cut the world price by $10 to $20 per barrel. Sales from the reserves would also send a strong signal to producing countries that the oil-importing nations were serious about promoting regime changes in this issue area.[18]

The fundamental policy focus, however, should be on restoring a semblance of market-related pricing to world oil. It is too much to hope that true market forces could replace the current producer control. The "theory of the second best" concludes that a significant market distortion should be countered by an offsetting market distortion whenever feasible, however, and oligopolistic selling should be countered by oligopsonistic buying in this case. The oil-importing countries, rich and poor, need to combine to offset the market power of the oil-exporting countries and push global prices toward levels that would be likely to ensue in the absence of their market manipulation. The first step in any new US effort in this area should thus be to seek support from the other major importing countries, including key developing countries such as China and India as well as the members of the International Energy Agency (IEA) in the Organization for Economic Cooperation and Development (OECD).

The results of such a successful strategy would be dramatic. Even the highest-cost production in present locales is no more than $15 to $20 per barrel. Marginal costs in the Gulf remain below $5 per barrel. Some studies suggest that OPEC's market power has kept world prices at levels that averaged about double their underlying value for much of the last 30 years. An equitable equilibrium price might be on the order of $25 per barrel, averaged over time and fluctuating within a fairly wide range of $22 to $28 per barrel as traditionally espoused by OPEC itself, or even wider, to allow for cyclical, seasonal, and other variations in market conditions.

All countries, producers as well as consumers, would also reap substantial benefits from reducing the enormous instability in world oil prices that derives from the current regime. Just as there is no mechanism to check sharp upward spikes, as occurred in 2004, there is no mechanism to avoid severe downward spikes as in 1986 and 1998. Abrupt price rises in the past have triggered the three largest postwar recessions. But dramatic price declines are also poisonous for the world economy, deterring investment as well as retarding the development of large low-income countries (such as Iraq, Mexico, Nigeria, Russia, and Venezuela) as well as small higher-income countries (including Saudi Arabia, Kuwait, and others in the Gulf).

18. The president of OPEC publicly called for release of crude oil from the US strategic reserve on October 27, 2004, and claimed, "I am always asking them to do that" (*Platts Global Alert*, August 31, 2004).

The mechanics of a new regime, to stabilize prices around a market-related level, are laid out in chapter 7 and are relatively simple. Exporting and importing countries would agree on the limits of the price range, and on the size and decision rules for the buffer stock (which could, for the first time, provide useful guidance for US government use of its strategic reserve rather than the totally ad hoc process that has applied to date). To start the latter, the importing countries would pledge some or all of their current strategic reserves. Those reserves should, over time, be roughly tripled from current levels (through purchases when the price dips toward the floor of the range) to provide an adequate stock to maintain the ceiling price. The existence of such a regime would clearly have precluded the sharp run-up in prices in 2004.[19]

The tactics for pursuing the new producer-consumer agreement are fairly straightforward as well. The United States would probably want to discuss it informally at the outset with Saudi Arabia. It would be essential to multilateralize the formal talks from their beginning, though it would not be a simple IEA-OPEC negotiation because both groups would presumably be joined by nonmembers that are important participants in the market (importers such as China and India and producers such as Mexico, Norway, and Russia).

The presence of mutual gains to producers and consumers, from the resulting stronger world economy and more stable oil market, offer reasonable prospects for a successful negotiation. Some producers might object to the short-term loss of income and market control that they would experience, so the United States and other large importers would have to convince them of their serious intent both to substantially alter the demand side of the market by cutting their own consumption and to reduce the world price by sales from their national reserves. In addition, the importers would have to be flexible in working out the level of the price band. They could also offer trade concessions, particularly on energy-related products, to enable the producers to diversify their economies into downstream industries and thereby achieve more sustainable and beneficial development. The importers would have to exhibit firm resolve in seeking an agreement, however, including the use of broader political leverage to induce cooperation.

19. Most previous efforts to construct and maintain international commodity agreements have failed to sustain their targeted price ranges and ultimately collapsed. Most of them, like the International Coffee Agreement and components of UNCTAD's Integrated Commodity Program of the 1970s, were explicitly adopted to transfer resources from consumer to producer countries and were inherently uneconomic. The principles required to implement such agreements are well understood, however, and some, like the International Tin Agreement, did work for many years. However, no agreement has ever been pursued for a product anywhere near the importance of oil nor for purposes of global economic stabilization. If major consuming and producing countries pursued the idea, a much more serious effort to make it work would clearly have to be undertaken.

Such a two-stage negotiation, initially to achieve agreement on a negotiating stance among the importers and then between them and the exporters, would be complex and take time. Its success, like that of other major foreign economic policy initiatives proposed in this book, would depend heavily on the backing provided by changes in domestic policies. It would inevitably interact with other foreign policy issues, particularly in light of the present delicate situation in the Middle East, and other economic issues such as the Doha trade negotiations. However, the stakes for the United States and other oil-importing countries are extremely high, and a successful negotiation on oil might even help restore effective working relationships among the key countries. The energy issue should rank very high on the agenda of foreign economic policy, indeed overall US policy, in the coming period.

Development Policy

The fifth focus of US foreign economic policy must be the developing nations, particularly the poorest people in those countries. Half the world's population continues to "live" on less than $2 per day and about 1 billion people exist on less than $1 per day. The consequences of this poverty are overwhelming in moral and humanitarian terms. But lack of development also exacts a serious cost on the world economy and fosters major security problems by producing "failed states" (or at least areas) that become breeding grounds for global terrorism as well as regional instability. Hence both the more advanced and the poorest developing countries deserve priority attention by the United States.

The development strategies of the past 25 years have recorded substantial successes, reducing the number of people in poverty by over 1 billion and extending to most parts of the world (Bhalla 2002). Inequality among individuals across the world, which had been increasing for almost two centuries, declined over the last 20 to 30 years. The main exception to these positive results has been sub-Saharan Africa where, despite a few individual success stories, poverty has risen by about 250 million since 1960 and per capita incomes have fallen over recent decades. In addition, large numbers of people remain poor in many countries where overall progress has been good, including such large nations as Bangladesh, Brazil, China, India, Indonesia, Mexico, Nigeria, and Pakistan.

US development policy should continue its two-part focus: promoting growth in all developing countries, without which lasting poverty reduction is impossible, and targeting efforts to curb poverty directly. In light of the enormity of the task, in intellectual as well as resource terms, US efforts in this policy area should be imbedded as extensively as possible in a multilateral context of cooperation with other donors. Official foreign assistance programs should be maintained and increased in some cases.

Private capital investment should be fostered, especially in the more advanced developing countries but in the poorest as well (Commission on Capital Flows to Africa 2003).

Trade policy, however, should become the chief tool of US and global development policy. It has now been convincingly demonstrated that a move to global free trade would represent the most powerful available instrument for spurring growth in the poorer countries and reducing poverty directly. Cline and Williamson show in chapter 13 that each additional percentage point in export growth has been associated with an additional 0.15 percentage point in a country's economic growth. Each 1 percent rise in the ratio of a country's trade to its GDP has been associated with a rise of 0.5 percent in long-term output per capita. Paul Krugman has concluded "that every successful case of economic development this past century . . . has taken place via globalization . . . by producing for the world market rather than trying for self-sufficiency" (Krugman 2003).

Elimination of all trade barriers by both the developing countries themselves and the richer nations, with each accounting for about half the benefits, could add $200 billion per year to incomes in the former. It could lift 500 million people earning less than $2 per day out of poverty, cutting the world poverty level by about 25 percent over 15 years (Cline 2004). Complete trade liberalization by the United States and other advanced countries could transfer about twice as much benefit to the poor countries as all current foreign assistance programs, which total about $50 billion per year.

The best development policy for the United States, and the rich countries as a group, is thus the trade policy already recommended: the maximum possible elimination of barriers to international exchange as quickly as possible. Reduction in barriers toward developing countries in fact maximizes the benefits of trade for the United States itself in light of the greater complementarity than in its trade with other high-income nations. At the same time, larger adjustment problems may be triggered. Hence increased domestic adjustment assistance for US workers dislocated by such trade should be viewed as part of the United States' "foreign aid" contribution, with higher payoff than most other expenditures for that purpose, as well as support for the very large gains that result for the overall US economy.

The second big issue concerning US development policy is whether the amount of financial assistance to the poor countries should be increased substantially. Such increases would be needed to have any hope of reaching the Millennium Development Goals for 2015 that the world's leaders adopted in 2000. The United Kingdom has proposed a new financing facility to double the flow of aid over the next few years for that purpose. For its part, the United States remains simultaneously the largest national donor of aid in absolute terms (about $10 billion) and the least generous of all donor countries as a share of its GDP (about 0.2 percent).

Two misconceptions have undermined US aid policy for many years. One is that "aid does not work" in promoting development and thus is wasted. Recent analysis at the Center for Global Development refutes this view by showing that the type of aid that supports short-run growth, like infrastructure projects and budget support, as opposed to aid for humanitarian purposes and long-term structural reforms (such as education), has very strong positive growth effects (Clemens, Radelet, and Bhavnani 2004). The second misconception is that the United States spends far more on aid than is the case in reality; polls show that the public thinks that 15–20 percent of the budget is allocated for these purposes, rather than the true figure of about 1 percent, and that the US government ought to be spending ten times as much as it does (which would make it the most generous donor by far).

The Bush administration pledged a 50 percent boost in annual US aid in 2002 and has sought to maximize the development benefits from that increase by creating the Millennium Challenge Account, which is to choose recipient countries strictly on the soundness of their policies and institutions as presented by the countries themselves (Radelet 2003). The United States should stick to this course, rigorously assessing the use of its aid but increasing the amounts thereof as substantially as can be justified. It should also steadily expand its contributions to the other demonstrably effective aid institution, the International Development Association of the World Bank Group, which lends (at very generous terms) only to the poorest countries. Several other specific ideas, including additional debt relief for the poorest countries, are presented in chapter 13.

The final element of US policy toward developing countries in the coming years should be institutional: expanding their roles in the multilateral economic organizations, both to enhance the effectiveness of those institutions and to increase their political legitimacy. Most importantly, the existing G-20 of finance ministers and central bank governors—which includes eleven of the most systemically significant emerging-market economies[20]—should gradually but steadily replace the G-7 of rich industrial democracies, including eventually at the level of heads of state and government, as the chief steering committee for the world economy. The failure of three of the G-7's recent major initiatives reveals its inability to fulfill that function by itself in the modern world:

20. The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States. Another member is the European Union, represented by the council presidency and the president of the European Central Bank. The managing director of the IMF and the president of the World Bank, plus the chairpersons of the IMF's International Monetary and Financial Committee and the IMF/World Bank Development Committee, also participate in the talks as ex-officio members.

- realignment of exchange rates to correct the global current account imbalances in an orderly manner, without participation by China or other Asian countries (such as Korea and India) whose currencies must play a central role in any such adjustment;
- resolution of the Argentine debt crisis, with its profound effect on the IMF and global capital markets, without participation by Argentina itself or other debtor countries (such as Brazil and Mexico) with huge stakes in the outcome; and
- reduction of world oil prices without participation by Saudi Arabia, Russia, or any of the other major producing nations.

In addition, the United States needs to accelerate its long-standing effort to realign the "chairs and shares" in the international economic institutions to reflect the major shifts in economic importance of the different countries and groups thereof (as analyzed by Boyer and Truman in chapter 5). The chief need is for a sharp drop in European representation, to reflect their move to a single economy and currency and thus the internalization (à la US states) of much of their former "international" activity, and the consequent freeing up of additional space for China and other rapidly developing countries. In the IMF, for example, the large emerging-market economies (LEMs) should pick up 10 to 15 percent of the total quota and as many as five seats on the executive board.

The legitimacy of the global economic institutions, in particular the role of developing countries in their formal voting arrangements and management systems, has justifiably become a central issue in the contemporary debate over globalization. The United States has a major interest in preserving, indeed strengthening, the role of those institutions. It should use its considerable influence to push the institutions in the proposed directions, both at the formal level of "chairs and shares" and at the informal but powerful level of steering committees like the G-20. Initiatives in this area, conducted with skill and persistence, could turn out to be among the most significant elements of US cooperation with the rapidly emerging countries that will be increasingly central to the global economy (and perhaps global politics) in the coming years and beyond.

US Foreign Economic Diplomacy

The fundamental changes in the structure of global economic power relationships described early in this chapter, and the proposed agenda for US foreign economic policy in the coming years, imply a significant alteration in the conduct of that policy. Major shifts are called for in the allocation of US attention to different countries and groups thereof, and therefore in the institutional underpinnings of US strategy.

For the past 40 years, since the onset of the modern world economy in the early 1960s, the United States has centered its international economic attention on the other large industrialized countries. Europe has been the chief focus throughout that period. Japan forced its way into the core group in the early 1970s. The institutional manifestations were the various "Gs": the G-10, created in the early 1960s to shore up the dollar-based monetary system of the day; the G-5, born in the wake of the first oil shock and onset of global stagflation in the mid-1970s; and its evolution, mainly for political reasons, into the G-7 (for the summits shortly after they were created in 1975 but not among finance ministers for another decade). Since the creation of the Common Market, and its decision to immediately centralize trade policy in the European Commission, the United States and the European Union have maintained a "G-2" relationship in an effort to steer the global trading system.

To be sure, individual developing countries have received considerable attention from time to time. Saudi Arabia and other key OPEC countries became centerpieces during the oil shocks of the 1970s and periodically thereafter. The newly industrialized economies, especially Korea and Taiwan, drew much notice when they burst into competitive prominence in the 1980s. Mexico moved into the spotlight with the creation of NAFTA in the early 1990s. China drew growing notice in the late 1990s and early 21st century, especially as it became a locomotive for the world economy and negotiated entry to the WTO. A number of developing countries played central roles in the succession of debt crises in the 1980s and currency crises in the 1990s.

A central theme of this volume, as developed in detail in chapter 5, is that the United States now needs to systematically shift an important part of its foreign economic policy focus to the large emerging-market economies (LEMs). Their markets offer the most attractive targets in the current and foreseeable rounds of international trade negotiations. Their full cooperation will be essential to reduce the adverse impact of the present energy regime on the world economy. Their buildup of foreign exchange reserves (along with that of Japan) has thwarted much of the needed adjustment of the threatening US current account deficit. Some of them remain potentially important sources of global financial disruption and even renewed crises. Their desires for larger roles in the global economic institutions are thus both justified and constructive, and the United States will need to work with them to fulfill those aspirations.

Overall foreign policy concerns suggest a similar shift in emphasis. World population is becoming more and more concentrated in developing countries. So are the sources of security threats to the United States, whether in the Middle East or in Muslim Asia (or in failed states on all continents). China alone is rapidly becoming the dominant player in East Asia, the most dynamic (and, in some senses, most unstable) part of the world. Russia, another emerging-market economy with particular importance on energy issues, will also remain a top security concern for the indefinite future because of its nuclear capabilities.

The United States should thus work with both its traditional allies and the new powers to amend the international decision-making structure. The G-20 should gradually but steadily supplant the G-7 at the center of the system. The emerging economies should be granted a significant increase in their "chairs and shares" in the key international institutions. The United States should thoroughly revamp its internal decision-making machinery to recognize, and respond to, this new power alignment (as proposed in chapter 5).

This new US strategy would focus on creating and supporting institutions in which industrialized and developing countries can work together on issues of common interest. There will also be opportunities for regional manifestations of this approach. US cooperation with Mexico in NAFTA should be sharply expanded. So should US collaboration with Brazil and other key Latin American countries in an FTAA.

A particular opportunity, and possible imperative, lies in APEC. The accelerating process of regional economic cooperation in East Asia, in both the financial sphere with the Chiang Mai Initiative and active negotiations for a large number of preferential trade arrangements, raises again the specter of "drawing a line down the middle of the Pacific" that sparked US interest in APEC in the early 1990s in the first place (Funabashi 1995). The United States may now find it essential to refocus on building transpacific institutional ties, along the lines of the transatlantic ties that have paid off so handsomely since the Second World War, to channel Asia-only arrangements that could do serious damage to US economic and even security interests in directions that would be supportive, rather than destructive, of US interests and the global system (see C. Fred Bergsten, "East Asian Regionalism," *The Economist*, July 15, 2000; and Bergsten 2001). One approach, which could also play a major role in galvanizing further trade liberalization at the global level, would be pursuit of a Free Trade Area of the Asia Pacific (FTAAP) as proposed by the APEC Business Advisory Council in 2004 (Bergsten 2004b). In this context, the need for new US emphasis on both the LEMs and East Asia comes together in a compelling manner.

In addition, the United States will on occasion need to work much more systematically with groups limited to developing countries themselves. A current case in point is the "G-22" that blocked agreement on the Doha round at Cancún in September 2003—correctly, because of the grossly inadequate offer by the United States and the European Union on liberalization of agricultural trade. Future instances may include an Asian Monetary Fund, evolving from the Chiang Mai Initiative of bilateral swap agreements among the East Asians, and any East Asian Free Trade Area that might evolve. The United States must devote much more time, resources, and priority to understanding and seeking cooperation with such groups—which are likely to expand at a rapid pace over the coming years as more and more developing countries realize both the commonality (albeit not uniformity) of their interests and their potential for successfully pursuing those interests when they mobilize effectively.

At the same time, the United States obviously cannot forget its traditional allies and their continuing major role in the world economy. The expanded European Union, despite its disappointing growth in recent years, remains the only other economic superpower and possible global rival to the United States. Japan, for all its recent travails, is still by far the world's largest surplus and creditor country. The United States would downgrade relations with these historic partners only at its peril.

However, the United States needs to refine its relationships with these countries to pursue its interests more effectively, including to take account of the new global context where the LEMs are becoming so important. In essence, it needs to create and maintain a series of special relationships (or "G-2" arrangements) in which it teams up with the other key player in each issue area to both provide the needed global leadership and to manage the central bilateral relationship in that issue area more systematically and effectively.

At least four such arrangements can be envisaged. The first, and broadest, would be with the European Union (C. Fred Bergsten and Caio Koch-Weser, "Restoring the Transatlantic Alliance," *Financial Times,* October 6, 2003). In addition to the "trade G-2," which has existed for many years, there are several issues on which only these two largest and most sophisticated players can take an effective lead: competition policy, where extensive cooperation already exists but has broken down in a number of high-profile cases; international capital markets (Draghi and Pozen 2004); international currency markets, perhaps to deal with the euro-dollar exchange rate during the coming adjustment period as well as systemic questions when and if the euro does begin to move up alongside the dollar; and possibly development assistance, investment, migration, and several others (Bergsten and Koch-Weser 2004).

Europe's lack of dynamic growth, however, means that it has now ceded its position as the world's second growth locomotive (along with the United States) to China. Indeed, in 2000–03 China accounted for over 20 percent of the expansion in world trade and has become the chief driver of prices in many global commodity markets—which means inter alia that it will be an essential player in any attempt to stabilize the international energy regime. A hard or even prolonged landing in China over the next few years, as a result, could have a major impact on the world economy. Moreover, as noted throughout this volume, China's exchange rate and related policies are playing a central role in the adjustment (or lack thereof) in the world's major international economic imbalances centered on the US current account deficit. China's trade policies, especially implementation of its WTO commitments, and other countries' behavior toward it in the WTO (as the Multi-Fiber Arrangement [MFA] expires, for example), will go far to determine the success of the global trading system. Hence the United States and China need to develop an informal "G-2" relationship to address all these issues together on a systematic and cooperative basis.

A third "special relationship" needs to be maintained with Saudi Arabia to address energy policy. It was stressed earlier that a new multilateral regime, bringing together the main producing and consuming countries, is essential to reduce the enormous instabilities in the global energy market and to bring prices much closer to levels that would be generated by market forces. Within such a broader grouping, however, the leaders of the two camps would have to steer the process. The currently tense state of affairs in the Middle East, and the hostilities toward the United States throughout the Arab world due to Iraq and the Palestinian question, will undoubtedly make it harder to construct such a relationship. At the same time, development of such ties might help ameliorate overall relations and carry some spillover benefits for the broader issues.

The United States will also need to strengthen its existing "G-2" relationship with Japan to protect its economic (and broader strategic) interests in East Asia. In part, the goal here is simply to maintain a counterweight against the rise of China in classic balance-of-power terms. In the context of growing East Asian tendencies toward regional economic cooperation, however, Japan's stance will be particularly critical for the United States. China will increasingly be the leader of these regional initiatives but none will proceed very far, particularly in the crucial areas of finance and trade, without active cooperation by Japan—still by far the region's richest country, source of capital and top companies, and technological leader. Japan thus has considerable leverage to shape the nature of East Asian regionalism in an outward-looking manner that will be compatible with the interests of the United States, defined in terms of both its narrow commercial interests and its broader systemic focus on continued credibility of the IMF, WTO, and other multilateral institutions (Bergsten, Ito, and Noland 2001).

Japan strayed sharply from such a course with its initial proposal for an Asian Monetary Fund in 1997 that carried an overtly anti-Washington orientation. Given the progress of East Asian cooperation since that time, the United States now might not be able to torpedo such an idea nearly so easily. Hence Japan's recent sensitivity to American concerns, in shaping the substance and rhetoric of the Chiang Mai Initiative on finance (Henning 2002) and other pan-Asian steps, has been extremely important to the United States. Japan's cooperation with the United States in both Afghanistan and Iraq has of course added a further security dimension to the ties between the two countries.

The best way to pursue this particular "G-2" would be through negotiation of either an FTAAP, for which Japan–United States agreement would be a crucial pillar, or a bilateral Japan–United States FTA. In addition to the trade policy benefits enumerated earlier, such a major institutional step would provide the framework for broader Japan–United States cooperation on a wide range of international economic topics. It would thus serve a number of important US objectives and should be part of any new agenda for US foreign economic policy.

Whatever the outcome of these efforts to create new steering committees and avenues to pursue US interests, the United States will maintain a strong stake in the effective functioning of the existing multilateral economic institutions—especially the IMF, World Bank, and WTO. Indeed, one of the central goals of the proposed new subgroups, whether the series of new "G-2s" or the encouragement of the G-20 to steadily supplant the ineffective G-7, is to strengthen the performance of these formal organizations by providing them with more effective leadership. Moreover, new multilateral institutions may be needed to manage the proposed stabilization arrangement for world oil prices and to coordinate new global environmental initiatives (Esty 1994). Such organizations will be essential for the successful pursuit of US political and security as well as economic interests around the world.

Conclusions

The agenda for US foreign economic policy over the next few years is very full. A number of issues, especially the exploding current account deficit and energy prices, need to be addressed immediately with decisive new strategies. Trade policy and development policy must be recalibrated modestly and pursued consistently. Expanded domestic policies will be essential to counter the backlash against globalization, consolidating the huge gains that it has brought the United States and enabling it to pursue the very large additional benefits that are available by restoring a firm political foundation on which an outward-oriented international stance can be sustained. All this must be done within a rapidly evolving global economic framework with the expanded European Union moving up alongside the United States as the world's largest economy and China, with the rest of Asia not far behind, becoming an economic superpower as well.

The president and Congress will have to work closely together to initiate key parts of this process soon after taking office in early 2005. They will need to launch a credible and effective program to reduce the budget deficit substantially over the next few years, to begin the process of reducing the current account deficit as well as to avoid higher interest rates and crowding out of private investment. They should adopt a series of new energy policies, some of which (notably a new gasoline tax of perhaps $1 per gallon) could also be part of the budget program while others (especially to increase domestic energy production, including of renewables as well as of traditional carbon fuels) would be added separately. A series of trade bills must be passed in early 2005, particularly to renew TPA so that the president can maintain an active and progressive program of trade negotiations. Special priority must be attached to strengthening the safety nets for workers dislocated by trade flows and other ramifications of globalization, and even more so to expanding and improving education and training programs to enable more Americans to take advantage of the opportunities generated by international trade and investment, hopefully with the full support of organized labor. Full funding for development initiatives must be pursued.

With this domestic foundation in place, the administration should be able to pursue the ambitious international agenda outlined in this chapter and detailed in subsequent chapters. It will need to work closely with its G-7 colleagues, and especially with China and other key Asian countries, to maintain the gradual and orderly downward adjustment of the exchange rate of the dollar, which began in 2002–03 and resumed in late 2004, until it has gone far enough to restore a sustainable US current account position. It will need to promptly approach the other major oil-importing countries, both via the IEA and bilaterally in the case of key developing countries (notably China and India), to initiate any cooperative program of sales from their strategic reserves that is needed to counter high world oil prices in the short run and to prepare for a joint approach to the oil-exporting countries in pursuit of a new international price stabilization agreement for the longer run. The United States will probably want to simultaneously approach Saudi Arabia, and perhaps some of the other main oil exporters, to pave the way for the consumer-producer negotiations that will be needed to effect such a new energy regime.

Another element of the proposed new international energy policy is the development of a North American energy strategy that promotes greater investment in energy production and distribution channels in all three NAFTA countries. To get this, the United States may have to offer "concessions" on migration and other border issues. These initiatives can, however, be structured in ways that will also advance US interests and essentially convert the existing trade pact into a much broader security agreement.

A number of additional trade policy initiatives should be pursued once TPA has been extended to 2007, confirming that date as the target for completing negotiations for both the Doha Round in the WTO and an FTAA. The United States should alter its priorities in the Doha Round to an important degree, placing even greater emphasis on maximum reduction of agricultural subsidies (including to help reduce the US budget deficit) and extensive liberalization of services markets (to help reduce the US current account deficit over time without additional dollar depreciation). The United States should strongly support a new initiative in APEC to pursue an FTAAP, in part to deploy the competitive liberalization strategy aggressively in promoting support for a meaningful Doha Round outcome with the European Union and other non-APEC countries. A series of new bilateral FTAs, with larger countries such as Japan and/or Korea as well as India and Egypt, should be pursued as well. All these trade initiatives should be viewed as an integral part of US development policy, in light of the substantial gains they can generate for poor countries and especially for poor people within them, as well as for their benefits for the United States itself and for the world economy.

The cumulative result of these several initiatives, if successful, would be threefold. First, there would be sizable additional benefits for the US economy: perhaps $250 billion or so per year from reducing and stabilizing energy prices, another $150 billion to $200 billion annually over the longer run from a successful Doha Round once its results were fully phased in, additional modest gains from new FTAs, and sharp reduction of the risk of a hard landing if the current account deficit were permitted to spiral upward and the dollar to crash.

Second, the world economy as a whole would derive substantial benefits. Other countries would gain even more than the United States from overcoming the global imbalances in a noncrisis manner, by avoiding both a hard landing and the continued escalation of US protectionism that would otherwise be spurred by dollar overvaluation. The rest of the world would gain at least twice as much as the United States, perhaps as much as half a trillion dollars per year, from restoration of market-related energy prices. Developing countries would derive particular benefits from continued reductions in (their own and others') trade barriers. More subtly, but perhaps even more importantly, the world as a whole would gain enormously from US adoption of new domestic programs that would decisively roll back the constant threats of protectionism and other internal reactions against globalization.

Third, vigorous pursuit of such a foreign economic policy would go far to restore US global leadership in overall foreign policy as well as purely economic terms. It should thus be extremely welcome around the world at this time. Indeed, it is quite possible that new economic initiatives of this type, encompassing important new negotiations with countries and regions ranging from Europe through the Middle East to East Asia, could play an important catalytic role in strengthening overall relationships that have been frayed in recent years both by the Iraq war and by more widely perceived US deviations from international norms and prior agreements.

There is thus a compelling case for the early adoption of new foreign economic policy initiatives by the United States. Some, as with the dollar and energy, are urgently needed to head off severe risks for both the US and world economies as well as to address longer-term structural problems. Others, as on trade and its domestic ramifications, turn more on potential long-run and systemic benefits. All bear directly on major economic and foreign policy interests of the United States.

Both the proposed currency and energy initiatives would seek in large part to counter market manipulation by other countries. China and others in Asia have been intervening massively in the currency markets to block the needed reduction of the US current account deficit. Saudi Arabia and other oil producers have been restricting output and doing whatever else they can to raise the world oil price, often with considerable success, for over three decades. Some observers will object to proposals for new governmental measures, carried out and led by the United States, to counter-intervene in these same markets. But it is folly to stand by idly when other powerful players actively seek to distort markets, especially in ways that are detrimental to US interests in very substantial ways. The only test should be whether practical methods can be found to effectively counter those distortions and thus to restore outcomes that would conform much more closely to those that would result from market forces.

Partly because of this problem of market manipulation, it may be necessary for the United States to "get tough" to achieve some of the goals set out here. The administration may have to impose new trade barriers against countries that refuse to let their currencies adjust against the dollar, as the Nixon administration did with its import surcharge against developed countries for three months in 1971, or at least threaten to do so. It may have to intervene in the currency markets to counter directly the unwillingness of some countries to let their exchange rates appreciate. It may have to provide preferential treatment for imports from oil-producing countries that agree to participate in constructive price stabilization arrangements and discriminate against those that do not. It would obviously be far preferable to work out all these problems through cooperative means but it is not clear that such methods will succeed on all fronts.

The rest of this book will analyze in depth the key issues facing US foreign economic policy in the early part of the 21st century, assess the impact of each on both the US and world economies (and, in some cases, on broader foreign policy concerns as well), and present proposals for addressing them. We hope they will provide a solid foundation for the adoption of a new international economic strategy for the United States for the next decade.

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