



The World at a Turning Point

Professor Lester C. Thurow

**Wednesday,
July 17, 1985**

THE WORLD AT A TURNING POINT

From 1950 to 1984 exports from the industrial countries rose from \$ 36 to \$ 1310 billion. The annual increase in exports, 11.1 per cent, far exceeded the annual increase in the GNPs of these same industrial countries. Even in countries such as the United States that have not traditionally been heavily dependent on international trade, exports rose from 5 per cent of the GNP in 1950 to 13 per cent of the GNP in 1981 before falling back to 10 per cent of the GNP in 1984. With exports rising at a fraction of GNP, the industrial world was effectively becoming more and more economically integrated.

Will the post World War II trend toward economic integration continue? I believe not. The world economy is in fact at a turning point and the next 10 years is apt to witness some retrogression in economic integration.

The reasons for this belief are simple. First the current degree of economic integration has outrun the world's political willingness to collectively manage it. To make today's world economy work the major industrial countries would have to be willing to coordinate their monetary and fiscal policies and to control movements in exchange rates between major currencies. While both are within the realm of economic feasibility, the industrial countries are politically willing and able to do neither. In the end the national instabilities produced by this collective management failure will force countries to reduce their involvement in the world economy.

Second, within the economies of each of the major industrial actors—Japan, Europe, and the United States—there are unsolved domestic economic problems that can most easily be solved by isolating themselves from world trade. America faces a productivity problem. To be competitive on world markets at current wage rates it must accelerate its rate of productivity growth. If it cannot find a solution for its productivity problem, it is likely to withdraw from international competition and retreat into protection. Europe faces an employment problem. If it cannot begin to generate jobs in the framework of an open economy, it must retreat to a closed economy where it can generate jobs. Japan faces a trade imbalance problem. Japan relies on exports to lead its domestic growth yet given the structure of the Japanese economy the rate at which exports must grow to maintain prosperity far exceeds the rate at which imports will grow without major structural changes within Japan. If it cannot make imports grow more rapidly, the rest of the world will gradually exclude Japan from their domestic markets and force Japan to reduce its dependency on world trade. While each of these problems has an economically feasible local solution, the local solutions are politically difficult and unlikely to be put in place. As a result the need to solve local problems will force a partial dismantling of the current world economy.

THE AMERICAN PROBLEM

America faces a problem that is simply put. The huge technological edge enjoyed by Americans in the 1950s and 1960s has disappeared. Whereas America once had effortless economic superiority, it is now faced with competitors who have matched its economic achievements and may be in the process of moving ahead of it. What is worse, at precisely the moment when America's effortless superiority has vanished the American economy has been absorbed into a world economy. For most goods there is now a world market, not just an American market. Competition is worldwide, not just American. As a result America faces the difficult task of learning how to compete in a new

world economy just at the point when America's relative economic strength is weaker than it has been at any time since World War II.

Productivity—output per hour of work—is the best general measure of a country's ability to generate a high and rising standard of living for each of its citizens. It is also a measure of America's ability to compete as a high-wage country on world markets. To fall behind on productivity is to fall behind on introducing the new products and the new production technologies that give American products an edge in world markets. If American productivity is not equal to that of the best, America can compete only on the basis of wages that are lower than those of the world's productivity leaders. While it is certainly possible to compete on world markets based on low relative wage rates (most of the world does so), I know of no American who wants to do so. Americans want to compete from a position of equality or superiority—not from one of inferiority.

Manufacturing is probably the best place to look at America's productivity performance vis-a-vis the rest of the world. All manufactured goods are potentially tradeable (they account for 70 per cent of America's exports) and essentially homogeneous from country to country. The problems that make precise productivity measurements difficult in government or service activities do not exist in manufacturing.

The data in Table (i) (next page) show the level of manufacturing productivity for seven leading industrial countries in 1983. As the data show, the United States has already been surpassed by Germany and France. Since we know that most of the small northern European countries (Switzerland, Sweden, Norway, Holland, Austria) have productivity rates similar to those of Germany and France, all of northern Europe with the exception of Ireland and the United Kingdom may now have moved slightly ahead of the United States in manufacturing productivity. And Italy and Japan are not far behind.

Table (1)

MANUFACTURING PRODUCTIVITY 1983

Country	Output Per Hour of work (1983 prices)	Rate of Growth 1977-83
United States	\$ 18.21	1.2 %
Germany	20.22	2.5
France	19.80	3.5
Italy	17.72	3.1
Japan	17.61	3.9
Canada	17.03	0.9
United Kingdom	11.34	3.3

While America's previous position of economic superiority has clearly ended, its current position is probably not one of inferiority. Germany, the most advanced country, has a 10 per cent edge according to the data. But given the vagaries inherent in any such measurements, a 10 per cent edge is not an unambiguous lead. The rest of the world has caught up but is not ahead. America's competitive position is one of "an equal among equals".

There is a real danger, however, that America is falling from parity to inferiority if one examines comparative rates of growth of productivity. American productivity growth rates have been below those of Europe and Japan ever since World War II, but more importantly they are still below those of Europe and Japan even though these countries have now essentially caught up. In the six years from 1977 to 1983 productivity grew at the rate of 1.2 per cent per year in American manufacturing; one-half Germany's growth rate (2.5 per cent), one-third France's rate (3.5 per cent), and essentially one-fourth the Japanese (3.9 per cent) rate. If such differences in growth rates continue to exist for very long, substantial inferiority cannot be far away.

Nor can one argue that manufacturing is somehow misleading relative to other areas of the American economy. Manufacturing is in fact a relatively bright spot in the American productivity picture, growing three times as fast as productivity in all of private industry from 1977 to 1982. Since World War II in the entire private economy productivity growth has fallen from 3.3 per cent (1947-65) to 2.4 per cent (1965-72), to 1.6 percent (1972-77), and to 1.0 percent (1977-84). And from the second quarter of 1984 through the first quarter of 1985 there was no productivity growth in the United States.

To outsiders there are simple solutions for America's productivity problems.

No one can build a high-quality economy out of low-quality inputs just as no one can build a high-quality product out of low-quality components. Yet whenever the basic inputs—capital, labour management, labour-management relations—going into the American economy are compared with those of the competition they just don't seem to measure up.

In America's large cities eight per cent of those entering the workforce test out as functionally illiterate (*i.e.*, they cannot read at a fifth grade level). The average American 17 year old knows half as much mathematics as the average Japanese 17 year old. Given such science and math scores it should come as no surprise that Japan produces twice as many engineers per capita as the United States and that with twice as many engineers on the payroll Japanese products seem to be a little better engineered. Test scores for both those leaving high school and to college and for those leaving college and going on to graduate school have fallen 10 per cent in the past 15 years. Where America once had a labour force with educational abilities equal to that of the best, it no longer does. Foreign firms with American production facilities have started to complain about inferior education and job skills among their American workers and to attribute lower productivity in their American facilities to defects in the quality of the work force. They have every right to complain.

In 1983 American gross investment (a measure that includes investment in housing) was 17 per cent of the GNP. At the same time the French were investing 20 percent, the West Germans 21 percent, and the Japanese 28 percent. If America were to have kept up with the Japanese in terms of plant and equipment investment per worker (and in the long run it must), it would have had to have essentially doubled its investment to 30 per cent of the GNP because of its more rapidly growing labor force. In any one year such gaps make little difference, but compounded over a few decades they spell the difference between success and failure.

America's personal savings rate, 5 percent in 1983, was the lowest in the industrial world by a factor of almost three. Our neighbors the Canadians saved 13 per cent, the German 14 per cent, the Japanese 21 percent, and the Italians 23 per cent. It does not take a genius to know that Americans cannot compete on world markets saving less than one-third as much as their competitors.

America invests less in civilian research and development than any of its major industrial competitors. American civilian R&D spending runs at about 1.5 percent of GNP while our competitors are spending 2 per cent. Americans aren't smarter than the Germans or French. German scientists with money will beat American scientists without money most of the time. In the 1950s and 1960s America spent more, not less, on civilian research and development than its competitors.

While it is not so easy to quantify, American management cannot escape its share of the blame. American firms have undeniable problems with quality control. When asked to rate the quality of their cars, American buyers listed only two American built cars among the top ten. Management is responsible for quality control. If American products are shoddily built then American management is shoddy.

When it comes to that famous bottom line, each major input into the American economy will have to be as good as those of the

competition if American is to be competitive. A world-class economy demands world-class inputs. Converting existing American inputs into world-class inputs is not technically hard. But doing so is politically difficult. It is not easy to tighten up a school system or reduce consumption. The easiest solution will be to gradually extend protection to non-competitive industries and reduce America's involvement in international trade.

THE EUROPEAN PROBLEM

In Europe the problem is a lack of jobs. Unemployment has risen every year for more than a decade and is now well into the double-digit range. In some countries unemployment exceeds the levels seen in the Great Depression. No set of democracies can tolerate such a situation for long. Europe's current slow withdrawal from the world economy will eventually become a flight into protection to create jobs unless the employment problem can be turned around.

While on a net basis there have been no new jobs generated in Europe since 1970, the American economy has in the same period of time generated more than 30 million, more than 4 million in 1984 alone. If one looks at the reasons for the differences between the United States and Europe on the jobs front, it is a good illustration of how it is easy to solve the problems of others while remaining unable to solve one's own problems.

The European problem begins with macro-economic co-ordination. President Reagan proved that Keynesian economics still works, but President Mitterrand also proved that no country in Europe is big enough to practice Keynesianism alone. If demand is to be expanded, all will have to expand simultaneously. If such co-ordination cannot be arranged, the European Common Market simply isn't viable. Its current stagnation can but continue.

While America and Europe are often seen as similar, their labour markets are in fact very different. Relative to the price of capital,

American wages were 37 per cent lower in 1983 than they were in 1972. This has not happened in Europe. Wages have risen relative to the price of capital.

The relative price of capital and labour provides a key signal for capitalists making investment decisions. In Europe where labour costs were rising relative to the costs of capital, firms were told to substitute capital equipment for workers wherever possible. Workers were becoming more expensive relative to machinery. Firms responded as they should to these signals, and the European capital-labour ratio rose 3 per cent per year in the decade ending in 1983. Firms, however, only add employees if their sales growth exceeds their productivity growth. Combine high-productivity growth with governments generally unwilling to pump aggregate demand into the system and European firms could meet their markets with the same or smaller labour forces. The net result was good productivity growth but bad employment growth.

In the United States the capitalists got a very different signal. With labour costs falling relative to the costs of capital, firms were told to substitute workers for capital equipment wherever possible. The substitution of cheap people for expensive capital leads to a slower rate of growth of output per hour of work, however. The net result was a poor rate of productivity growth but a situation where much smaller increases in sales were necessary to persuade firms to add employees. Combine this with an American government generally willing to pump aggregate demand into the system, and the net result is good employment growth but bad productivity growth.

The relative movements in average wages also underestimate the real differences between the two economies. Legally mandated and socially expected fringe benefits are much larger in Europe than in America. By law, workers in Belgium get a six week vacation. By law, no one gets any vacation in the United States and two weeks is the accepted social norm.

While average wages are very different in Europe and America, there is much less variance in Europe than in America. Minimum wages are also much closer to average wages in Europe than they are in America where the legal minimum wage is just 40 per cent of the average hourly wage and largely unenforced (8 per cent of the American work force works at less than the legally mandated minimum wage). In the recession of 1982 only 43 per cent of those unemployed received any unemployment insurance payments whatsoever and among those who did receive payments it replaced 40 per cent of what they had previously earned. As a result low-wage industries can thrive in the United States paying low wages (workers are available) whereas they could not pay low wages and survive in Europe (workers are not available). Much of America's employment gain has in fact been in low-wage jobs which the average European worker would reject as unacceptable.

It is easy for an American to tell Europeans to lower their wages, reduce fringe benefits, and relax legal or social minimum wages, but it is politically hard to do so. No one wants to give up those long vacations and generous fringe benefits.

Europeans are often envious of the rapid growth of new firms in Silicon Valley in California or on Route 128 in Boston. Their response has tended to focus on subsidies for research and development and the need for a European venture capital industry to help new start-ups. Such activities are unlikely to solve the European jobs problem. What is needed is different forms of social organization.

New start-ups have one great advantage in America. Firms can easily fire unneeded workers. Advance notice need not be given; severance pay need not be paid. Firms simply do not need to carry the burden of unneeded workers if demand is not what was expected. Workers can be hired with the knowledge that if they are not needed they can be quickly fired.

In Europe firings range from difficult and expensive to impossible. Employees must legally be given several months' notice and then several months' severance pay. When labour is hired it is with the knowledge that it cannot easily be fired. This makes it much riskier and more expensive to go into business. What is a reasonable risk in America where labour is a variable cost becomes an unreasonable risk in Europe where labour is an overhead fixed cost.

I am not recommending the American solution to the European job problem. It would be far better to create labour market flexibility with a variable bonus such as that of the Japanese, but if Europe is not able to adopt some solution it will have to close its economy and reflate to create jobs. If one looks at what has happened to unemployment rates in the past decade under the current system it is difficult to imagine that the current system can continue for another decade.

THE JAPANESE PROBLEM

Japan relies on exports to keep its economy running. When the multiplier effects are included, exports accounted for all of Japan's growth in 1983 and two-thirds of its growth in 1984. In 1981 and 1982 there were quarters where domestic Japanese sales were falling but the economy was still growing. Exports were providing more than 100 per cent of the net growth in Japan. When these exports hit the American and European economies, however, they cut local sales and produce unemployment. The unemployment that would normally flow from a stagnant Japanese domestic economy is essentially being exported to the United States and Europe. This was acceptable when Japan had a small weak economy and America a strong one, but it is not permissible given a large Japanese economy and a less strong American one.

America's trading deficit with Japan, \$37 billion in 1984 and likely to be much higher in 1985, is economically and politically unacceptable. Within the United States, the trade imbalance leads to irresistible political pressures to retreat into ever-widening circles of protection.

Americans have to take some of the blame for the trade deficit with Japan. American firms have refused to design products explicitly for the Japanese market, have been shoddy in their quality control, have refused to learn the Japanese language and customs, have demanded instant success, and have often acted as if it is the duty of Japan to run its economy precisely as the U.S. economy is run. Our government has contributed to the problem by letting the dollar-yen exchange rate rise until it is simply impossible for any American manufacturer to compete.

If the United States were the only country having trouble exporting to Japan, one could say that Americans will simply have to learn how to sell their products in foreign markets. But it isn't only Americans who are having trouble. Countries such as West Germany, with a demonstrated track record of exporting success, have found it extremely difficult to break into the Japanese market.

Japan is still operating its economy as if it were small and weak. Agriculture benefits from overt protection and other areas benefit from covert protection, such as expensive safety inspections. Even more important is history and custom. How does a foreign firm break in as a new supplier of industrial components when Japanese firms place a premium on maintaining long-term, intimate supply relationships in the just-in-time inventory system? Ascribing blame, however, has become irrelevant. A solution is needed now.

There are essentially two options. Japan could practice domestic Keynesian economics to keep demand growing and change the structures of its economy and culture so that imports grow in pace with exports or Japan could find itself systematically kept out of foreign markets to hold its exports down. From the point of view of a world economy, the first option is best, but the second option is by far the more likely.

MACRO-ECONOMIC CO-OPERATION

In the recovery from the 1981-82 recession the Reagan Administration proved that Keynesian aggregate demand policies still work and that the United States is still strong enough to use Keynesian policies to restart the world's economic engines. What is not clear how long the United States can pull the resultant load.

Of the 3 million jobs lost in the 1984 trade deficit of \$123 billion, Japan, Europe plus Canada, and the rest of the world each received the gift of about 1 million jobs if bilateral deficits are examined. The OECD estimates that one-third of the growth in Western Europe in 1984 could be traced to the American recovery and the high valued dollar. Despite this external impetus to their economic growth, however, most of the rest of the world was still caught in stagnation in 1984. Some countries had positive growth rates, but few countries outside of the United States had growth rates strong enough to reduce unemployment. Without those jobs from America most of the rest of the world would have still been buried in the recession that began in 1981.

There is a real question as to how long the United States can continue to provide such a Keynesian stimulus to the rest of the world. America, like France earlier, is being inundated with rising imports and falling exports. Between 1981 and 1984 imports captured 42 per cent of the growth in domestic American spending. Even such a historically strong exporting industry as agriculture lost half its foreign markets between 1981 and 1984. Imports of computers and office equipment soared 50 per cent in 1984. Electrical machinery imports were up 38 per cent.

The only difference between France and the United States was that the value of the dollar did not fall. In 1983 and 1984 foreigners were willing to finance America's trade deficits, and the inflows of capital paid for the outflows of funds necessary to buy all of those foreign-made products. This was possible since the United States was running a monetary policy where real short term interest rates were being

held at levels twice those in Japan or West Germany. America was simply a very attractive place to park money.

Such a combination of policies presents a number of short-run and long-run problems. While a large budget deficit can keep a recovery going in the face of high real interest rates, the high real interest rates discourage the economy from making the long-term investments it ultimately needs to be competitive. The recovery is consumption (demand) rather than investment (supply) orientated. What works in the short run (pump consumption into the system) hurts in the long run (there is too little investment).

While a large budget deficit can offset high interest rates and prevent a recession, a rising trade deficit requires a large and **rising** budget deficit. If the trade deficit were to be larger than the federal budget deficit, the two would represent a net subtraction of demand from the American system and in conjunction with high interest rates lead to a recession. As a result, ever higher federal deficits are required to offset ever higher trade deficits.

In the United States this requires a willingness on the part of both the federal government and the country to go ever deeper into debt. While ever larger federal debts are probably manageable (Americans hold both the assets-bonds-and the liabilities-taxes owed), an ever larger international debt is not. Foreigners own the assets; Americans hold the liabilities.

In just a few years the sums get so large that the rest of the world has neither the willingness or ability to lend what must be lent even if interest rates remain high. Whereas America had net assets of \$152 billion in 1982, it is estimated that it will have net debts of \$700 to \$850 billion by 1989 if the dollar remains high that long. A trade deficit financed by foreign borrowings represents a debt like any other debt, and no one can forever accumulate debts that grow faster than one's income. At some point the rest of the world will decide that it has lent

America enough, just as America decided that it had lent Mexico enough, and the lending will stop. When this happens the value of the dollar will fall.

The United States will regain the 3 million jobs it is now losing but be hit by an inflationary shock in the form of much higher prices for imports. The rest of the world will lose 3 million jobs but be helped on the inflationary front with cheaper imports. America, as France did earlier, is apt to apply a dose of austerity and a retreat from the goal of full employment and economic recovery. The rest of the world essentially becomes a train which the American locomotive could no longer pull uphill. As the American locomotive starts to slide backwards under the weight of its load, however, the rest of the train slides backwards with it.

The current situation comes about for a simple reason. While the United States has been pursuing an expansionary fiscal policy of large and rising Federal deficits, the rest of the industrial world has been pursuing exactly the opposite policy. America expanded its structural budget deficit from 1980 to 1984, but the rest of the industrial world contracted theirs. Conversely the rest of the world has run a low-interest-rate policy while the United States was running a high-interest rate policy. The net result has been a rapid recovery in the United States which fueled a weak recovery in the rest of the industrial world. Abroad the positive demand effects from the American trade deficit more than offset the negative demand effects from falling foreign government deficits. But unless one believes that the United States can forever run a large and rising trade deficit the macro-economic underpinnings of the current recovery are unsustainable. Whenever the dollar falls and the American trade deficit unwinds, the recovery in the rest of the world stops.

Given the current degree of world economic integration, it is no longer possible to have unco-ordinated national economic policies where countries attempt to go it alone. The major countries in the

industrial world will either learn to co-ordinate their economic policies or they will sharply reduce the current degree of economic integration and return to the era when it was possible to have viable national economic policies. At the moment, the world is moving toward less economic integration and more viable national economic policies. The process is already under way as industry after industry—steel, shipbuilding, cars, consumer electronics—are withdrawn from real international trade and becomes a “managed industry with formal or informal quotas or other government marketing arrangements. Protection will provide the vehicle for disintegrating the world economy and making national economic policies once again viable, but at an enormous economic and political price.

CO-ORDINATING EXCHANGE RATES

Co-ordinating monetary and fiscal policies would remove some of the violent swings in exchange rates, but not all. Flexible exchange rates are an area where the economics profession, myself included, was simply wrong. Back in 1971, when the world went onto the current system of flexible exchange rates, economists were sure that it would be impossible to have large fluctuations in exchange rates between major countries over short periods of time or to have currencies that were fundamentally over or undervalued. Yet in the past decade both have occurred.

If changes in productivity, inflation and nominal exchange rates are added together, the real dollar-yen exchange rate rose an amazing 70 per cent over a few months in the early 1980s. In 1983 the dollar-mark rate changed 5 per cent within a single day. Between its low point in the third quarter of 1981 and the first quarter of 1985 the value of the dollar rose more than 85 per cent relative to the value of all other currencies. When the dollar does fall, it will almost certainly overshoot and become undervalued as it was in 1979.

With such violent swings in exchange rates, it simply isn't possible to run efficient economies. No one knows where economic activity should be located; no one knows the cheapest source of supplies; wherever economic activities are located they will be located in the wrong place much of the time. The result is a needless increase in risk and uncertainty, rising instability from protectionism, a shortening of time horizons as firms seek to limit risk and uncertainty by avoiding making long-term commitments, reductions in major new long-term investments, large adjustment costs as production is moved back and

forth to the cheapest locations, the expectation of future inflationary shocks, with consequent instability in interest rates.

Agriculture perhaps best illustrates the problem. The United States had a dominant position in world agricultural exports but it was also vulnerable in that it could not possibly consume all that it produced. Although exports were falling in the 1981-83 period of time, they still accounted for 54 per cent of the wheat, 22 per cent of the corn, 41 per cent of the soybeans, 43 per cent of the cotton, and 45 per cent of the rice grown in America. If American agriculture were to be cut off from its export markets it would have to shrink by similar amounts. Millions of farmers would have to be forced out of business and millions of acres have to be taken out of production. That process is painfully now underway.

If the dollar were to remain at its current levels forever about 85 per cent of American manufacturing would also have to be liquidated.

Left alone, the dollar will eventually fall. When it does, however, it will not slowly fall to an equilibrium point where exports equal imports but is apt to rapidly fall to being as grossly undervalued as it is overvalued in early 1985.

The German multinational treasurer who has moved his marks into the United States at three marks to the dollar knows that he will only get 200 million marks and not 300 million marks back when he tries to move his \$ 100 million out after the dollar has fallen to two marks to the dollar. He also knows that foreigners will not forever be willing to add to the dollar bank accounts at a rate high enough to finance the American trade deficit. At some point they will have too many of their assets tied up in dollar investments and will stop investing more. As a result the treasurer and every other investor would like to be the first person out the door when the dollar starts to fall. As a consequence, the dollar is likely to fall very fast when it starts to fall. And given the history of the past decade, the dollar is apt to plunge right through its

equilibrium point, shifting from being overvalued to being undervalued. If the dollar is 40 per cent overvalued, a fall of 60 per cent would not be surprising.

When this happens, the world rapidly moves from a situation where it is coping with an overvalued dollar to a situation where it is coping with an undervalued dollar. Economics are disrupted both here and abroad. Production that has moved off shore moves back. This is good for recovery in the United States but bad for recovery elsewhere. And if the dollar-yen exchange rate is going to move rapidly back and forth between 277 and 177 every few years, neither side knows where it is most efficient to locate production. As a consequence no one is willing to build major new facilities in either America or Japan.

Anyone who believes in gravity and watches water run uphill has a fundamental problem. Facts are difficult to deal with when they conflict with theory. Before changing theories, most human beings will spend long periods of time pretending that the facts don't exist, hoping that the facts will magically go away, or denying that the facts are important. Only if the facts are very painful and very persistent will humans deal with the fundamental inconsistencies in their world views.

Nowhere is this more true than when it comes to the value of the dollar. For believers in the virtues of free unregulated markets, such as the Reagan Administration, it is simply impossible to have a persistently overvalued dollar. Free markets can't produce bad results. Yet there the dollar sits 40 percent overvalued. Water is running uphill. The Reagan Administration sits hoping that the facts will go away, but the facts are very painful.

It is true that no country has an unlimited ability to hold up the value of its currency. For America to hold up the value of its currency it must buy dollars, and this can only be done to the extent that it has perviously acquired the foreign currencies necessary to buy dollars in international currency markets. When foreign exchange reserves are

spent, America has no further ability to hold up the value of its own currency.

Countries have, however, an unlimited ability to hold down the value of their currencies, and fortunately this is what the United States needs to do. To hold down the value of the dollar, America must sell dollars; and there is no limit on the number of dollars that can be sold. America prints dollars. The only limit has to do with how fast a country wants its money supply to grow, and even here it is possible to offset adverse money supply effects with what is called a sterilized intervention.

To note that timid German interventions have not held down the value of the dollar in early 1985 is not to prove that a massive American intervention could not hold down the value of the dollar. Germany has a finite supply of dollars; America has an infinite supply of dollars. Traders also know that Germany is dependent upon its export surplus for its recovery and does not want big reduction in the value of the dollar. It only wants to stop the mark from dropping further. Many foreign currency traders will bet against timid German interventions; few would bet against massive American interventions.

There is also a fundamental difference between interventions designed to hold a currency above levels consistent with its productivity and inflation and interventions designed to prick a speculative bubble and force a currency down to its appropriate level. Any announcement that such a policy was under way would send corporate treasurers and currency speculators rushing to sell dollars.

In a little more than a decade the prevailing intellectual fashions have gone from 'governments can stop any and all movements in foreign exchange rates' (that is the belief required to operate a fixed exchange rate system) to a belief that "governments can do nothing about foreign exchange rates." Neither is true. No government can forever hold

its currency above the levels dictated by wage rates and relative productivity, but it is equally true that no government has to accept a grossly overvalued currency or a wildly fluctuating currency.

The market will eventually correct the value of the dollar. But the market will not eventually correct the problem of currency fluctuations. To move from an over valued dollar to an undervalued dollar is not to solve the problem but merely to change the nature of the problem.

To correct this situation one need not go back to the fixed exchange rates that existed from World War II until 1971—that is neither possible nor desirable—but it does mean an international agreement to dampen wild fluctuations. The obvious answer is some system of crawling pegs where an attempt is made to isolate the changes needed in foreign exchange rates to accommodate changes in countries' long-term competitiveness—their relative rates of inflation and productivity—from the temporary factors that cause capital flows from one country to another. No one can make these judgements perfectly but almost anyone can produce a better result than those now occurring.

But this is unlikely to occur. Intellectual fashions often dominate current events and the present intellectual fashion favours non-intervention. But with non-intervention the current fashion world economic system cannot work. It will have to be scrapped for a more workable national solution.

NEEDED: AN INTERNATIONAL MANAGER

While the United States is no longer strong enough to dictate economically to the rest of the world, as it did at the first Bretton Woods conference, it is still the strongest country in the industrial world. As a result it still needs to play the role of manager of the international trading system. In the next twenty years the manager's job is going to be one of seeking consensus and making compromises—not giving orders—but only the United States is capable of filling that frustrating role. For

unless there is a manager who is actively concerned about the future of the international trading system, the system will simply disappear in a sea of protectionism.

Unfortunately America has abdicated on a responsibility that only it can fulfill. The international trading system won't take care of itself as the Reagan Administration seems to think. International organizations are not ipso facto bad. If the world economy is to work, a creative manager is needed, and America had better apply for the job if it wants a healthy domestic economy and healthy international alliances.