

VANCOUVER 1996

The Annual Meeting of The Trilateral Commission

Dialogue: 49

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INTRODUCTORY NOTE

THE TRILATERAL COMMISSION held its 1996 annual meeting in Vancouver, British Columbia, on April 20-22. One reason Canadian Trilateral members—who hosted this meeting—chose Vancouver was to emphasize Canada's growing ties in the Asia Pacific region. This publication setting out the presentations made at the Vancouver meeting begins with two sessions focused on the Asia Pacific area. Security in the area was the concern of the first of these two sessions, while the second looked more broadly at the growing sense of a region and its institutional expression.

The Trilateral Commission seeks to highlight and nurture the shared leadership responsibilities of the three principal industrialized democratic areas of the world—European Union countries, North America and Japan—in a global framework. Reports prepared by teams of authors from the three regions provide a means to examine particular issues more deeply and are discussed in draft form in the annual meeting. This publication includes excerpts from the two reports discussed in Vancouver, each of which is appearing separately in published form. One report is entitled *Maintaining Energy Security in a Global Context*. This project began with the observation that the percentage of the world's oil supplies provided by Persian Gulf exporters is rising again and, by 2010, is projected to be back to the levels of the early 1970s which helped set the stage for the tremendous "oil shocks" of that decade. This is a serious ongoing concern, the authors argue, with important policy implications for Trilateral countries. The second Vancouver report, called *Globalization and Trilateral Labor Markets: Evidence and Implications*, concludes that trade with developing countries

has had only a relatively small role in the deterioration of the relative position of less-skilled labor in the labor markets of Europe and North America. Rather different patterns are evident in Japan's labor market. A third Vancouver session started from a speech late last year by Paul Volcker, the Commission's North American Chairman, entitled "The Quest for Exchange Rate Stability: Realistic or Quixotic?". The target zone proposal in the Volcker speech was vigorously debated in Vancouver, as the presentations in this publication indicate.

The annual meeting also provides an occasion to review recent developments in each region, with a special emphasis on the host country. The discussion of Canadian developments gave particular attention, of course, to Quebec and the Canadian federation. Outgoing Trade Minister Roy MacLaren spoke of Canada's economic transformation, reflected in productivity and export growth and in an increasingly global mind-set. Justice Minister Allan Rock spoke of the Chrétien government's efforts to put Canada's fiscal house in order and redefine the role of the national government.

Kiichi Miyazawa has served as acting Japanese Chairman of the Trilateral Commission since early 1994, after Akio Morita was incapacitated by illness. In October 1996, Yotaro Kobayashi, Chairman and Chief Executive Officer of Fuji-Xerox Co., Ltd. and active in the Trilateral Commission for many years, will become our new Japanese Chairman.

SECTION 1
SECURITY IN THE
ASIA PACIFIC AREA

The Vancouver meeting took place a few days after President Clinton's trip to South Korea and Japan. The Joint Declaration of President Clinton and Prime Minister Hashimoto with regard to the U.S.-Japan Security Treaty and the agreement on U.S. bases in Okinawa became major topics in the Vancouver discussions. Aside from the Nye, Owada and Han presentations which follow, see also the later presentations by Yoichi Funabashi, John McCain and Chuck Robb.

JOSEPH S. NYE, JR.

Policy Responses to the Principal Challenges

A FEW YEARS AGO people looked at the vibrant economic growth of the East Asian economy and often came to conclusions like the "geo-economics has replaced geo-politics" or "it's all economics now." I think that was and still is profoundly wrong. Unless there's a solid political security structure, the economies cannot flourish and prosper. Or, as I put it in a Department of Defense report a year or so ago, security is a lot like oxygen. You don't notice it until you begin to miss it, and then you think of nothing else. It's important that we focus on the security underpinnings of the vibrant economic growth in East Asia.

What's Going to Happen to North Korea?

There are two large security problems in East Asia, and they're of different sorts. In the short run, the great security problem is: what's going to happen to North Korea? I will leave most of this to my friend, Han Sung-Joo.

The deal to prevent North Korea from developing nuclear weapons worked. It wasn't perfect but it avoided a clear and present danger; and it's working now, as we know through the IAEA inspections. Essentially, the North Koreans have stopped the nuclear program. If they hadn't stopped, they would have separated plutonium for about four or five nuclear weapons. So that's a net plus.

On the other hand, North Korea still has 1.1 million men under arms, two-thirds of them within 100 kilometers of the Demilitarized Zone. With famine in parts of the country and severe economic decline for the last five years, it's remarkable how many resources North Korea is pouring into keeping readiness in that military component. You could say, well, if they're going through such bad conditions, will this problem not take care of itself? Not necessarily. Sometimes when a country has its back to the wall, when there's no alternative, they will take higher risks than they would take in normal circumstances. I suppose the analogy is: if you were on the twelfth floor of a burning building, and there was only one chance in ten you would survive if you jumped but 100 percent probability you would die if you stayed put, you might jump. That's the situation in North Korea today.

The policy responses are two-fold. One is to maintain a capability to deter any North Korean actions, so that the probabilities of success don't even look like one-in-ten for a risky action, but look like zero. That means keeping a major military capability, which we have in place. The other policy response is to use the Korean Energy Development Organization (the institution developed to work on the nuclear deal) as a way to open up North Korea—to have South Koreans going into North Korea, to have North Koreans finding ways to get out into the world. We hope that the combination of a very powerful position of deterrence and finding ways to open up North Korea can produce a "soft landing."

The Rise of Chinese Power

The larger and longer-term question of security in East Asia is the rise of Chinese power.

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The one thing that seems to me absolutely clear about East Asia is that China will become more powerful. (There's some possibility that China could fragment or stagnate; I think that's very unlikely.) We know historically that it's times when you have the rise and fall of powers that you have maximum anxiety and possible friction. This goes back to Thucydides and the Peloponnesian War. The cause of the war was the rise in the power of Athens and the fear it created in Sparta. Note the second part: the fear that it created.

The critical thing in reacting to the rise of Chinese power is to make sure we understand it and take it into account, but not to exaggerate it, not to create an enemy when we don't need to have an enemy. People sometimes ask: how will China use its new strength? Will it throw its weight around? Will it be an aggressive power expanding into Southeast Asia? There are different views among the experts on this. It's certainly not like the Soviet Union as a global expansionist power, but it obviously will have great weight in the region.

We don't know how China will behave. Suppose we said we'll just flip a coin—it's 50:50 whether China will be an expansionist power or not. If we were to treat China as an enemy now, we would be discarding 50 percent of the futures. (Whenever we speak about "future" we should always use the plural, because it's indeterminate.) And if we discard the 50 percent of the futures that are the more benign futures, we will have hurt ourselves unnecessarily.

So the correct response to the rise of Chinese power is to structure the situation in East Asia so that China is constrained to be a responsible actor in the region. There are two pieces of that. One is to work to develop some bilateral and multilateral arrangements in the region which will make it expensive for China to behave badly.

A good example of this is the ASEAN Regional Forum, which grew out of an economic organization but has been successful in terms of creating a set of political constraints. Last year when China, in the Mischief Reef incident,

began to throw its weight around in the South China Sea, the fact that China found that it would complicate its relations with a whole range of countries led the Chinese to back off. The Chinese statement at Brunei last August that they would obey the law of the sea in approaching the Spratlys was a major and significant step. I think the ASEAN Regional Forum gets a good deal of credit for that.

The other diplomatic framework we talked about in the session just before this. The Joint Declaration last week reaffirming the U.S.-Japan Security Treaty as the basis for stability in East Asia in the post-Cold War period (and the work that accompanied it) may turn out to be one of the most important things that has happened in American foreign policy, or indeed in East Asian politics, in decades. Someone asked this morning whether there is anything new here. I think it's profoundly important. If you think of the balance of power in East Asia, for the next ten or twenty years it will be largely a three-part balance of power: the United States, China and Japan. And any time you have a three-part balance of power, it's better to be in the two than the one. To put that more diplomatically, if China were able to play off the United States against Japan, to divide the United States from Japan, it would have far fewer constraints on being a responsible power in the region. So I believe that the results of last week's U.S.-Japan summit were tremendously important.

That still leaves the question: what policy toward China? It seems to me the policy toward China ought to be the one the Clinton Administration is trying to express—not always as well as it should—which is the idea of constructive engagement (some call it conditional engagement) and not pre-emptive containment. There are some Americans like the columnist Charles Krauthammer who say, "China is going to be a threat in the future; get 'em now before they get too strong." Big mistake. First, as I said earlier, this throws away half of the possible futures; and second, China is not like the Soviet Union after World War II. It's

simply a mis-application of a historical example or period to talk about containment of China in that sense.

We could not develop the diplomatic coalition to contain China even if we tried. There is only one country that can produce containment of China, and that's China. If China misperceives its interests, if it misbehaves, if it throws its weight around, then it may indeed produce containment. If we start out with a policy of engagement, it will always be possible to reverse it if China misbehaves. But if we start out with a policy of containment, we will not be able to move back toward engagement. The key question—as Jim Baker once said—is to have a policy toward China that's as complex as the problems that China creates.

We have an enormous number of issues with China: Taiwan, proliferation, trade, environment, regional stability, human rights. All of these are difficult. What we need is to see them in a larger strategic perspective, and explain why a country of this scale and this magnitude has to be engaged and encouraged to become a responsible power, both regionally and globally.

Will this work? I don't know. Domestic politics in three countries threaten it: in the United States (as you heard at lunch yesterday), in Taiwan (which is feeling its democratic oats and may press toward more independence), and in China (where Communism essentially is dead and has been replaced as a unifying religion by ethnic Han nationalism). In that sense, in all three countries there are pressures against taking this long-term strategic view. But it seems to me that we have to resist that. Because if there is a new cold war in Asia, we will all be losers. If we, on the other hand, are able to produce a security system in Asia which undergirds continuing prosperity, we will all be winners.

Joseph S. Nye, Jr. is Dean of the Kennedy School of Government at Harvard University. He was former U.S. Assistant Secretary of Defense for International Security Affairs in 1994-95.

HISASHI OWADA

Asia Pacific Security and the U.S.-Japan Cornerstone

THERE IS A GENERAL FEELING—because of the remarkable economic growth prevailing in East Asia and the resulting political stability and social resilience—that everything is fine in East Asia. However, I think that, compared with the security situation in Europe, the security environment in the Asia Pacific region is potentially more volatile and its future—at least in a long-term perspective—more uncertain than is normally assumed.

North Korea, China, Russia, Diversity

North Korea is still a great source of anxiety in the region. Fortunately, the issue of North Korea's nuclear development has been contained at least for the moment by the arrangements under KEDO, but the situation continues to pose more than a regional problem, as it could fly in the face of global efforts for consolidating the non-proliferation regime. And the domestic condition in that country is still very hard to predict.

China, with its very impressive economic growth and restored confidence seven years after the Tiananmen affair, is a major factor to be taken seriously in our equation for regional security. I'm not going to say whether China is going to be a threat or not a threat. That depends very much on China. But at the same time, to a certain extent that depends upon how we deal with China. I was listening to the television this morning and Mickey Kantor was being interviewed. Although I don't agree with all the things that Mickey Kantor says, particularly in relation with Japan, I was very much in agreement with his answer to a tough question about whether he regarded China as an enemy or a friend of the United States. He said,

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"It's a reality." The interviewer asked the same question again, thinking that he mistook the question, and he replied again, "It's a reality." That's exactly right. It is not a question of whether China is an enemy or a friend by definition. China is a reality that you have to accept; and the question is how you can make the best of that reality.

The number one policy objective for the Chinese government is to achieve modernization. There is no question about it. That is the legitimacy on which the present regime establishes its power and that has been the aspiration of the Chinese people for more than 100 years. That is exactly what the leaders of China have been saying all along, and there is no reason to question the validity of that assertion. If that is the objective, at least in a short-term and medium-term perspective, then what we should try to do is to encourage China to modernize itself in a context of cooperation and constructive dialogue—so that China can be part of the community. In that sense there are many things that we can do—although we will not be the main factor—in trying to prepare an environment in which the Chinese leadership or the Chinese people can try to achieve their objective in a way which would be in harmony with the external environment.

Russia with its uncertain future is another factor that we have to keep in mind in thinking about the framework of security in East Asia. The reform efforts carried out under President Boris Yeltsin towards democratization and a market economic system have been very impressive in dissipating the perception of the former Soviet Union as a military as well as an ideological threat to the region. Nevertheless Russia is a major variant that we have to take into account in thinking about the basic security framework of the Asia Pacific region.

There are a number of geopolitical characteristics of the security environment in the region. I would like to emphasize the diversity which is characteristic of this region—diversity in various senses, not only in terms of socio-cultural or historical background, but also in terms of the sizes of the countries involved, their populations, the balance between their political power and eco-

nomic power, their military strength, and so forth. The diversity is such that you simply cannot talk about the security framework in that region in European terms, for example, where you have a more homogeneous group of countries and where it is much easier to form a security framework.

Multi-Layered Network Model is Best

That brings me to the discussion of the possible models for the security framework of the region, projecting into the future—perhaps a longer-term future. Given the specific characteristics of the region, certain models are feasible whereas other models are not feasible. The integration model, the type that Europe has in the form of NATO and the European Union, is based on shared common values. This is almost impossible to achieve, in the Asia Pacific area, at least in a short-term perspective, given so many different aspects of diversity in this region. The second model, which is very much talked about again, is balance-of-power model. Henry Kissinger says, for instance, that "peace requires either hegemony or balance of power. We Americans have neither the resources nor the stomach for the former. The only question is how much we have to suffer before we realize it." I question the validity of this statement as a statement of universal application, as far as the situation of Asia Pacific is concerned. Quite clearly in the Asian setting, hegemony is not the solution to the problem; so I have excluded this from the beginning. But equally I very much doubt that a balance-of-power model is going to be the viable model. It is true that in the Cold War period lots of bilateral arrangements were made in this region. Some were created on the basis of the Cold War confrontation, with its spillover effect to the entire region of East Asia, but others—the more important ones like the U.S.-Japan Security Treaty—have very little to do with the Cold War situation.

The third model is what I would describe as a multi-layered network model. Admittedly, the multi-layered network model is an eclectic model, but it is much more viable and much more feasible, at least for the present time, where diversity that exists in various senses makes it impossi-

ble for us to envisage a more coherent structured world. It consists of a series of concrete bilateral defense mechanisms, together with a regional arrangement which would encompass in a very loose way all these bilateral networks, while in between you have sub-regional arrangements which would be a connecting link between the regional framework, the cover, and the concrete bilateral defense arrangements. I think that is what is most viable and feasible in the East Asian setting, with all the characteristics that I would have liked to detail if I had time.

U.S.-Japan Security Treaty and Recent Joint Declaration

The significance of the Japan-U.S. Security Treaty is very often misunderstood. Many people feel as if it were very much like NATO (although it is bilateral while NATO is multilateral), in the sense that both were the offspring of the Cold War confrontation, and part of the global strategy of the United States to cope with the Soviet threat. It may be true that this element is not totally absent in the background of the U.S.-Japan Security Treaty, but it is not the main element. The U.S.-Japan Security Treaty was concluded in 1951 as part of the San Francisco regime. The Cold War had already started, and more importantly the Korean War was going on. But the concept of the U.S.-Japan Security Treaty had started much earlier, and it was part and parcel of the designs of the Allied Powers to create a Japan that was going to pose no threat to the region again, the kind of Japan the Allied powers were going to create in this part of the world. The Constitution of Japan was adopted already in 1947, with Article 9 conspicuously present. The U.S.-Japan Security Treaty was one device to establish compatibility between the spirit of the Constitution (under which Japan was to pursue a pacifist orientation without aiming for a state which would have the military capability) and the objective necessity to provide Japan with the shield to defend itself. These are two ostensibly incompatible requirements. The U.S.-Japan Security Treaty was created primarily to provide Japan with a framework to defend itself in cooperation with the United States. This has very

little to do with the Cold War situation; with or without the Cold War that necessity has been and is there.

The second important point is that the U.S.-Japan security relationship from the beginning was conceived as a cornerstone of the entire strategy for the maintenance of peace and security in East Asia, against the background of what happened in the past. In other words, it not only gave the assurance of security to Japan (in the narrow sense of the defense of Japan) but it also gave reassurance to the countries in the region about the future of Japan. These two important points should be relevant in understanding the significance of the Joint Declaration issued quite recently, to which Joe Nye has just made reference. I also attach great significance to the Joint Declaration, in the sense that it has really revitalized and reaffirmed the two important aspects of the U.S.-Japan security arrangement that I have talked about, for the first time since the establishment of the arrangement. The Joint Declaration has made it quite clear that it is the cornerstone of the framework to make Japan safe within an environment full of uncertainties, but at the same time articulated the point that this is a cornerstone for achieving common security objectives, for maintaining a stable and prosperous environment for the Asia Pacific region. The question is how to do it in a way which is compatible with the spirit of the Constitution and within the framework in which the Japanese have been operating and in which we are determined to operate in the future.

Japanese Views of Joint Declaration

I think it is fair to say as my first point that there is a general acceptance in Japan, of this new evolution. Having said that, the second point is that, nevertheless, there is a risk that a polarization of views into two different groups may come about, as represented by the editorials of the major newspapers. Typically, the *Asahi* and the *Mainichi* newspapers were critical of this Joint Declaration, saying that this amounts to the de facto revision of the Security Treaty. The *Yomiuri* and the *Sankei* newspapers took the position that this is a very healthy development, as a logical development

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of what has always been inherent in the Security Treaty arrangement. The interesting question is whether this polarization is going to remain, and, if so, which of the two main currents will be the main dominant trend in the future. My guess is that there will be a greater degree of acceptance of the approach enumerated in the Joint Declaration, provided it is confined within the basic framework of the spirit of the Constitution. I think it's wrong to talk about the Constitution as a constraint on the Japanese people. The Constitution is an expression of the national credo of the people in Japan, as of now. Why then, has this polarization come about? Let me give you three factors to explain this and end my presentation. First of all, there is confusion—very unfortunately but inevitably because of the legacy of the past—between two different things. One is the question of how to consolidate the effectiveness of the U.S.-Japan security arrangement for the security of Japan in the broader sense of the word, including the maintenance of stability in the region. The other is the question of how this approach is perceived by those who fear that it could lead to the resurgence of a revisionist orientation by which Japan may go in the direction of discarding the spirit of the Constitution. These are two totally different theses. But the two can get very easily confused with each other. Hence, some accept that this is a healthy approach, while others feel that this is going to be a dangerous approach.

Nevertheless, I think public opinion generally is more favorable in the sense that there is a growing awareness on the part of the public that we Japanese should get out of the psychological cocoon, so to speak, in which Japan has been secluding itself for such a long time. This has dawned upon the Japanese mainly as result of the experience at the time of the Gulf Crisis. The third point, which to me is the most important point, is that the future will depend very much upon the reaction of the countries in the neighborhood, the external environment. If the external environment is going to be negative with regard to this development, that will make the polarization much more acute. If on the other

hand, the external environment is more understanding about the constructive element which is involved in this approach, then the general trend in the Japanese public reaction is going to be much more positive and constructive.

Hisashi Owada, former Vice Minister of Foreign Affairs, is now Japan's Ambassador to the United Nations. He spoke in a personal capacity.

HAN SUNG-JOO

North and South Korea

Interpreting North Korea

NORTH KOREA IS OFTEN compared to an airplane (I would use the analogy of a bomber in trouble), and we hope for a "soft landing." What a soft landing means has never really been defined. I think what we want is for North Korea not to crash into a crowded street, or buildings in a city. We have seen transformations in Eastern and Central Europe of formerly Socialist countries. If North Korea's transformation is anything like Poland's, or Czechoslovakia's, or even East Germany's, I would consider that a soft landing. What we are afraid of is that North Korea might do something in desperation—lash out in order to deal with its internal and external problems, or suddenly implode with the resultant instability and chaos, including hundreds of thousands of refugees into China, into Japan, into South Korea.

North Korea has one position: it would like to negotiate a peace agreement with the United States. This is not a new position. In the past, North Korea had this position, I think with a view to inducing withdrawal of U.S. troops; but now the situation is somewhat different. North Korea wants to do that because it thinks that the United States is the only key to deal-

ing with its own internal problems. North Korea first tried to get out of its isolation by talking with South Korea, and feels that didn't work out. In 1992 North Korea started negotiating with Japan for normalization of relations, but because of the nuclear issue and because the United States didn't approve of either Japan or South Korea dealing with North Korea without resolution of the nuclear issue, the negotiation didn't get anywhere. So North Korea feels that the right button is the United States. Even with the nuclear issue, North Korea insisted it would talk only with the United States.

North Korea also wants to talk only with the United States because it is afraid to talk with South Korea. It has seen what happened in Germany. North Korea feels that East Germany mistakenly had talks, exchanges and dealings with West Germany, with the result that East Germany ultimately collapsed and was absorbed into the West. It also insists on dealing with the United States because North Korea feels that is one way to drive a wedge between the United States and South Korea. South Korea is very much opposed to the United States talking with North Korea over the head of—or behind—South Korea.

Now why did the North Koreans recently take the risk of greater confrontation by sending rather heavily armed troops into the Demilitarized Zone, in violation of the armistice agreement of 1953? There is also a question about the timing of it, because it happened during the last phase of the parliamentary election campaign in the South and the result was a helping of the government party—President Kim Young-Sam's party—to elect more seats than it would have without North Korean action.

My conclusion is that North Korea wanted to demonstrate that it has leverage, and the United States and other countries have to reckon with North Korea. This time it was incursions into the Demilitarized Zone, but next time it could do something else. It would not hesitate to do something that would be very extraordinary. North Korea probably felt

that its nuclear card, so to speak, has been exhausted.

But what about the timing of it? I don't think the North Koreans intended to be helpful to President Kim Young-Sam. They probably did it despite the possibility of helping President Kim Young-Sam's party. It's not likely that they were not aware of that possibility because the North Korean actions came in the wake of the Chinese contribution to Lee Teng-hui's election victory in Taiwan. The North Koreans probably timed their actions with President Clinton's visit. So if President Clinton had not visited South Korea, the North Korean incursions may not have taken place. This is an interesting conjecture.

I turn next to the proposal by President Clinton and President Kim Young-Sam to have a four-party meeting to discuss peace and security in the Korean Peninsula. At first the White House said that President Clinton would not have the time to visit South Korea on his way to Japan. That was not taken very kindly in South Korea. I think it was a good thing that President Clinton decided to visit South Korea, if only for several hours. The four-party meeting was proposed because North Korea insisted on a two-way meeting with the United States, and South Korea was of course very much opposed to that. This proposal has been floating around in South Korea. They all attribute the proposal to me personally. I had proposed a two-plus-two setting in which South and North Korea would agree on a structure of peace (which would replace the 43-year-old armistice agreement) and the United States and China, which are the signatories of the armistice, would endorse and guarantee the agreement by North and South Korea. North Korea is very much eager to have this armistice replaced with some kind of a peace agreement. Of course North Korea wants to have a peace agreement between North Korea and the United States. South Korea wants to have a peace agreement between North and South Korea.

The North Korean reaction to the four-party meeting proposal is a very interesting one. For

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the first time, it says it wants to know more about the proposal. It hasn't rejected it outright. I think there are chances that North Korea might accept this proposal, but argue that South Korea and China attend the meeting only as observers. Of course, South Korea and the United States will insist that, if that meeting takes place, all four countries participate as bona fide participants.

This proposal has been around before. Former Secretary of State James Baker had an article in *Foreign Affairs* to that effect. I made a proposal of that kind. When the Chinese Prime Minister Li Peng was visiting South Korea in 1994, he also suggested a similar format. The Chinese reaction to the latest proposal has been somewhat guarded, but more on the positive side than on the negative side.

North Koreans recognize that the status quo on the Korean Peninsula is to its own interest. In the past North Korea wanted unification of Korea on its own terms, because that seemed possible in the past. Now North Korea would like to keep the two sides divided, North and South Korea, because any unification will be at the expense of North Korea.

South Korean Perspectives

After what Joe Nye and Hisashi Owada have said, let me also introduce the South Korean reaction to the new U.S.-Japan security declaration. South Koreans are generally very sensitive to any regional role that Japan would play. Even though the new declaration includes many other items, probably with greater weight, than the possibility of Japan playing a regional role (such as re-affirmation of the 1960 Security Treaty, continued presence of U.S. troops, U.S.-Japan cooperation in weapons development and so on), South Korean media and commentators talk about the United States opening the way, giving a green light to Japan to augment its military capability and play a regional role. Such is the concern that South Korea has about increasing Japan's capability and role. I think this calls for a greater effort on the part of both

the United States and Japan to explain what this declaration really is, because there is inadequate understanding of the declaration.

South Korea, I think, is beginning to recognize the need for a Korean version of what is known as the Nye Initiative: to look together into the medium- and long-term future of U.S.-South Korea—and possibly U.S.-South Korea-Japan—security cooperation. Some effort was made along these lines a couple of years ago, but Koreans were a little apprehensive about that, for three reasons. First, South Korea was conscious of its relations with China. Second, South Korea was concerned about the possibility of playing a regional role when the security situation within the Korean Peninsula was still very critical. Finally, with weapons systems such as the theatre missile defense system, what kind of cost-sharing would be involved? But now, having seen the fruits of this initiative in U.S.-Japan security relations, I think there will be greater receptivity on the part of South Korea to look into such long-term arrangements.

I see some optimistic developments in South Korea. So far there has been too close linkage with domestic politics in establishing and implementing foreign and security policies in South Korea (as would be the case in other countries, but probably more so in South Korea). Now, I think, especially with the parliamentary elections over, there is a sense that we have to get down to business in dealing with Japan, the United States, North Korea. We cannot let emotions or simple fears prevail over rational and more realistic judgments. So, in the case of South Korea, I think the debate is beginning, a debate that has been suppressed because of these overwhelming domestic needs.

Han Sung-Joo, Foreign Minister of the Republic of Korea in 1993-94, is now at Korea University as Professor and Director of the Ilmin International Relations Institute.

SECTION 2
THE EMERGING ASIA PACIFIC REGION
AND TRILATERAL COUNTRIES

JUSUF WANANDI

Institution-Building

I WOULD LIKE TO TALK about growth prospects and regionalism, about institution-building in the region as I see it, and about the roles for Trilateral countries.

Regional Institutions Now Important for Sustaining Growth

The macro-economic policies that we have followed, the high savings rates, the open economies that are more and more becoming a fact should make for sustainable growth in the longer term—although we have to give more attention to the environment, to deepening research and development, and to human resources and training and education. If there is anything that is going to really dent the economic growth of the region in the future, I think it will be mainly for political and security reasons. The external environment may put some limit on growth—Korean peninsula dangers, for instance, as well as the emerging of China. Domestic policies are also going to be a very important factor in whether economic growth will be sustainable or not in the future for East Asia.

I think one of the main reasons why regionalism and regional institutions have been developed in our part of the world is the recognition that after such a growth period, which economically really started from the bottom up (30 years ago and before, academics and businessmen started this process of growth and cooperation), regional institutions have now become much more important to make the sustainability of economic growth a fact in the future.

APEC

APEC comes first to mind. Fred Bergsten is going to talk about how he sees APEC developing in the future. It suffices for me to say that, besides the economic part of APEC, which is for real and of course gets the most attention, APEC also has four strategic reasons to be developed in the future. First is to keep the United States in the region. It is a very important part of APEC that the United States be involved economically in the region. Second, APEC is also a very important vehicle to smoothen the bilateral relationship (so important to the region) between Japan and the USA, in the economic field. Third, APEC is important for the involvement of China. Last but not least, some of the issues of relations between developing nations and developed industrialized nations have been put in a much more effective model in East Asia through a regional cooperation framework like APEC. That could be a model to be emulated in other parts of the world.

So that is the strategic importance of APEC; the economic side I will leave to Fred Bergsten to discuss.

ASEAN Regional Forum

We have started fairly recently with efforts on the political security side. During lunch we heard that the base of security and stability and peace in the region is the alliance between the United States and Japan. I think everybody in the region accepts that fact and is supportive of the alliance. But this bilateral relationship alone may not be adequate in the future. A much more multipolar world is going to develop in the longer term, and for that we need some adequate mechanism and institutions to complement the alliance. That's why the ASEAN Regional Forum had to be established.

In the beginning the ASEAN Regional Forum is really a conflict-prevention mechanism—in the forms of confidence-building and preventive diplomacy. At a later stage it is hoped we can develop that into a conflict-resolution mech-

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anism. We just started two years ago, although there are a lot more activities now than we thought could be possible when we started the ASEAN Regional Forum.

The ASEAN Regional Forum will succeed only if there is a feeling of all the countries now members that it really could be useful for the stability and peace of the region in the future. The three workshops that have been established in the ASEAN Regional Forum have already provided a lot of momentum to that effect. One is on confidence-building, the second is on peacekeeping, and the third is on search-and-rescue. The Chinese have been participating actively in all the three, including in the confidence-building measures one where I participated a few days ago in Jakarta. The Chinese have even sent their military people to participate. I think it is very positive that the Chinese feel comfortable and would like to pick up the leadership of the confidence-building workshop. They have invited the workshop to be continued in the future in Beijing.

ASEM

The third regional institution I would like to mention here is of course what was recently established in Bangkok, and that is ASEM: the Asia-Europe Meeting. Consisting of 25 leaders of both regions—Europe and East Asia—definitely it has a potential to develop this missing link between Europe and East Asia.

I would like to argue with Zbigniew Brzezinski that there is no intention to leave the United States out.* Exactly the idea of ASEM is to fulfill what he expected of us, and that is that we have to cooperate together to support the presence of the United States. When ASEM came together in Bangkok, the United States was very much in mind.

*In an article circulated at the Vancouver meeting, Zbigniew Brzezinski described the Bangkok meeting as "a summit of impotence. Absent from it will be the world's only superpower, America....America, though formally absent, should be very much on their minds."

Discussions in the corridor mentioned the importance of how to keep the United States involved internationally, and how to keep her honest multilaterally in the lot of international affairs.

The first ASEM was a very successful one because both sides recognized this lacuna that has happened because of inward-looking-ness of the two parts of the world—and both sides are now, in a very natural way, reinventing their relationship. The potential, although it's different than APEC, is there to be developed in the future. It's basically where Europe would like to deal with Asia on an equal basis. Economic development and the economic relationship is very much a priority, of course, but political security issues are also going to be taken up (Europe is also a very important member of the ASEAN Regional Forum). The second-track institutions, the non-governmental institutions are a very important vehicle to make this possible, to support all these regional institutions.

Since peace is indivisible, Trilateral countries definitely have a role to play not only in the particular part of the world they live in, but also in other parts. Europe is important for us in the future, and we should look to our cooperation with Europe.

Jusuf Wanandi is Chairman of the Supervisory Board of the Centre for Strategic and International Studies, in Jakarta.

APEC

AT THIS POINT the Asia Pacific Economic Cooperation forum, or APEC, is the most developed of the Asia Pacific regional organizations. I will say a few words about what it is and where I think it's headed, and then derive four important implications for the Trilateral world.

Potentially the Largest Trade Agreement in History Is Moving Forward

APEC received a major boost in Seattle when President Clinton hosted the first APEC summit back in 1993. The leaders at that summit agreed to form a community of Asia Pacific economies. The next year in Indonesia, APEC took the huge step of agreeing to achieve free trade and investment in the region by a date certain. Last year's summit in Osaka developed an Action Agenda to implement the free trade pledge. This year's summit in Subic, in the Philippines, will put the flesh on the bones and begin the process (starting next January). And then in 1997 the fifth annual APEC summit will take place here in Vancouver, I suspect in these very buildings.

APEC represents potentially the largest trade agreement in history. It comprises countries making up literally half the world economy, who have agreed to achieve free trade and investment in the region by a date certain: 2010 for the industrial economies (that make up 85 percent of the region's trade); the rest by 2020. Important as they have been, GATT negotiations have never set a goal of free trade, but rather have aimed for incremental reductions in barriers; hence it is fair to say that APEC is potentially the biggest trade deal of all time.

The Industry Commission of Australia, Australia's equivalent of the U.S. International Trade Commission, recently published a comprehensive estimate of the economic impact of

APEC. Its judgment is that a successful implementation of the APEC program would increase the gross product of the region by \$750 billion annually when completed. That is about 3-5 percent of the GDP of the region now, a little less by the time it is implemented, but a very good outcome for government work. Of that \$750 billion, a little less than half comes from trade *liberalization* (getting rid of barriers) and a little more than half from trade *facilitation*—customs harmonization, product standardization, competition policy coordination, the whole range of brick-by-brick items, as they are sometimes called, that are an integral part of the APEC program. The free trade pledge to eliminate barriers provides the momentum to undertake trade facilitation as well.

I have said it is "potentially" the greatest trade agreement in history, because it has to be implemented. And there are skeptics. I happen to believe that the prospects are very good. The Osaka summit last November did for APEC what the Punta del Este declaration did in launching the Uruguay Round back in 1986. It agreed on the principles to govern the negotiation, it agreed on the fifteen areas that would be liberalized, and it agreed on timetables to achieve the outcome. The individual countries are now developing their plans. They began putting them forward starting in May 1996; they are to be agreed at the Subic summit in November, with implementation to begin in January 1997. If that occurs, and I am sure that at least the process will begin, it will have taken barely two years from the time the APEC countries pledged to achieve free trade, in Indonesia in late 1994, to the time they begin to implement the free trade commitment, in January 1997. That contrasts with the eight years it took the GATT to move from the Punta del Este declaration to the eventual Uruguay Round deal reached only in early 1995.

Therefore I conclude that APEC is moving very rapidly and very successfully. I further believe that it will achieve its goal before the target dates, not after. Every successful regional free trade agreement in the postwar period

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has achieved its goal much faster than the deadlines negotiated by the cautious governments. The European Union in the 1957 Treaty of Rome laid out a deliberate twelve-year program to eliminate tariffs. They did it in seven. Australia and New Zealand negotiated an agreement to liberalize in twelve years and did it in seven. The U.S.-Canada agreement has been implemented much faster than originally negotiated. It was for the same reason in every case: once the governments set the framework credibly, the private sector took over, invested to get into a competitive position by the steady state at the end of the implementation period, and thereby telescoped and escalated the whole process.

I would therefore suggest that APEC is going to be a major driver of world trade policy by having literally half the world move to free trade within the next 10-15 years.

Four Implications for Trilateral Countries

This has four major implications for the Trilateral world?

First, APEC has already eliminated the risk of a three-bloc world. A few years ago there was much *angst* about the possibility that the world would move to three competing blocs—one in North America, one in Asia, one in Europe. I always thought that was a mistake, but APEC has certainly terminated that risk. A two-bloc world may still emerge, but that is certainly less bad. A three-player game is the most dangerous of all.

Second is a point that Jusuf Wanandi made. A successful APEC would eliminate the risk of North-South conflict, at least in the economic area. There are huge differences in per capita income within APEC. The range between Japan's per capita income and Indonesia's is more than thirty-to-one. Contrast this with Europe, where it was about six- or seven-to-one, and within NAFTA? eight- or ten-to-one. Yet these countries are moving together to achieve a common goal, with a little different timetable for the developing countries

but with the same goal, the same starting date, the same sectoral coverage.

Third, APEC will probably be the catalyst for the next big round of global trade liberalization. APEC could clearly qualify under the GATT/WTO rules as a free trade agreement. It could declare itself a preferential area. But APEC does not want to do that. Right from the start, one of its key principles has been *open regionalism*. Every country in the region is committed to it. Already at the Seattle summit, the APEC initiatives were decisive in bringing the Uruguay Round to a successful conclusion. When I asked one of the chief European negotiators, a month after the Uruguay Round concluded, why after delaying for three years or more, Europe finally agreed, he said to me, "The decisive element was the APEC summit in Seattle, because it told us you had an alternative, and we did not." Already, APEC has been a driving force for global liberalization, and it wants to be such a force in the future as well. APEC will offer to extend its liberalization to the rest of the world. A few APEC countries might even do that unilaterally, but my strong guess is that APEC as a group will offer to generalize its liberalization to the rest of the global trading system on a reciprocal basis. In my view that's the right way to do it, because then you double the global benefits. That APEC offer, accounting for half the world, is an offer that will be very hard to refuse. Countries outside the group would not want to be discriminated against by half the world, including the United States and Japan. The Europeans wouldn't want it; other countries outside the group clearly would not want it. So it seems to me that when APEC begins its process and makes that offer, it will catalyze the next big effort for global liberalization.

In the May/June 1996 issue of *Foreign Affairs*, I note that over 60 percent of world trade now takes place within regional agreements that have already achieved free trade (like the European Union) or are en route (like NAFTA) or have declared they will do it (like

APEC and the Free Trade Area of the Americas). We have therefore already gone almost two-thirds of the way, and the obvious conclusion is to globalize free trade. Take the regional agreements, roll them together, and avoid the risks of conflict among regions. Then new preferential arrangements will not be needed. We can start the process at this year's WTO ministerial in Singapore, as APEC, having come to its agreement in Subic, goes down the road, so to speak, and makes these proposals at Singapore. It would be premature at Singapore to try to launch a global free trade initiative. But within the next two or three years, we should think in terms of holding the world's first global trade summit, drawing on the experience of the EU, of APEC, of the Miami summit in the Western Hemisphere. We should put those programs together, through a global trade summit, and come to an objective of global free trade by 2010. APEC can be a major catalyst for that.

The fourth and final implication of APEC is in the security area. Yusuf Wanandi also referred to that. APEC does not discuss security issues, but it has huge security implications—in a volatile region with a history of conflict and no previous institutional framework to prevent it. APEC provides a constructive institutional framework to engage China, Japan, and the region as a whole. (Incidentally, now that it's clear it will not be getting into the WTO any time soon, China has suddenly become energized in APEC. Last summer, about the time it became clear their WTO bid was not going to be accepted soon, China became quite active at APEC, announced a big trade liberalization package in Osaka, and has begun to see APEC at least as a half-way house.) As Jusuf Wanandi says, APEC helps keep the United States engaged in Asia, because of a high-level trade-off: The U.S. will stay involved in security terms; APEC will make sure that the region opens its markets in economic and investment terms.

* * *

In conclusion, we are now beginning the institutionalization of relations in this region, with APEC at the head. At the end of World War II, the world's focus was on Europe and the Atlantic. There was a spurt of creative institution-building at that time in that area. There were many skeptics then. People consider the Europeans homogeneous now, but they didn't look that way after three wars in a hundred years and a millenium of slaughtering each other. Yet what they have pulled off over the last fifty years is not only successful, but spectacular.

At the end of the Cold War, the world's focus has turned to Asia and the Pacific. We need a similar spurt of institution-building that will likewise build defenses against trade conflict, against military conflict, and for stability. Here, too, there are skeptics. My bet is that it will work. It has certainly begun, and is moving rapidly and successfully. This may well become one of the first institutional successes of the twenty-first century.

C. Fred Bergsten is Director of the Institute for International Economics, in Washington, D.C. He was Chairman of the APEC Eminent Persons Group throughout its existence in 1992-95.

... GLOBALIZE
FREE TRADE.
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AMONG REGIONS.

Japanese Manufacturing Forced to Change

HAVING LISTENED to Jusuf Wanandi and Fred Bergsten on where regional arrangements are and what we can expect of them, particularly of APEC, I have very little to add to that big picture—except a couple of comments.

We have several key players that play a very major role in the development of this region:

- One is *China*, that, if I may use a term like harnessing, has to be harnessed within collective regional economic arrangements. The potential that China has is so enormous. My worry is that, before we are ready to graduate out of many of the (mid-tech and some high-tech) industries that we have in developed countries, we will feel a massive impact from the coastal developed zone of China, directly or indirectly. This is a major challenge and a good enough reason for us to want to engage the Chinese in the regional arrangements.
- *Japan*, which so far has sort of represented Asia as the only developed Asian country, just cannot go on on our own. We have to be a part of collective regional economic arrangements.

For both of those needs the presence of the *United States* is critical. And there are the ASEAN countries, the *Asian NIEs*, and of course the *European Union*.

Now on the corporate level, Japanese companies have been very aggressively shifting their investment—particularly to Asia and particularly to China, for obvious reasons. The Japanese investment environment has become somewhat unkind not only to foreign friends, but

even for the Japanese. Certainly, Asia (and particularly China) is where big and bigger markets will be, and siting theory tells us you have to put your factories where the customers are. We also will be procuring offshore. That has already become a very important part of the corporate activities of many Japanese manufacturing companies. That's why the manufacturing sector in Japan has become more competitive, as compared to only five years ago. The high yen has helped us to take many drastic actions.

Because of the potential threat of competition, particularly from China but also from other areas, it is so absolutely important for the Trilateral countries to collect our forces to develop new industries and markets. This is no time for so-called techno-nationalism. We probably need to be a little more loose about the national security implications of some technologies. This is the time for techno-globalism. The United States, some Western European countries and Japan have great responsibility to really put these forces together in order to create new markets and new industries. Now this is happening in the United States, much more aggressively than in a country like Japan, but I think collectively Trilateral countries have to create bigger markets in new areas for us to shift some of our redundant labor into. At the same time we can open our markets to the inflow of the high-quality, high-tech, low-cost products and services from neighboring Asian countries.

Yotaro Kobayashi, who will become Japanese Chairman of the Trilateral Commission later in 1996, is Chairman and Chief Executive Officer of Fuji Xerox Co., Ltd.

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Growing European Involvement

AFTER THE PRESENTATIONS of my three colleagues, I shall address the same subject but from a different perspective—as a European and as an industrialist. I shall concentrate more on economic developments and give you some examples drawn from my personal experience at the head of the Solvay Group, which I have led since ten years and developed in Asia. Of course, the economic relationship cannot succeed without some political framework and I will address that briefly too.

First Asia-Europe Summit in Bangkok

On March 1-2, 1996, the first Asia-European Union summit meeting—ASEM—was held in

Bangkok with, on its agenda, a strong mutual desire and intention to facilitate economic relations and strengthen political cooperation between the two regions. This event raised at once hopes and scepticism. The hopes are that, after many years of purely bilateral cooperation, a decisive step can be made to promote trade and investment flows between the two regions. The scepticism, sometimes verging on derision, is from those who see in this meeting an occasion for pure rhetoric from the new and the old rich, hardly masking a paralyzing lack of unity of each group and many problems at home.

European Economic Involvement in Asia

Will Europe be as involved in the future in Asia as the United States and Japan? In order to try to answer that question, I have looked at a few figures for direct investment and for trade. I have used seven countries as "Asia": Singapore, Indonesia, Malaysia, the Phillipines, Thailand, Republic of Korea and China.

As far as direct investment is concerned (see Table 1), among the Trilateral entities, Japan has played and still plays a leading role with

THE HOPES ARE THAT... A DECISIVE STEP CAN BE MADE TO PROMOTE TRADE AND INVESTMENT FLOWS BETWEEN THE TWO REGIONS

TABLE 1
Foreign Direct Investment in Developing Asia*
(billions US\$)

	1980		1985		1993	
Japan	6.8	(25.8%)	11.6	(25.2%)	41.7	(20.1%)
European Union	4.6	(17.4%)	8.5	(18.5%)	27.5	(13.2%)
United States	3.7	(14.0%)	8.4	(18.2%)	26.4	(12.7%)
Trilateral Total	15.1	(57.3%)	28.4	(61.9%)	95.6	(46.0%)
All Countries	26.4	(100%)	45.9	(100%)	207.6	(100%)

*China, Republic of Korea, Singapore, Indonesia, Malaysia, Thailand, the Phillipines

Exchange rates: 1ECU = 1.39US\$ for 1980; 1ECU = 0.76US\$ for 1985; 1ECU = 1.17US\$ for 1993.

Source: UNCTAD, Division on Transnational Corporations and Investment, FDI database

TABLE 2
Trade Relations with Developing Asia*
(billions US\$)

	1984	1994
Japan		
exports to developing Asia	31.9	121.3
imports from developing Asia	43.6	72.4
European Union		
exports to developing Asia	15.3	67.5
imports from developing Asia	19.3	62.0
United States		
exports to developing Asia	23.0	75.4
imports from developing Asia	40.4	93.6

* China, Republic of Korea, Singapore, Indonesia, Malaysia, Thailand, the Philippines
Source: World Trade System, based on IMF data, updated in January 1996

\$41.7 billion invested in 1993 in these countries of Asia. The surprising figure is that the EU comes second with \$27.5 billion, a bit ahead of the United States with \$26.4 billion.

Amongst the countries in receipt of direct investment from all sources, Indonesia and China are the undisputed champions. European investors have shown a preference for Indonesia. China was far behind for the Europeans in 1993. But if I take European CEO discussions (as I live them every day and every week) and also recent announcements as criteria, I would guess that the figures for European investment in China will grow dramatically in 1996 and 1997.

If we look at exports to Asia—this “Asia” that I mentioned—of course they are still marked by the supremacy of Japan, then the United States, and then the EU (see Table 2). The figures for 1994 are \$67 billion for the European Union, \$75 billion for the United States, and \$121 billion for Japan. It is interesting to see that between Europe and that Asia, trade is very balanced in contrast to the great surplus run by Japan and the large deficit incurred by the United States.

Given those growing investment and trade relations, it is inevitable that Asia and Europe come to the conclusion that both need a closer cooperation at macro-economic and political levels. It is therefore not surprising that the European Union has established, in all of Asia, 20 delegations and offices to facilitate trade and investment—and even sometimes to coordinate the diplomatic offices of the 15 European Union members.

Solvay Group

I would like to add now some comments from my direct experience in Asia with the Solvay Group. We started in Asia only ten years ago. We are a European chemical and pharmaceutical group with \$9 billion in sales and 38,000 employees, and with two-thirds of our activity now in Europe and 23 percent in the Americas, mostly North America.

Our strategy is to develop our industrial as well as commercial presence in the fast-growing Asian region. We established a regional head office in Singapore ten years ago; and we have built operations successively in India, in Japan, in Korea, in Thailand, and, only one

... EUROPEAN
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year ago, in China. We have established, in the course of ten years, 30 different subsidiaries.

In each of the countries where we went, of course the situation was considerably different. Adapting to local habits, to local markets and to local regulation has been sometimes difficult. In most countries, we created joint ventures with local partners—we have ten different partners all over Asia—who helped us adapt locally and who were eager to develop our strong technologies. We never had difficulty finding good partners. We are associated with various groups: in South Korea, for instance, with Samsung; in Thailand, with Charoen Pokphand; in China, with public state companies.

For each operation we were rarely in profits before two or three years. It was easy for us to reach rapid sales growth, but difficult to attain high profits and return on investments.

Political consistency is a consideration of prime importance for investors, particularly, as in Solvay's case, for technology-intensive and capital-intensive industries. A reliable framework of laws and the protection of intellectual rights are important. The inconsistency of certain governments in those respects may act as a serious deterrent. Inconsistent trade policy is also a major difficulty: Thailand, for instance, had promised us ten years of tariff protection for building an infant industry; but scrapped half of it after five years, without any warning, overnight on 31 December 1994. Therefore, our present policy is to build new investments only if they will be competitive without any tariff. Trade barriers are looked upon by us as a temporary bonus for start up, but never as a permanent structure. Due to APEC and WTO pressures, we think and hope that Asia will become an open part of the global economy.

The biggest issue we face now is how to develop in China. There also we believe that tariffs will decrease. We have already two joint ventures and are negotiating three others. We are impressed, of course, by the size and the growth of the market, but also by the quality

of the public and private managers. Due to the concentration of power, the right choice of a partner seems to us even more important than in the rest of Asia.

Conclusions

1. European private investment and trade in Asia are developing very rapidly indeed and are becoming as big as the American, but still somewhat smaller than the Japanese.

2. European business needs some European political support. The Bangkok summit of March 1996 is a first step which will be deepened and enlarged in the coming months by lots of hard work and by a London summit in 1998. The economic issues are the priority, but other political issues such as human rights will not be absent. The dialogue between Asia and Europe will promote a deep cooperation, including culture and education. This dialogue should be conducted on the basis of mutual respect.

3. Contrary to the United States, Europe has no major military involvement in Asia. This can be looked at as a weakness for some industries, but as a strength for others where *politically* motivated ruptures of contracts can be avoided.

4. Due to their history and to their geopolitical ambitions, the three trilateral entities—Japan, the United States and Europe—have very different assets for developing economically in Asia. The European position is very different but equally strong.

Baron Daniel Janssen is Chairman of the Executive Committee of Solvay SA, based in Brussels.

EUROPEAN
BUSINESS NEEDS
SOME EUROPEAN
POLITICAL
SUPPORT.

SECTION 3
MOVING TOWARD GREATER
EXCHANGE RATE STABILITY

Circulated as background for this Vancouver session was a speech by Paul Volcker entitled "The Quest for Exchange Rate Stability: Realistic or Quixotic?"—delivered in London in November 1995 as the 50th anniversary Stamp Lecture. Mr. Volcker was unexpectedly unable to be in Vancouver. Fred Bergsten took his place as the opening speaker.

C. FRED BERGSTEN

The Volcker Target Zone Proposal

...HIS STRONG
POSITION ON
THIS IS REALLY
THE CENTER-
PIECE OF THE
STORY.

AN INTERVIEWER recently asked me who my heroes are. At the top of the list I put Paul Volcker. He's the person who brought inflation under control in the United States. He, more than anyone else, contributed to solving the Third World debt crisis in the 1980s. I think he is a real contemporary hero.

For our purposes today, it's perhaps more important that Paul Volcker has had more direct experience with international economic cooperation than any other living person. I say that with possible apologies to Hans Tietmeyer and Jean-Claude Trichet, but it's probably true. The early 1960s, when Paul Volcker was deputy to Bob Roosa at the U.S. Treasury, was the period in which the G-10, the GAB, and the swap networks were created. When Paul Volcker was Treasury Under-Secretary in the late 1960s and early 1970s, he was at the center of efforts to address the breakdown of Bretton Woods, two big currency realignments, and the failed

effort to negotiate a revision of the monetary system. In the late '70s when he was at the New York Fed, he participated actively in the effort to stabilize the dollar. And then, of course, as Chairman of the Fed, he was deeply involved in all of the cooperation efforts in the mid-1980s—in particular, the 1985 Plaza Agreement and the 1987 Louvre Accord.

So for 35 years, Paul Volcker has been in the midst of the issues that we talk about today. It is therefore quite significant that someone with such enormous authority has now come to take such a strong position in favor of international monetary reform. Unlike other advocates of that effort, no one could accuse Paul Volcker of being a radical. He comes to this position with experience over a period of decades and sober personal reflection.

Paul Volcker's recommendations, as set out in his Stamp Lecture circulated before this meeting, now go far beyond the proposals of his Bretton Woods Commission as recently as 1994, and I'll talk about some of the differences. But his strong position on this is really the centerpiece of the story. He is now explicitly changing some of his own earlier views and making some very specific proposals for improving the international monetary system.

Paul Volcker is recommending a system of target zones for the major currencies.* He very explicitly makes four suggestions:

- The first is that the major countries "should reach a consensus on broadly appropriate equilibrium values for their curren-

*That's particularly important for this Trilateral Commission. Paul Volcker's proposal is not for the world as a whole, not for the developing countries, not even for smaller industrial countries, but for the big industrial countries that are the members of the G-7. All the members of the G-7 are, of course, Trilateral countries. This is part of a bigger issue. I've just finished a book which argues very strongly that the G-7 as a whole has declined very sharply in its ability to deal with issues—even in its willingness to deal with issues—and that doing something along Paul Volcker's lines would be part of the remedy. The Commission might want to talk at a subsequent meeting about the decline of the G-7 as an effective steering committee for the international monetary system.

cies...to be expressed as ranges, say, of plus or minus 10 percent around a central point."

- Second, the participating countries would have to "jointly defend the indicated range with intervention, on a substantial scale if necessary. Such intervention would be required at the margins, but could be tactically desirable well within the limits" as well. So the second point is: defend the ranges with intervention, as necessary.
- Third, the participating countries would have to be "prepared to modify their monetary policies in support of the exchange rate objective." One of the central themes of Paul Volcker's Stamp Lecture is how he, with all his experience in this field, believes that the monetary authorities should be prepared to follow the exchange rate signal and that the result would be better monetary policy in terms of the domestic economic objectives of the participating countries. I'll come back to that point.
- The fourth point in Paul Volcker's proposal is for the IMF to be centrally involved in the whole operation, prepared at its own initiative to propose appropriate courses of action. Somebody representing the views of the world and the system as a whole has to play a central role.

What Paul Volcker has proposed in a way is not all that dramatic; it's evolutionary. But it would represent a new international monetary regime—a system of target zones.

A Middle Course between Fixed Rates and Freely Floating Rates

In interpreting this proposal, there are three key points to keep in mind. The first is that neither Paul Volcker nor anybody else who advocates this approach is trying to return to a fixed-rate regime. The Bretton Woods system failed; the EMS failed as recently as 1992-93. We know that rigidly fixed exchange rates do not work, and nobody who advocates target zones is trying to restore fixed

rates. In fact, one should see target zones as an alternative means of managing a system of flexible rates. Because the bands are quite wide—plus or minus ten percent—exchange rates would float most of the time, just like they do now, but there would be the obligation to limit the extent of that fluctuation around the notional midpoints.

Everybody agrees that our countries cannot let exchange rates float freely either. That too has failed. When the pure experiment was tried in the early 1980s—during the Reagan Administration—the dollar went to levels that were the furthest out-of-line for any major currency in history, leading to huge U.S. deficits, converting the United States into the world's largest debtor country, generating enormous trade protectionist pressures, setting up the risk of a "hard landing" financially: all the evils of misaligned currencies brought to their most extreme form in modern history.

So we know that rigidly fixed exchange rates do not work, and we know that freely flexible exchange rates do not work. Therefore, the world has been groping for a middle course.

Target Zones More Effective than Ad Hoc, Episodic Intervention

We know that governments don't want to let exchange rates float freely. They've intervened massively (they did so as recently as a year ago to support the dollar after it had fallen much too far against the yen and other currencies). So the issue is not whether governments should intervene. The issue is: what is the most effective technique for intervention? And the argument here is: target zones would be a more effective way to manage a system of flexible exchange rates than the ad hoc, episodic intervention that now takes place. On that Paul Volcker is surely right.

Under the ad hoc system, everybody agrees that huge errors have been made. When the yen went to 80 a year ago, everybody said that the yen had become far too strong and

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was way out of line with the underlying fundamentals. Everybody agreed that the dollar in the mid-1980s was greatly overvalued. Most people agreed that the yen in the late 1980s weakened far too much, creating subsequent huge surpluses in Japan.

The goal of the target zone system is not to eliminate day-to-day volatility. It does not try to manage rates on a day-to-day basis. It simply tries to avoid the very large misalignments—the large and prolonged moves away from underlying equilibrium levels—which don't happen every day or even every year, but happen frequently enough to cause huge economic problems.

So the second point is that target zones would be more effective than the present ad hoc, episodic, highly personalized system of managing flexible rates, which is grossly inadequate.

Monetary Policy and Exchange Rates

The third point, and it is a crucial one, is Paul Volcker's view that it is desirable to devote monetary policy to the exchange rate in those infrequent cases when exchange rates move so far as to be at the edges of the zones. There have been a number of episodes in his personal experience in which governments ignored the exchange rate signal and made a huge mistake. We know governments like to avoid any constraints on their behavior. We know they like to stay flexible. We know that even central banks like to stay flexible. Paul Volcker's argument is that they maintained the flexibility to make big errors. Had they followed the exchange rate signal when it went way out of line, they would have pursued policies that were more sound purely in terms of their domestic objectives. In the early 1970s when Bretton Woods broke down, the United States should have tightened money earlier than it did when the dollar was falling sharply. When the dollar went down sharply in the late 1970s, the United States should have tightened earlier. We finally did so, but only when the dollar collapsed.

In the first half of the 1980s, the exchange rate signal called for tighter U.S. fiscal policy to avoid that huge overvaluation of the dollar. Paul Volcker laments the failure of both the United States and Japan to change monetary policy to support the Louvre Agreement more effectively in the late 1980s.

Paul Volcker has thus made a very significant and substantial argument that all of our countries would be better placed to give the exchange rate a bigger role in the management of our domestic economic policy. This need not occur on a day-to-day basis but, when an exchange rate moves to the edge of the band (ten percent or more away from its equilibrium level), then you are in trouble if you do not respond.

An Indirect Path to Better Macroeconomic Policy Coordination

Another major policy point that Paul Volcker makes with respect to macroeconomic policy has to do with the relationship between exchange rate commitments and policy coordination among countries. Those of you who follow this issue know that Paul Volcker's Bretton Woods Commission did favor a target zone system, but said we should only move to that system once countries already had an effective mechanism for coordinating their domestic monetary and even fiscal policies.

On further reflection Paul Volcker has called that view "pious rhetoric"—because it will never happen. There is no historic example, even in Europe, of countries agreeing in a direct, explicit way to coordinate their macroeconomic policies. By contrast, there are at least three good historic examples of countries agreeing to exchange rate system commitments—and in defending those exchange rate objectives they were induced in turn to coordinate their domestic policies, particularly their monetary policies. That was true (for better or worse) under the old gold standard, it was true to an extent under the Bretton Woods system in the 1960s, and it

has been true to a large extent in the European Monetary System over the last 15 years.

Paul Volcker therefore concludes that the way to get better policy coordination in the Trilateral world is to agree to an exchange rate system. The currency commitment in turn will imply cooperation on broader policy goals where necessary to maintain the currency commitment. In other words, if policy coordination is done in an indirect, inductive way (rather than frontally), the chances are much better for success. Again, coming from Paul Volcker, this strikes me as a very important argument that cannot be ignored.

Can Governments Identify Equilibrium Rates?

The final question in all this, of course, is: is it practical? Paul Volcker comes to the conclusion: yes, resoundingly so. It is practical.

There are two very tough operational questions that I've glossed over so far, and that have to be faced squarely. First, can governments (or economists or anybody) accurately identify the equilibrium rates on which the zones would be based? That is the crucial question. We've published a lot on this question at my institute; Paul Volcker has studied it. We all feel that, within the ranges we're talking about, the answer is yes. If a country was trying to pinpoint an appropriate fixed rate with narrow margins, I would have little confidence that could be done. But when we're talking about plus or minus ten percent around the notional midpoint, then I think there is an enormous amount of evidence that countries can in fact hit the target. Authorities have to keep the ranges under constant surveillance. If there's a German unification shock, if there's a big oil shock, or if some other big event happens, they must be ready to change the ranges—just as parities are changed when they're clearly out of line. Those conditions do have to be met—no one would try to hide that. But it is doable. And again, given the results with the current

ad hoc, episodic, unstructured system, it ought to be tried.

Start with the Yen-Dollar Rate

At the end of his lecture, Paul Volcker suggested some ways to implement a system of this type. It was already tried in a modest way under the label "reference ranges" in the Louvre Accord in 1987. It was installed not quite along the lines Paul Volcker is talking about here—it didn't meet some of the criteria—and it was put in place prematurely, before the dollar had completed the correction set out in the Plaza Agreement. So it could not be sustained for long.

For Paul Volcker's current argument, it is particularly important that the Louvre agreement for reference ranges was begun not by the G-7, but by the G-2. Treasury Secretary James Baker and Minister of Finance Kiichi Miyazawa agreed in the fall of 1986 to a yen-dollar target zone agreement. They actually tried it. The Europeans joined it four months later at the Louvre and the system existed for about a year. What Paul Volcker has suggested is trying that again.

Given that Europe is heavily engaged in its own internal monetary union negotiation, now may not be the moment to create a global system—though obviously it would be preferable. Paul Volcker is suggesting we start out with the dollar-yen rate. I think the argument for that is fairly strong.

The dollar-yen rate is probably the most important in the world with respect to foreign trade because of its major effect on trade between the two biggest economies. And the dollar-yen rate has gyrated wildly for the last 25 years. If you trace the intensity of U.S.-Japan trade friction, there is one clear causal variable that drives it from a steady state of some anxiety to real tension, real crises—and that is the exchange rate. Every time the dollar gets way overvalued or the yen gets way undervalued, or more likely both, the Japanese surplus jumps, the American deficit jumps, and trade tension between the two increases enormously. It would

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be of immense value for the two countries—and the world system, which is so affected by U.S.-Japan trade problems—if those difficulties could be reduced.

The other key point is that exchange rate adjustment between the United States and Japan has worked. After the Plaza Agreement, when the dollar declined back to the level of 1980 and the yen strengthened sharply, the American current account deficit dropped from 4 percent of our GDP in 1987 to under 1 percent in 1991. The Japanese surplus dropped from over 4 percent of their GDP in 1986 to 1.2 percent in 1990. The currency adjustments worked—just like a textbook case. People say, “Ah, these big currency changes and imbalances still exist.” That ignores what happened after 1987. The G-7—the Japanese and the American Treasury in particular—went to sleep at the switch again, and let the yen weaken by fully one-third in 1989 (despite continued improvement of Japan’s competitiveness). What happened? Just as the textbook suggests, the Japanese surplus jumped again and American protectionist pressure hit like a ton of bricks (with effects for the trading system). Then, inevitably, the yen appreciated with enormous speed from 1993 to 1994 and trashed the Japanese economy, further extending and deepening its recession. In other words, Japan was a huge double-loser from that weakening of the yen in the late 1980s. It faced tremendous trade pressure; and then it saw a huge appreciation that deepened its recession. The whole system was destabilized.

The bottom line is, if the yen-dollar rate could have been stabilized a year-and-a-half ago when the yen first went to 100, we would have avoided last year’s crisis. The yen would not have risen to 80. That could have been avoided if government guidance to the markets had been accurate (and believed to be such) and intervention had been maintained to defend the zones credibly. Private capital would then have worked in favor of stability, not against it.

Conclusion

Paul Volcker is arguing—I think persuasively—that the international monetary system of today is grossly inadequate. Furthermore, the G-7 stewardship of it is grossly inadequate. The extremes have been tried. Fixed rates don’t work; freely flexible rates don’t work. The world has been groping for a middle course for the last 25 years, since the breakdown of Bretton Woods. The Europeans have found a way that they feel comfortable with and are working to perfect within their region. Why can’t the world try to do the same thing, particularly when economic differences (measured by inflation rates, growth rates and the like) are less between the United States, Japan and Germany (for a European average) than they are within Europe itself? The objective conditions are there. Paul Volcker suggests we try it.

C. Fred Bergsten is Director of the Institute for International Economics, in Washington, D.C. and former U.S. Assistant Secretary of the Treasury for International Affairs.

Greater Stability is Vital

SINCE JULY 1986, when I became the Finance Minister, Paul Volcker and I often discussed the need for exchange rate stability as colleagues in the G-7 meetings. The discussion continued when I became the Prime Minister in 1991. With Fred Bergsten I have been engaged in discussion on the subject many times since we first met at the time of the creation of this Trilateral Commission in Pocantico in 1972.

The Bitter Experiences of a Practical Politician

During these years I had the very bitter experience of the rapid appreciation of the yen following the Plaza Agreement of September 1985, which almost devastated the Japanese economy. The yen, which stood at 242 yen to the dollar on the day of the Plaza Agreement, started to rise very rapidly—beyond anybody's expectation—and reached 200 yen at the end of the year, in just three months. It kept going up, to the 150s by the summer of 1986—a 40 percent appreciation in ten months—when I became the Finance Minister.

This sudden and unprecedented rise of their currency drove Japanese businesses to move their production offshore on a very large scale. Those were the days when business executives would discuss their moving plans, only to find out, when they broke up for lunch, that the yen rose another three yen against the dollar. In the evening they would meet me, the Finance Minister, at the teahouse; and I know they were very, very angry at me, at this do-nothing Finance Minister.

For my part, it was very difficult to explain what I actually did during the day. In the morning I had instructed the relevant officials to intervene massively in the market, only to be

told in the evening by the officials that, while they intervened to buy \$2 billion, the money really was sucked into a kind of black hole, and the yen rose another three yen. I certainly would not tell this sad story to my businessmen friends at the teahouse, because I really squandered the taxpayers' money. To buy \$2 billion dollars knowing that the dollar would devalue was a very scandalous thing. But that was what I really experienced myself.

Now besides these repeated interventions, as Finance Minister I spent a lot for public works and tax reductions. As a result, huge excessive liquidity was created which gradually pushed up the prices of stocks and real estate. Business confidence was restored after a year, followed by a boom. When Black Monday came on Wall Street in October 1987, Japan was confident that it could hold, and was prepared if necessary to extend helping hands.

The boom, however, ended in 1990, and the bust came inevitably. The Japanese economy is still suffering today. As Japanese businesses moved their production facilities to ASEAN countries, to NIEs, and later on to China, when faced with this steep yen appreciation, a very rapid industrialization of these countries started. Private investment from Japan to these countries in the nine years since 1986 is about three times the accumulated total of the preceeding 35 years. Thailand got 8.5 times as much, Malaysia 4.6 times. That really explained the extent of the rapid outflow of yen from Japan to these countries.

While Paul Volcker spoke in London last November from his experience as the most respected administrator of the key currency, I just mention my personal experience as a practical politician.

Time to Try Specific Target Ranges Again

Looking back, we shifted to a floating rate system in February 1973. Since then, capital flows among major industrialized economies have grown exponentially both in volume and in their degree of freedom. Against this background, going back to a fixed-rate system does

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not seem to be feasible or practical, as Paul Volcker rightly pointed out in his paper.

We G-7 countries must try again what is now remembered as the Louvre Accord. Paul Volcker was there, I was there, in February 1987. What we intended to achieve then was to create a situation in which major countries agree on policy cooperation and on close coordination in currency markets with specific target ranges in mind. The Accord did not bear fruit. My honest analysis is that the yen at that time had more momentum than most of us wanted to believe. On the Louvre day the yen stood at 154 yen to the dollar. In two months it rose to 137.

Now, eight or nine years after the Louvre Accord, a new attempt is being tried and implemented, very quietly now, by authorities of some of our governments. We had a G-7 meeting in Washington in April of last year. That was immediately after the yen hit the new high of 79 yen—a scandalous rise of the yen, which discouraged business confidence which was just about to rise. That shattered Japanese confidence for the rest of 1995 (together with the Kobe earthquake and Aum Shinrikyo). The April 1995 G-7 meeting agreed to bring on an “orderly reversal” of the movements of some major currencies—I’m quoting from their statement—and a kind of framework for policy coordination has been tacitly established for that purpose among major industrialized countries. Since the G-7 meeting in April of last year, we are watching the situation. It’s more or less calm now. The yen is now around 106-107 to the dollar, as distinct from 79 at about this time last year.

Yen Debt of Other Asian Countries

In Asia, as I mentioned earlier, many countries are now on the path of rapid industrialization, and some exchange rate accommodation is becoming their vital concern. While their export proceeds are mostly in dollars, many of them are in debt to Japan in yen, as a result of economic cooperation loans from Japan in the preceding decades. The rapid

appreciation of the yen during this time makes their repayment of yen loans very difficult. They would have to repay almost three times what they once received, due to the yen’s appreciation. This motivated these nations to meet in Kyoto in March of this year for the APEC Finance Ministers’ conference. A major item on the agenda of this Kyoto conference was the effects of exchange rate movements on trade and investment of these countries. It will not be long before some kind of arrangement will be worked out among these countries in East Asia.

Kiichi Miyazawa is Japanese Chairman (Acting) of the Trilateral Commission. A Member of the Diet, he was Japan’s Prime Minister in 1991-93.

Informal Cooperation is Better

EVERYBODY SHARES Paul Volcker's concerns about volatility and misalignments in the exchange markets and their repercussions on the real economy, described by both Fred Bergsten and Kiichi Miyazawa. German industry has been hit time and again, and has had to cope with periodic bursts of appreciation of the deutschmark. Stable and appropriate exchange rates among major industrialized countries are doubtless better than the opposite. But how do we achieve this? And what are the costs?

Inevitable Political Constraints

It is impossible to have, simultaneously, capital mobility, fixed exchange rates and sovereign national monetary policies in all countries. One of the three will have to yield. In the case of the ERM in Europe, there is a clear division of labor. The issuer of the anchor currency, the Bundesbank, looks after domestic price stability. The others peg their exchange rates to the deutschmark. But even for medium-sized economies in Europe, giving up monetary sovereignty in this way is politically not always easy to swallow. On a more global scale, this is far more difficult to achieve. The larger a country, the more economic policy is driven by domestic considerations, whether we like it or not.

Pegging exchange rates would not only involve sacrificing monetary sovereignty, but also independence in other areas, because G-3 exchange rates are not only driven by interest rates. I cannot see national parliaments (including the U.S. Congress) willing to accept compulsory mechanisms and subordinate fiscal policy to exchange rate constraints.

Experience, so far at least, does not point to that direction. It is likely that domestic policy-makers will look to monetary policy alone to smooth exchange rate fluctuations.

Now Paul Volcker and Fred Bergsten speak only of wide bands (of 10-15 percent) to be defended. Don't governments and central banks already today attach importance to the exchange rate when pursuing their policies? Pragmatic central banks like the Bundesbank, for example, take exchange rates into consideration, maybe more than they presently admit. But there is a difference between accepting that exchange rates do influence the degree of tightness of a given set of interest rates and all-out commitments to defend certain target zones. In a modern paper money standard, central banks depend almost entirely on their credibility. They should thus only shoulder obligations they can truly master, and I doubt that defending target ranges is among them.

Who Should Adjust?

Furthermore, Paul Volcker implicitly assumes that having found appropriate exchange rates means maintaining them. In the world of low inflation that may look like a safe bet. But what if there is a need for change in real exchange rates because two or more economies take different roads? Do governments renegotiate and publish their findings? What if they end up bickering; what if an election campaign is underway; what if divergent opinions as to the appropriate answers surface? This may cause more harm than any previous or subsequent benefits. From our ERM experience we know that financial markets sometimes sense a need for change earlier than some governments are willing to admit. Experience teaches us it is wishful thinking that exchange rate issues will not be hijacked by politics for whatever purpose.

But the truly controversial issue in any legal or just de facto fixed-rate system is: who is the one who should shoulder the burden for adjustment? Just as two decades ago, we would still today debate the issue of which country (or

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group of countries) should adapt its policies—the one with the lower growth rate or the one with the higher inflation rate? Should countries with current account deficits save more and spend less or should those with surpluses reflate (to use a word from “G-7 speak”)?

Informal Cooperation is Better

My own impression is that the scales have tilted somewhat toward stability, when we discuss the issue of sustainable and non-inflationary growth these days. The substantial reduction in inflation rates in most industrial countries, compared with ten years ago, is probably the single most important achievement of international cooperation.

But all the same, even today, this cooperation is all about arriving at acceptable solutions by using sensible political judgment. The less G-7 summits or ministerial meetings talk about it in public, the better off we are. Maybe the cooperation among major industrial nations in the area of exchange rates has meanwhile improved anyway. As much as I agree that we have seen quite a bit of overshooting and volatility in the exchange markets over the past two decades, more calm has been restored, by and large, since last summer. There seems to be an increased awareness among the G-3 countries and beyond about the fragility of the present economic upswing. Even U.S. authorities now accept that exchange rate swings are not zero-sum games between the countries involved. Not every yen's worth of depreciation of the dollar is a free lunch if the other side desperately needs a break and is close to collapse.

I doubt there is much to gain from formalizing this kind of informal and behind-the-scenes approach. Unlike Paul Volcker I see less merit in Louvre-type of arrangements. The present Japanese problems go straight back to the expansionary straitjacket which the U.S. authorities managed to put Japanese monetary policy into after the Plaza and Louvre agreements.

Paul Volcker and I may agree on the merits of less volatile exchange rates, but I have little faith in governments and central banks'

ability to manage this properly once it appears on the formal political agenda. Paul Volcker says at the end of his lecture: without trying we will never know. I think we have tried already and did not fare very well. Again, to avoid misunderstandings and confusion, I do endorse informal and discreet cooperation among treasuries and central banks, including professionally managed intervention now and then, in order to counter misalignments in the exchange markets.

Otto Graf Lambsdorff, European Chairman of the Trilateral Commission, is a Member of the German Bundestag and former Federal Minister of Economy.

SECTION 4
MAINTAINING ENERGY SECURITY
IN A GLOBAL CONTEXT

The Vancouver meeting discussed a draft report by William F. Martin, Ryukichi Imai and Helga Steeg entitled Maintaining Energy Security in a Global Context. The following are excerpts from the final chapter of the published report.

WILLIAM F. MARTIN
RYUKICHI IMAI
HELGA STEEG

Summary of Policy Conclusions

FOR POLICYMAKERS in Trilateral countries, maintaining energy security has three faces. The first involves limiting the world economy's vulnerability to disruption as dependence rises on oil imports from an unstable Persian Gulf region. The second involves more broadly assuring the reasonably smooth functioning of the international energy system over time—so that supply is provided for rising demand at reasonable prices. The third face of energy security is the energy-related environmental challenge. Policymakers need to help steer the evolution of the international energy system over time to keep it within the constraints of sustainable development. The policy conclusions which follow begin with the first face of energy security and proceed to the third.

1. For any policymaker who remembers the enormous disruptions associated with the oil shocks of the 1970s, the most striking aspect of energy forecasts out to 2010 is the substantial rise in the percentage of world oil supplies coming from the Persian Gulf exporters—

back to the levels of the early 1970s which helped set the stage for those earlier oil shocks.

2. The likely reemergence of such substantial dependence on Persian Gulf exporters is a serious, ongoing concern with important policy implications for Trilateral countries. The Trilateral countries must maintain in active working order the arrangements for coordinated responses to emergencies evolved in the framework of the IEA since the first oil shock, refining these arrangements to fit changing circumstances.... The rise in dependence on the Gulf exporters will reinforce the importance of security in the Gulf. While the Arab-Israeli peace process has made great steps forward since the early 1970s, some key regimes may be threatened by internal collapse and some governments may present threats to key neighbors....

3. National energy policies of Trilateral countries will vary according to national circumstances and objectives, but in their own ways can slow the rise in dependence on the swing producers in the Persian Gulf through encouraging the development of diverse additional supplies, greater efficiency in energy use, and new energy technologies....

4. The trend toward greater market orientation in Trilateral energy policies is positive, though still somewhat experimental. The extent of market orientation varies among countries, though the trend is in the same direction....

5. The continuing implementation of market-oriented reforms in Russia is critical for expanding Russia's contribution to world energy supplies and for Russia's energy resources to become a major contributor to the general welfare of the country....

6. The optimal outcome in Central Asia and the Caucasus will be the development of multiple pipeline routes. Multiple pipelines will not only enhance the security of these Newly Independent States and the export of their substantial energy resources to international markets, but will introduce greater competition and result in lower costs over time....

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SECTION 5
GLOBALIZATION AND
TRILATERAL LABOR MARKETS

The Vancouver meeting discussed a draft report by Niels Thygesen, Yutaka Kosai and Robert Z. Lawrence entitled Globalization and Trilateral Labor Markets: Evidence and Implications. The following are excerpts from the final chapter of the published report.

NIELS THYGESSEN
YUTAKA KOSAI
ROBERT Z. LAWRENCE

Conclusions and Policy Implications

OUR SURVEY has revealed similarities and differences among Trilateral countries. Throughout the Trilateral countries there is concern about labor market performance and the role of globalization. It is striking that there are also noteworthy contrasts in labor market performance and patterns of trade with developing countries.

- The United States has experienced growing wage inequality, particularly in the 1980s, and sustained slow growth in average wages, but relatively low rates of unemployment. Indeed, the United States is presently at virtually full employment. America's trade patterns with developing countries are highly differentiated along lines of skill and education, i.e. American exports to developed economies are concentrated in industries which employ more highly educated workers, and the United States has experienced a growing trade deficit in manufactured goods with developing countries since the early 1980s. By contrast,

7. Energy use is growing particularly strongly in the rapidly industrializing countries of Asia. The Trilateral countries, and the broad multilateral institutions in which our countries are involved, can seek to improve global energy security by participating in this economic growth in ways that serve energy security objectives. One interest shared by Trilateral countries and rapidly industrializing countries is that this growth be as energy-efficient as possible....

8. Although the expansion of nuclear power generating capacity has dramatically slowed in North America and Europe, expansion continues in Japan and developing Asia. North America and Europe may turn back to expansion of this energy source in the period after 2010.... The greatest contribution of nuclear power to energy security may be in the context of long-term sustainable development, should the growth of fossil fuel emissions need to be significantly curtailed....

9. The third face of energy security, the "sustainable development" face, will continue to be of considerable salience in the energy policy debates in our countries....

10. Maintaining energy security in a global context is a broad foreign policy challenge. It can only be accomplished by the Trilateral countries working together, providing constructive leadership which takes into account the needs of the wider international system—the underlying idea that drives the Trilateral Commission. The Trilateral countries cannot accomplish the maintenance of energy security on their own, but it will only be accomplished if the Trilateral countries provide constructive leadership for the wider effort. National energy policies of Trilateral countries will vary according to national circumstances and objectives, but can and should contribute to collective needs.

...CONSTRUCTIVE
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American imports from developed countries are more concentrated in industries such as automobiles and steel in which workers earn premium wages.

- In Japan, particularly recently, there has been no significant trend towards widening income inequalities. If anything there has been in recent years a slight tendency towards increasing equality accompanied by considerable disguised unemployment and rising average wages. The Japanese are also concerned about international competition, but the concern reflects the problem of being squeezed out of manufacturing activities that are increasingly undertaken by the Asian NIEs and the difficulties of moving into the industries of the future. Unlike the United States where premium wages are to be found in the highly concentrated manufacturing industries, in Japan these premiums are to be found in sectors sheltered from international trade, such as utilities. Japan's trade with developing countries is less distinctly differentiated along the lines of skill than the United States. As a result, an expansion in trade with developing countries has relatively weaker effects on wage inequality than is the case in the United States. However, since on-the-job training accounts for a much higher proportion of skills acquisition in Japan than in the United States, occupational categories appear to reflect differences more sharply than those based on educational attainment.
- In Europe the concerns relate to high rates of unemployment particularly among workers with little skill or education. There is by contrast little evidence of increasing inequality—with the exception of the United Kingdom—or of a failure of average wages to grow. Europe's trade with the developing countries is relatively small and exports of manufactures exceed imports, albeit by a shrinking margin.

Despite these differences, the overall role played by trade with developing countries seems to have been relatively small in all Trilateral countries....

Would the conclusion be greatly changed if one tries to look ahead as major new actors with very large populations and even lower cost levels enter the global trading system? We regard this as unlikely....

There is clearly a discrepancy of major proportions between the alarmist views often expressed in the public debate and the conclusions of most economic analyses, including our study. It remains a major task for economists and the policy-makers whom they advise to explain carefully and patiently that there is an important exaggeration in the proportions perceived in the public debate. The most fruitful line to take in this effort is not to deny there is a problem—a process of trade expansion does create both losers and winners—but to explain why efforts at correcting growing inequalities in the Trilateral countries should not be directed in any significant way towards restraining the growth of trade and foreign direct investment. Regardless of whether these flows in an increasingly globalized economy are responsible for only a minimal or a small, but still significant part of the deterioration of the relative position of less-skilled labor, it would be a mistake to attempt to slow down the process of globalization. There are more efficient ways of dealing with the implications of this process for the labor markets in the Trilateral countries....

In the long run the most efficient course of action is to upgrade the skills of the work force, hence gradually shifting the relative supply of skilled and less-skilled. Such a process has long been underway, but it has not kept pace with the shift in demand towards the skilled.

In the shorter run the focus has to be also on measures which change the relative price of skilled versus unskilled labor, in other words enlarge the scope for wage differentiation, since this will shift the demand for labor towards the less-skilled. But in order to preserve accept-

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able consumption possibilities for the latter, greater differentiation of wages should be accompanied by changes in tax and transfer systems which assure that the less-skilled are not left too far behind in the evolution of their disposable incomes...

The challenge to the Trilateral countries does not lie therefore in seeking any direct response to the increasingly vigorous competition in a globalized economy by simply trying to limit active participation in it. Such a course of action would reduce welfare rather than enhance it. Rather, the task is to strengthen the capacity to adjust to change while both preserving the considerable net benefits of free trade and investment flows and temporarily compensating those who are initially most unfavorably affected by them.

SECTION 6 CANADA'S POLITICAL CHALLENGES

L. R. WILSON

Quebec and the Canadian Federation

LESS THAN SIX MONTHS ago, Canada came dangerously close to being plunged into a political crisis. The separatists in Quebec fell short by a mere 50,000 votes—or about one percent of the ballots cast—of gaining majority approval for a proposal to negotiate the separation of Quebec from Canada. To elicit maximum support, the proposal, as outlined, assured Quebecers that, separation notwithstanding, they would nevertheless be able to retain their Canadian passports and the Canadian currency. Some fifteen years earlier, a similar referendum also failed, but by a much more comfortable margin.

I will try to deal with two questions: First, how did Canada come to this? And, more important, what are the chances that the separatists, having missed by so little in 1995, may succeed the next time? Similar questions have been perplexing Canadians for generations—they do not give rise to easy answers. However, I shall attempt a brief summary, from my own perspective—that of an English Canadian born in Ontario and now living and working in Quebec.

How Did Canada Come to This?

The separatist movement in Quebec has to be understood in a context that stretches back almost four centuries to the founding of New France. Four hundred years of continuous francophone occupation of a homeland, equipped with its own set of unique institutions, has created, *de facto*, a distinct society within the

anglophone sea of North America.

At the deepest level, therefore, we are dealing with a powerful sense of *national identity*. The *Quebec* vision of Canada is a vision of two founding nations—French and English—within the bosom of a single state. The vision *outside Quebec* tends to be of an English Canada with a French minority, albeit sizeable and concentrated in one province. As Michael Ignatieff, a Canadian, writes in a recent book on nationalism: "The Canadian federation's essential problem has always been that francophone Quebecois identify Quebec as their nation, and Canada as their state, while English-speaking Canadians identify Canada both as their nation and as their state."

Moreover, the Quebec vision tends to be interpreted by Canadians outside Quebec as a claim by Quebec for special privileges. As other parts of our country—particularly Ontario and the Western provinces of Alberta and British Columbia—have grown both in economic weight and population, the anxiety of Quebecers to preserve their own institutions and their position in the federation has increased.

The Quebec separatist movement is seen as a conundrum by almost all Canadians outside Quebec. Why would Quebec want to leave one of the world's most successful and peaceful countries, especially since Quebec's language and culture are guaranteed by constitutional and other legal and traditional assurances that in many cases date back more than two centuries?

Well, in Quebec, we are dealing with the *emotions* of ethnic/linguistic nationalism as well as with *concerns* about the role of the national government. These concerns were exacerbated during the 1960s and '70s by federal government incursions aimed at establishing national standards in certain areas of provincial jurisdiction, such as health and welfare.

However, it is important to emphasize that Quebec separatism does *not* derive from the specific grievances of a suppressed population. Rather, the separatist movement in Quebec is

an expression of a mixture of national pride and insecurity that has ebbed and flowed, literally for centuries.

The events of last October have to be understood in this context. What made that encounter so hair-raising is that the federalist forces in the Quebec referendum were so confident of victory that they virtually went to sleep right up until the last few weeks of the campaign. It was the sudden entry of Lucien Bouchard—whose charismatic rhetoric evoked the roots of Quebec nationalism—that turned the separatist campaign completely around to come within a whisker of its goal.

Genuine Cause for Concern

Canada is now in the throes of post-referendum blues. The mood is somber, even brittle, in the wake of a verdict which nobody really won and which settled nothing. There is a profound sense of frustration which permeates the debate because there is no straightforward solution—certainly no consensus on *how* or *who* may bring us to a solution. Frankly, most Canadians are weary of what has been called our "neverendum." But there is a reluctant recognition that, having settled nothing, we can't escape another round in our never-ending constitutional struggle.

In my opinion, there is genuine cause to be concerned. For example, the mood in the rest of Canada lies somewhere between concerned and fed up—certainly not a prescription for compromise. Efforts to accommodate Quebec are perceived in some quarters as appeasement. On the other hand, efforts to take a firm position with Quebec—by stating, for example, that if Canada is divisible, so is Quebec—are deeply resented by the great majority of francophone Quebecers, both separatists and federalists alike. In this regard, one of the real emotional flash points is the contention that the lands occupied by aboriginal people, which are extensive, should remain in Canada even if the rest of Quebec were to separate.

One of the biggest problems is that the federalist cause in Quebec lacks a leadership fig-

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ure with the *emotional* impact of Premier Bouchard. Prime Minister Chrétien, though a Quebecer, represents a political viewpoint with which many Quebecers—even federalists—do not agree. To address this, the federal government has recently recruited some fresh, new cabinet talent from Quebec to bolster its position. The problem is that there is really no agreed *message* for new messengers.

Perhaps this reflects a deeper malaise that afflicts so many democracies these days. There is a great deal more cynicism about the political process and about political leadership. There is a craving for new answers, especially if they turn out to be simplistic answers.

Unfortunately, this is fertile soil for populism, if not demagoguery, and in Canada we are seeing examples of both. In an era when “talk radio” is king, rational discourse is not a prime commodity. We can add to this the fact that technological change, globalization and instant communication of almost anything, anywhere, are upsetting attitudes and traditions which were a part of the glue or stability for previous generations.

Meanwhile, the Quebec economy, and particularly the city of Montreal, is in poor shape, obviously made worse by renewed uncertainty over the political future. This is hurting all of Canada, and is probably the main reason why our long term real interest rates have remained so high, despite much improved macro-economic fundamentals. The question now is: how much longer can Canadians tolerate having the axe poised above their necks? There is understandably a powerful sentiment to settle the question of Quebec’s future—one way or the other—once and for all, and the sooner the better. It’s hard to “cool it” under these circumstances.

The Stronger Case for Optimism

I would nevertheless argue that, despite these very real concerns, there is *on balance* a stronger case for optimism. Let me outline it, in conclusion.

Most important is to remember that while

francophone *nationalism* in Quebec has never waned, *separatism* in Quebec is part of the ebb and flow of Canada’s history. It is not a trend advancing *inevitably* to the break up of the country.

In fact, many of the more fundamental trends point in the opposite direction. The demographics of an aging baby boom clearly favor the federalist cause. And as for Quebec’s desire for greater powers, the power in our federation is now flowing back from the national government toward all the provinces anyway, in part for fiscal reasons. This means that the separatists can’t really make a credible case anymore that the federal government is crushing Quebec’s aspirations.

The separatist movement has only been able to hold against these trends because of the charismatic appeal of Lucien Bouchard. But now that he has become Premier of Quebec, since the referendum, he is saddled with the responsibility of actually governing a province mired in fiscal and social problems. He may find his image as a savior, and his perceived ability to deliver, somewhat compromised.

Finally, the close brush with disaster last October has caused Quebecers, and indeed all Canadians, to think much more carefully about the implications of separation. The more carefully one considers the proposition—particularly the economic implications, not to mention the virtual impossibility of a smooth, negotiated separation—the more, I submit, will Quebecers and other Canadians turn their minds to moving towards a pragmatic compromise. As a step in this direction, since the referendum, the Canadian Parliament has passed a bill recognizing Quebec as a “distinct society” and providing a veto on further constitutional changes for Quebec and for the other provinces.

After centuries of living together with our contradictions, there continues to exist, in all parts of the country, a strong desire to preserve Canada and the Canadian federation. Indeed, recent polls indicate that a strong majority of Quebecers would rather try to work

something out to stay in Canada. I believe that these feelings—mixed with a large dose of pragmatism—will rise to the surface and propel us in the right direction. We won't reach a perfect or permanent solution, but it will be a typically Canadian solution—lumpy, inelegant and incomplete. The process is likely to be more like sausage-making than interior decorating.

* * *

So, Canadians will likely have to continue to grapple with this interminable question for many years to come. If we fail, we will have squandered one of the greatest legacies of the modern world. I don't believe *that* will be our fate.

L.R. (Red) Wilson is Chairman, President and Chief Executive Officer of BCE Inc., based in Montreal.

CONRAD M. BLACK

Bonne Entente and Quebec Separatism

Canadian Identity

WE SHOULD for this discussion remember that Canada was composed originally of disparate groups that absented themselves, for different reasons, from the American Revolution. We had a large influx of Empire loyalists who left the United States because they wanted to remain subjects of the British king. French Canadians resisted the entreaties of Benjamin Franklin (and the then loyal revolutionary Benedict Arnold) not because they had any great enthusiasm for the English, but because they thought their chances of not being numerically overwhelmed and culturally assimilated were better with the English-Canadians than with the Americans. This does not in itself make for a great deal of coherence, and we have been attempting to build a coherent nationality—to build a plane in the air—ever since then. The last group to join Canada en bloc was Newfoundland in 1949, which did so by a very narrow vote and only after they had gone bankrupt as an autonomous dominion.

Since the setting up of the United States, Canada has quite naturally been preoccupied (and often obsessed, in a non-neurotic way) with making itself—at least in its own eyes—distinctive vis-a-vis the United States. For the longest time the elements of this were the British connection and the existence of large numbers of French Canadians—and a sort of mantra (endlessly repeated, usually quite benignly and not spitefully) to the effect that we were not Americans, repeated in a way that wasn't always particularly thoughtful, I felt. But as time has gone by, the British connection, with the influx of immigrants from many other

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places, has become a rather nostalgic factor. And as we all know, the existence of French Canadians as a quarter of the population is now not so much a reinforcement of Canadian identity as a threat to its integrality.

We have come perilously close in this country to identifying our national character with what is represented as more generous social programs than in the United States. This representation of Canadian distinctiveness takes many forms. Sometimes it's merely stated that Canada is a gentler country than the United States; and I think, with no disrespect, that case can be made. Canada has approximately a quarter of the per capita murder rate, and about a third of the per capita number of imprisoned people. But Canada is not a kinder country than the United States. The attempt to institutionalize this has made the social safety net in this country a bit of a hammock at times. And it's caused the country to be somewhat overtaxed (a factor in causing many talented people in this country to move to the United States, in different fields). In any case, I do not believe that we can seriously suggest that social programs, subject to the evolution of taxing and spending by any regime, constitute a serious basis for a nationality. That won't work.

Bonne Entente

My view has always been (and I know it's shared in large measure by the other panelists here) that the only basis upon which Canada can function durably and successfully and achieve its undoubtedly very great potential is if, fundamentally, English- and French-Canadians believe they are fortunate to have each other to share a country with. That view is received with some incredulity in many parts of Canada, English- and French-speaking. I think it's a splendid source of strength and not of regret or weakness that we have these two cultures so well-established, invested with all the instances of a political society, in the same country. This is the traditional view of *bonne entente*.

I put it to you that there is in fact very little discernible difference between English

Canadians and Americans from states neighboring Canada. It doesn't take a sociological genius to distinguish between your average Texan and someone from Vancouver; but someone from Seattle and someone from Vancouver are almost indistinguishable from each other, even to a Canadian—or someone from Toronto and a nearby large American city like Detroit or Cleveland. The problem that we have is that there isn't a particularly great and obvious distinction between English Canadians and Americans.

There is a difference, as I said, in our societies. If I may use a football metaphor, Canada is between the 30-yard lines. You don't get extremes in Canada. You don't get the distressed masses of the large urban underclass in some parts of the United States. But on the other hand (some of my countrymen will disagree with this), we don't get the tremendous fermentation of very exceptional people in virtually every field either. We get some, but not as many as we would wish, because a lot of them move to the United States.

This spirit of *bonne entente*, while it is a hackneyed theme in some ways, is sincerely felt by a great many Canadians. In centers such as Vancouver, where there are very few French-speaking people, there are large numbers of English-speaking schoolchildren who go, by their parents wish, to French-speaking schools. The numbers are somewhat debated, but in English Canada there are 200,000-300,000. They are not there because they're coerced. They're there as a gesture of good will, by parents who think it is an advantage to have English- and French-speaking communities in the same country.

Decentralization and Inter-Regional Transfers

Canada is already one of the most decentralized countries in the world, and there will be another constitutional conference next year. It was 51 years ago that the longest-serving Premier of Quebec referred to them as *cir-conférences*, just going around in circles. I don't doubt they will be going on for quite a while, but we are

accustomed to them not accomplishing very much. The distribution of powers in this country now is that the provincial authorities are in charge of property, civil rights, most natural resources, most labor law, virtually all welfare programs except unemployment insurance, almost all of education, and have a full concurrent right in taxation. We simply can't decentralize much more without a complete dismemberment of the federal state. Some of the devolution proposals during the Mulroney government would have, in my judgment, taken us right to the brink of doing that, although they were certainly very well-intended.

We can't hand out a great deal more money in inter-regional transfers. We have already run up far too much debt. Quebec today gets \$700 million more out of the unemployment insurance program than it puts into it. The citizens of British Columbia and Alberta and Ontario—the three most prosperous provinces—pay (every man, woman and child) an average of approximately \$1,000 per year in transfers to other regions, Quebec in particular. We simply can't do much more than that in my opinion.

The Rising Trend of Quebec Separatism

The mortal enemy to this spirit of *bonne entente*, as everyone knows, is the spirit of Quebec nationalism. Where I take issue with Red Wilson is that I don't think this is quite the ebb and flow that he described. In my time as a Quebecer, the avowedly separatist vote in Quebec elections went from 2 percent in 1962, to 9 percent 1966, to 24 percent in '70, to 30 percent in '73, to 41 percent in '76 (when the Parti Quebecois under René Lévesque won for the first time). It stayed around 40 percent until the referendum last October, when it went up to between 49 and 50 percent. For the first time the majority of French Quebecers voted for independence. I wish I could see that as an ebb and flow, but I'm afraid I can't. I see it as a rather disturbing trend, and I don't see the trend reversing itself.

Lucien Bouchard evoked, in the referendum campaign, the ancient sentiment that has

lurked in the minds of Quebecers since the departure of the French 230 years ago that ultimately they should have their own country. There is nothing discreditable about that idea; it is a reasonable ambition that all nationalities subscribe to. And there is very little in it that's anti-English or anti-Canadian. (There is comparatively little real tension between French and English Canadians. Of course there is the occasional incident and zealots on both sides try to fabricate abrasions, but there is very little real friction.) I am afraid it's going to be very difficult for us to persuade them that they shouldn't have their own country, that they should forego that and stick with us. I hope I'm wrong. I'm quite a militant federalist. But that is the way I see it.

One of the nationalist Quebecers' greatest grievances is that we English Canadians really haven't given them a serious grievance. If we had, they would have seceded a long time ago. Now there were legitimate irritations, and shabby treatment of French minorities outside Quebec in previous generations; but in my time of watching these things, English Canada has done everything that could be expected and more, I think. I've supported personally, as a citizen, all these things, but we've done all and more that could be expected of a nearly three-quarters majority of the population to placate the French, and impress them, and entice them with the legitimate prospect of a trans-continental status of equality with us. And we should continue to do it, as I'm sure we will.

While I think the likelihood is, unfortunately, that this trend will reach its logical conclusion, there'll be all sorts of discussions. Canadians have an astonishing propensity for endless good faith discussion even if it doesn't achieve very much. There will not be any violence—or hardly any. There's no tradition of that in this country and there's no great residue of ill will at all, not much more than minor grumbling. (We only have one or two political murders per century in this country—the last was the Vice-Premier of Quebec in 1970.)

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English Canada and the United States

If my much-regretted conclusion should come to pass, it is not the end of the world. Many of you are from countries that have had such experiences. The Belgians seceded from the Dutch, the Norwegians from the Swedes, and the Slovaks from the Czechs. But in none of those cases did the entity seceded from border a country speaking the same language and fourteen times as large.

You Americans don't realize perhaps how magnetic a presence you are. Our former Prime Minister, Mr. Trudeau, said at the National Press Club in Washington that it was like sleeping with an elephant. The fact is that 90 percent of English Canadians live within 100 miles of the U.S. border. Almost all Canadians take their holidays in the United States. Almost all Canadians are addicted to American television. And as I said earlier, the real distinction between English-Canadians and Americans is quite a subtle one. If Quebec were to achieve its independence (I become a stench in the nostrils of my more peppy nationalist compatriots when I say this), there would be the possibility, if Canadians and Americans desired it, to create a greater intimacy between the United States and English Canada.

* * *

Canada is, as everyone knows, a very rich country with quite a skilled population. While we have never quite got the political scaffolding worked out and settled properly, it will work out eventually in some configuration. In the future as in the past, I don't think anything too dramatic is going to happen here.

Conrad M. Black is Chairman and Chief Executive Officer of Hollinger Inc.

MICHAEL E.J. PHELPS

Western Canada Perspectives

Canada's Identity, Quebec's Insecurity

AFTER LISTENING to Red Wilson and Conrad Black, I'm tempted to open with the oft-repeated adage that Canadians are uniquely poised to enjoy many of the best things in the world. In particular we were poised to draw from the best of French culture, British political stability, and American know-how. Unfortunately we wound up with French political stability, British know-how, and American culture. The power of American culture is a major political issue in this country. It is a major force in the whole debate concerning Quebec. It's a matter of identity. Some years ago I was in Egypt, and was so forcibly struck by the number of Egyptian children walking around with Bugs Bunny T-shirts and that the most popular television show in Cairo was Dallas. If it is an issue in Cairo, I thought, what chance does Canada have?

Although I now sit faraway in Vancouver, I was raised in Quebec and had the unique advantage as a youngster of being the only English-speaking child in a large French school. Being from the only English-speaking family in a small Quebec town, one has an opportunity to make some observations. It is my view that something of what drives the Quebec issue is a fundamental insecurity—a reasonable insecurity. Quebec has watched its share of the national population and of the overall national influence wane very steadily. From being approximately half of the population in the last century and an equal partner, it's now down to just over 20 percent. The laws of arithmetic mean it's not entitled to the same political influence that it used to have, and this drives a lot of what's happening. It was only 35 or so years ago that the role of the French language and Quebec's influence—

ALLAN E. GOTLIEB

Allan Gotlieb, North American Deputy Chairman and head of the Canadian group, presided at the Vancouver session on “the very serious challenges to the unity of this country.” In brief comments at the beginning and end of the session he helped set the context for non-Canadians and added a few additional points:

- Mr. Gotlieb noted that within a few weeks of the October 1995 referendum — in which 49.4 percent of the population of Quebec “voted, in effect, for separation from the rest of the country” — opinion polls in Quebec indicated that “support for independence, put the baldest way” had risen further, to about 55 percent. There was talk of another referendum in 1996, talk from which Lucien Bouchard (now Premier of Quebec and leader of the Parti Quebecois) did not disassociate himself. Since then there has been “a curious change in mood.” Mr. Bouchard now says he will not have another referendum until after the next Quebec election. The next election could come as late as 1999, and a referendum during a renewed mandate after that election could come as late as 2003 or 2004. In the meantime, Premier Bouchard has declared that Quebec (in order to be able to separate later) must “get its economic house in order.” In a dramatic change from the preceding Parti Quebecois government, he has given top priority to balancing the budget by the year 2000.
- The basis for the departure of Quebec from Canada would be the principle of self-determination, but that is a principle for peoples, not territory. If Quebec ultimately secedes from Canada, there is an “extremely serious possibility” that Quebec itself will then fragment. We will see the native peoples and quite possibly English-speakers in Montreal demanding a similar right of self-determination. Mr. Gotlieb noted that 95 percent of English-speakers in Quebec voted against separation in the October 30 referendum, and the percentage was “even higher” among native people in a separate, somewhat earlier referendum.
- Mr. Gotlieb reflected that the earlier prosperity of Montreal and Quebec was based on the dominance in Canadian trading patterns of trade across the Atlantic—through the port of Montreal. Since World War II, Canada’s trading patterns have come to be dominated by trade with the United States, north-south trading patterns which have been accompanied by the rise of Toronto and Ontario. In this sense the economic decline of Montreal and Quebec in recent decades has been “irreversible.” But the Quebec government has “compounded the decline” by turning away from the multicultural, pluralistic society which was crucial for whatever “soft power” Montreal would retain. Some 335,000 Anglophones have left Montreal since the election some twenty years ago of René Levesque, the first separatist leader.
- Is Mr. Gotlieb pessimistic or optimistic about the unity of Canada? He recalled a Canadian variant of an old joke: “Why does a Canadian cross the road? To get to the middle!” We Canadians may be able to “muddle through and work this out.”

Allan E. Gotlieb, former Ambassador to the United States, is associated with the Toronto law firm of Stikeman Elliot.

despite sending many, many Prime Ministers to Ottawa—was a secondary and subsidiary one. So there is a certain insecurity—that I

hope will be the fundamental basis for some rapprochement someday.

The fight in Quebec will be a simple one.

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Very approximately, a third of the Quebec population are committed separatists and a third are committed federalists. The fight will be over the hearts and minds and votes of the remaining third, whose views slide somewhere in between.

Western Perspectives

Now if I talk about Western perspectives, I will not spend most of my time talking about the constitutional debate or the national unity debate, because those are not issues that resonate very loudly in Western Canada. In fact, there is a certain impatience with the whole debate. In my view that's misplaced, but it is very low on the list of concerns of Western Canadians.

Western Canada is not a monolith. Manitoba and Saskatchewan are still largely agrarian societies with populations of around a million each, populations and societies that are by and large more tolerant of political accommodation than Alberta and British Columbia. Alberta and British Columbia feel very much their economic strength, and desire more political strength.

British Columbia is in fact at least three separate entities. One is the interior, basically resource-based with a very conservative society.

Another is Vancouver, large and growing rapidly, with a buoyant economy for at least a decade. While there will be some ups and downs in Vancouver, those oscillations will not be all that large compared to the rest of the country. Vancouver very much feels its strength. Its list of issues does not touch very much on Quebec. Vancouver's issues relate first to immigration. The Asian population of Vancouver approximates 22 percent. While an objective view would point very quickly to the leavening and enriching aspects of this immigration, there has been a significant degree of social tension because it has come so quickly. It has fundamentally come within ten years. For instance, in a significant part of Vancouver called Richmond, ten years ago 3 percent of the school population claimed English as a

second language. So 97 percent claimed English as their first language. Today there are entire schools where less than 20 percent would claim English as a first language. This has come so quickly that the community has had difficulty adapting to it.

The third part of British Columbia—largely the coast and Vancouver Island—has a different political ethic, and it's unique in the Canadian context. I sometimes tease my left-leaning friends that while the physical remains of Karl Marx are buried near his home in London at Highgate Cemetery, his soul is buried on Vancouver Island. It remains one of the most heavily unionized parts of Canada, the most supportive of government intervention, and the most heavily committed to the maintenance and even enhancement of the social safety net. And so it changes the political dynamic here.

Some Western perspectives would be shared with the U.S. Midwest. Essentially the societies are conservative—small “c” conservative. Essentially the political societies are populist. So to the extent there is support in Canada on a national level for initiatives like recall and referenda, they are based and animated from Western Canada. There is still a significant degree of alienation and a degree of protest. Western Canada speaks with more or less one voice on a lot of issues, like gun control, metrification, crime agendas and so forth. It's animated by a more conservative view of the world. There is a feeling of a lack of influence commensurate with the economic force of Alberta and British Columbia.

With regard to the national unity debate, there is unfortunately a significant divergence between the elites, so-called, and the electorate, broadly speaking. The elites in Western Canada, for the most part, would make an accommodation with Quebec. The elites in Western Canada, for the most part, would like the issue put behind us. The elites recognize the impact on interest rates, on the efforts to curb national deficits. Assuming this would buy peace (probably a faulty assumption), the elites see recognizing Quebec's aspirations con-

stitutionally speaking—in terms of devolution, in terms of sanctifying a distinct society status—as prices worth paying. In fact Western Canada wants its own form of devolution, constitutionally speaking.

But the broad electorate is in no mood to allow for this kind of accommodation, and regrettably it will constrain the ability of political leadership to make the kind of compromise needed. Until the day comes when Quebec recognizes that it will have to temper some of its constitutional demands, and Western Canadians (and others in central Canada) recognize that some compromise must be made, there will not be constitutional peace. It makes me wish I was British in a sense. An unwritten constitution has a lot of advantages, not least of which is the ability to avoid all these constitutional meetings. We are well on our way to joining Washington, D.C., for the number of lawyers devoted to these issues.

Emerging Issue is Maintaining Social Safety Net

As I look to the future, I still am fundamentally optimistic in a careful and cautious sort of way. I suspect over the course of the next few years the constitutional issue will continue to whimper. Perhaps the decibel level will increase now and again, after the 1997 constitutional conference, but I think by and large there will be a desire to contain this issue, to ignore it for a bit and see if that will make it go away for at least a while (which I rather doubt), and to get on with other issues. The number one looming debate in this country—and it is so much of our culture and what distinguishes us in the minds of ordinary Canadians—will be about the maintenance of the the social safety net. It's a well-known debate in Western Europe. Here, with an aging population, I would guess it will become the number one item for political debate.

Michael E.J. Phelps is Chairman and Chief Executive Officer of Westcoast Energy Inc., based in Vancouver.

ALLAN M. ROCK

Fiscal Restraint and the Changing Role of the National Government

IT'S 20 YEARS NOW since the Trilateral Commission last met in Canada. Much has changed since then. The world is not the same place. Canada itself has changed enormously. I was reminded today that 20 years ago, then Prime Minister Pierre Trudeau, at the Commission's meeting in Ottawa, boldly pronounced that Quebec separatism was dead. Well, five months later it rolled away the stone, and the province of Quebec elected a government committed to the separation of that province from the rest of Canada. And since then, Canadians have been coping—so far successfully but never easily—with the stresses and the strains of different national aspirations within the bosom of our federal state.

I could devote my remarks this evening to a survey of the constitutional issues currently preoccupying Canadians. That would be a difficult enough subject for Canadians to have to sit through, but for an international group I thought it might constitute cruel and unusual treatment. I was present this morning for the excellent discussion of the subject, and this evening I would like to focus my remarks on issues that only indirectly relate to national unity.

But they are of great importance not only to Canada but to other industrialized nations. Like countries everywhere, we are dealing in Canada with the challenge of shifting demographics, a restructuring economy, and shrinking fiscal resources at the disposal of government.

Indeed, in broad terms, the preoccupation

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of Prime Minister Chrétien's government during its term in office has been to redefine the role of the national government in Canada in light of the new fiscal realities. I'd like to describe the nature and results of our efforts to put Canada's fiscal house in order; and, secondly, to explain what we have learned in the process about the changing role of the national government in the current age.

Putting Canada's Fiscal House in Order

Since our election in the fall of 1993, we have been engaged in an intensive effort to restore fiscal balance—by reducing the deficit and working towards the day when we can begin paying down the debt and decreasing the tax burden of our citizens. Many of you will find this a familiar theme in your own countries. By the time the Prime Minister was sworn into office in November 1993, governments—of all parties and at both the provincial level and the federal level—had allowed deficits to pile up to awesome mountains of debt. Simply stated, governments had been given an unlimited budget and had exceeded it.

I hasten to add that while the party that preceded us in power was of a different political stripe, it must not bear all the responsibility for this problem. Indeed there's plenty of blame to go around. My own Liberal Party, which was in power during the '70s and the early '80s, established the pattern of deficit spending very firmly. From a postwar low of 20 percent of gross domestic product in 1974, Canada's national debt climbed to more than 70 percent of GDP in the wake of the 1990 recession. Interest charges, which took up only 11 cents of every federal revenue dollar in the mid-1970s, consume 36 cents of every such dollar. Canadians were left to wonder about a government that raised their taxes and then used the revenue to pay interest on the money that it had borrowed. An inability to generate sufficient domestic savings led to constantly increasing borrowing abroad. The result: an accumulated foreign debt (owed by public and private sectors combined) of 45 percent of the

gross domestic product, one of the highest in the OECD.

Commencing in the early 1970s, our national government's debt increased at a faster rate than our economic growth for almost 20 consecutive years. Naturally, the results of high deficits were high interest rates, a weak economy and slow growth. In those circumstances, reducing the deficit was not simply a desirable option, it was an absolute necessity. I am reminded of what John Kennedy said when asked about his heroism during the Second World War. He said, "I had no choice, the enemy sank my boat." Well, we had no choice. The era of checkbook politics had come to an end.

I'm able to report that during the past two-and-a-half years we've made respectable progress. The process has been arduous and wrenching, but it has yielded some positive results. Consider these facts:

- Next fiscal year, 1997-98, our deficit will be cut to 2 percent of GDP, down from 6 percent in 1993, and we remain committed to eliminating it entirely.
- Next year our cash borrowing requirements (which correspond to the definition of the deficit in the United States and most other countries) will be down to 0.7 percent of GDP, the lowest level projected by any of the G-7 countries.
- By 1998 program spending will be reduced to 12 percent of GDP (down from 17 percent in '93), the lowest level in 50 years, and making Canada the only member of the G-7 to budget an absolute decline in program spending.

And these results have been achieved without any increase in personal income tax rates or sales tax rates. Happily, a similar resolve has been shown in every provincial capital. Recently, several provinces have reported a budget surplus, and some are ready to start paying down debt.

Canada's success in taking on the deficit has yielded positive news on other fronts. Inflation is at its lowest level in 30 years, one

of the lowest among OECD countries. The commitment of our central bank is to keep inflation in a band of 1-3 percent. More than half a million new jobs have been created in the period since 1993, 125,000 since last November alone.

As a trading nation, almost 40 percent of our gross domestic product is dependent on international trade. We're happy to see that trade is up significantly, especially in technologically sophisticated goods and services. And may I say that a significant contribution to that success was made by my former Cabinet colleague (and your colleague as a member of the Commission) Roy MacLaren, until recently our Minister of International Trade, who spoke earlier today.

These results are also a tribute to the commitment of the Prime Minister, and the skill of the Minister of Finance, Paul Martin, especially because we've all been working in the shadow of the separation of Quebec, which causes instability in both the economic sphere and the political sphere.

At the same time, we know this is not a record to rest on. It's a base to build on. Our determination must remain until the deficit is gone, and until we make inroads on the repayment of debt.

Redefining the Role of the National Government

My purpose in providing that report is broader than simply to demonstrate that Canada is getting its fiscal house in order. I want to emphasize that our budgets have been more than cost-cutting exercises to mollify the markets or rescue our bond ratings. What we've been doing is engaging in a fundamental reappraisal of the appropriate role of the national government. And that leads me to the broader topic I'd like to speak to briefly this evening.

At a time when spending is so severely curtailed, what is the role of the national government? With checkbook politics behind us, what is its relevance and its function? What principles should govern the definition of our

purpose, the choice of our priorities and the thrust of our policies? And for those of us who believe in a socially progressive and proactive government, how can the political philosophy of the Liberal Party of Canada be reconciled with the fiscal facts of the federation?

Let me begin by putting these questions in a very personal context. I was born after the Second World War. I grew up in a Canada where uninterrupted economic growth was taken for granted, in which each year brought more prosperity than the last. As a student in the 1960s and the 1970s, I watched as well-meaning governments created more and larger programs aimed at ever-broader and grander objectives. Students were encouraged to accept grants, no strings attached, to finance vaguely described enterprises. Businesses were plied with subsidies. And the scope and cost of social programs were extended and enriched.

To a young Canadian who had no basis for comparison, it seemed that government was a bottomless well of resources. What an irony it is that what I was watching in those years was the steady accumulation of the very debt that now represents the greatest challenge of the government of which I am a member. And what a sign of the changing times that when a politician is asked to describe an achievement, that person doesn't boast of spending, but rather of efforts to reduce it.

The days are gone when Liberals can overcome impediments to their political progress by lubricating the machine with cash. It's simply no longer possible to paper over problems with dollar bills. In the new age of fiscal restraint, government as spender is gone, and the most effective government interventions in both the economic and the social spheres will require at least three new roles for a national government:

- first, government as *architect*, using policy to design a framework that both enables the private sector to succeed and attracts domestic and international investment;
- second, government as *restrained regulator*,

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REGULATOR...

GOVERNMENT AS
BULLY PULPIT...

exercising the power to make regulations, where and how it makes sense; and

- third, government as *bully pulpit*, a place from which to identify, to articulate and to help realize broad national goals and priorities.

Let me deal for a few moments with each of these roles to explain further what I am suggesting.

First, government as *architect* would be committed to creating a framework that will permit greater productivity. That, of course, is the foundation for international competitiveness, which in turn is the surest path to economic independence, to growth and employment. Government as architect could help to achieve that framework by working towards lower real interest rates (which are achieved by spending less rather than more); by encouraging higher levels of savings (to reduce the cost of capital); by providing more open access to markets, both internally and internationally; by encouraging excellent domestic infrastructure, including research and first-class communications; by reforming unemployment insurance to get the incentives right and to broaden skills; and by promoting the acquisition of new technologies and best practices by businesses throughout the country.

What of the role of government as *restrained regulator*? Clearly, sound architecture means less if the framework is over-regulated. A fine balance must be struck between regulation that is necessary in the public interest and the creation of an unreasonable paper burden. Regulatory reform means bucking the bureaucratic resistance and interest-group politics, but there is nothing that small business wants more—except, of course, lower taxes, and we can't yet afford that.

Finally, government as a *bully pulpit*, a place from which leaders can articulate broad priorities and facilitate their achievement. What are the roles of the government as moral leader and facilitator?: (1) to describe and to

foster national values that are the defining characteristics of our country; (2) to preserve domestic assets that reflect those values and confer a comparative advantage (such as our healthcare system); (3) to coordinate and to lead truly national efforts (such as in trade where the Prime Minister himself recently traveled with the premiers of the provinces on Team Canada trade missions, focusing on specific regions, accompanied by Canadian business leaders); (4) making the most of opportunities for young people through early intervention, quality education and assisting in the transition from school to work; and (5) marshalling the resources of our communities by encouraging volunteers to help in achieving national objectives.

Now let me spend just a few moments developing that last point, because I believe that with the demise of government as spender, if we're to make real progress on the most critical social needs we face, we must have more meaningful civic action. This is the broad resource that Peter Drucker calls the social sector. It's what Robert Putnam spoke of when he spoke about making democracy work—he observed that those democracies work best that have the highest degree of civic involvement. Government programs and their bureaucracies can become too expensive. And what's more, they can sometimes be ineffective in achieving real progress in addressing social needs. So it should be among the top priorities of the national government to use the bully pulpit of public office to inspire community action and enlist volunteer help in everything from child care to involvement in public school education, to dealing in the community with young offenders who commit the less serious and non-violent crimes. It was Louis Brandeis who observed that the highest office in a democracy is the office of citizen. And if governments use their authority to call the public to that task, it seems to me we will be able to multiply manyfold the limited public resources that are available for the purpose.

So, what is the future role of the national government after the age of checkbook politics? The picture that emerges is of a government that thinks more and spends less, that draws far more than in the past on the resources and the wisdom latent in the broader community, using tools of partnership and facilitation, targeted expenditures and well-crafted policies to guide resources in the public interest. To quote my colleague, Paul Martin, the Minister of Finance, "in broadest outline the re-defined role of government is becoming clearer. In metaphorical terms, it is to be more like the tiller of a sleek modern sailboat than the paddlewheel of a nineteenth century steamer."

Now in my view all of this is entirely consistent with the political philosophy of the Liberal Party of Canada—because it very much involves a government that is still fully capable of assisting the disadvantaged, that is unconditionally committed to our publicly funded national system of healthcare, that is more adept at providing those things that the private marketplace cannot (such as strategic support for aspects of science and technology). It involves a government that is focused on getting the incentives right, whether it's fostering environmental protection or attracting footloose investment or springing people from the welfare trap onto the job ladder.

What is called for here is not only a change in attitude, it's a sea change in the nature of politics as it's been practiced in the affluent democracies during the past five decades. And it seems to me that the job of getting government right—or "reinventing government" or whatever slogan is used—is much more than just a theme. Indeed creating a public sector where it can truly be said that less is more is among the greatest challenges that we face.

Allan M. Rock is Canada's Minister of Justice.

SECTION 7

U.S. POLITICS AND FOREIGN POLICY

JOHN MCCAIN

Clinton and Dole Foreign Policies

I WILL TAKE the subject "U.S. politics and foreign policy" as an opportunity for me to practice politics by criticizing the President's foreign policy, and making a case for a return to Republican statecraft. Let me preface my remarks, however, by exempting Senator Robb from any of the criticisms to follow. He is a man of exceptionally sound judgment on foreign policy matters, always putting the national interest before political interests. He is, in short, a statesman. What follows should only be construed as an examination of the differences between Republican and Democrat foreign policy views as those views are expressed by our parties' candidates for President.

Important Differences, Important for Election

In comparing the foreign policy views of the two candidates, the news media have typically resorted to the sort of facile, formulaic analysis that is often substituted for insightful political commentary today. Increasingly, reporters have asserted that there isn't much difference between the candidates' foreign policy views—only, perhaps, in their styles as foreign policy leaders. They further assert that the stylistic differences have narrowed as President Clinton has lately recovered from his earlier ineptitude on the world stage. Thus, they mistakenly conclude, foreign policy should not play a significant role in the presidential debate this year.

I am sure you will not be surprised to learn that I strongly dispute both the premises and conclusion of that argument. The argument

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overlooks not only major policy differences between Senator Dole and the President—Ballistic Missile Defense, Bosnia, Iran, Korea and NATO expansion come immediately to mind—but it devalues the importance of leadership style to the conduct of foreign policy. Both the conceptual and operational flaws of the incumbent Administration's statecraft and the alternatives which Senator Dole's election offers should be and will be an important focus of this election.

President Clinton's Mismanagement of Foreign Policy

A presidential election is primarily a referendum on the incumbent's record. A challenger draws distinctions between himself and the incumbent by first examining the performance of the incumbent, and criticizing the flaws in that performance as a means of identifying what the challenger would do differently. In a comparison of foreign policy views, to minimize those distinctions between these two candidates as merely "stylistic" differences is to reject important principles of American diplomacy.

Let me elaborate a few of those principles which I think have been casualties of President Clinton's style of foreign policy leadership.

First, words have consequences: the President must make no threat or promise which he is not prepared to keep. The casual relationship between presidential rhetoric and presidential action in the Clinton Administration has badly damaged the President's credibility abroad and done substantial harm to the most important relations we have in this world.

Second, diplomacy must be led from the top for it is the President who gives strategic coherence to American diplomacy. The President must prioritize our interests and oblige policymakers to integrate policies to serve those priorities. When the president is passive, government will not be organized cohesively to conduct foreign policy, second- and third-level officials are elevated to leading policy roles, and single-issue advocates fragment our diplomacy.

Absent such cohesiveness, Clinton

Administration officials have poorly prioritized U.S. interests, often placing peripheral interests before vital ones; pursued case-by-case policies that collided with one another; and conducted relations with some countries in ways that disrupted relations with others. Diminished presidential leadership in foreign policy has also resulted in the often harmful extension of foreign policy franchises to non-Administration figures—former President Carter's intervention, for example, in the North Korean nuclear crisis.

Third, there is no substitute for American leadership in defense of American interests. The Administration's reluctance to give primacy in our post-Cold War diplomacy to American leadership or even, at times, to American interests has caused it to forget or violate proven rules of American leadership. Among those are: protecting our security interests is the precondition for advancing our values; force has a role in, but is not a substitute for diplomacy; build coalitions to protect mutual security interests, don't neglect security interests to build coalitions; and don't slight your friends to accommodate your enemies.

The direct consequences of the Administration's failure to observe these rules have been its misguided efforts to cloak the national interest in "assertive multilateralism," its poor record of building coalitions despite its virtuous regard for multilateralism, and its paralyzing confusion about when and how to use force.

Fourth, foreign policy should serve the ends of domestic policy, and, just as importantly, domestic policy should serve the ends of foreign policy. For instance, investing in an adequate defense and balancing the federal budget to encourage savings and investment will strengthen America's ability to protect its interests abroad; just as maintaining stable alliances and balances of power will strengthen our prosperity and tranquility at home.

The President has misconstrued this relationship, often using foreign policy as an international variant of pork-barrel politics to serve

his own political ends. This explains the Administration's interventions in Haiti and Northern Ireland, and its pursuit of managed trade solutions to our trade imbalance with Japan. It explains, in part, the Administration's gross mishandling of our relationship with China. However, the most damaging effect of this flaw is that it has hurt the President's ability to discharge a fundamental responsibility of any president: persuading the American public that our vital interests require America to remain internationally engaged. This failing has led to a demonstrative increase in isolationist sentiments in both political parties.

To combat the media's curt dismissal of "stylistic differences" between the candidates we could offer a shorthand response: "style is substance." But we serve voters better by elaborating, as I have tried to do, what those differences say about each candidate's leadership capacity, and by examining where the President's leadership has failed. The three countries—Korea, Japan and Russia—which the President just visited are an appropriate place to examine those failures.

I believe it can be fairly said of the President that he has terribly mismanaged relations with all three countries on his itinerary. Indeed, the purpose of his visits to Korea and Japan was to repair the damage done by his previous policies for those relationships.

His heavy-handed threats of economic sanctions to coerce Japanese acceptance of numerical quotas for American exports risked divesting our relationship of its vitally important security components. Thus, when we required Japan's help in mustering a credible threat of economic sanctions against North Korea, to coerce Pyongyang's abandonment of its nuclear ambitions, that cooperation was not forthcoming. And when the despicable rape of an Okinawan girl by three American Marines increased opposition among the Japanese public to our military presence in Japan, Japanese leaders were slow to defend our presence—hence, the need for the President to go to Japan for the purpose of reaffirming our security relationship.

In Korea, the President's visit was intended to reaffirm American resistance to North Korea's attempts to drive a wedge between South Korea and the United States. Seoul's apprehension about the effect North Korea's provocations in the DMZ might have on alliance solidarity is well-justified, considering the wedge that we allowed Pyongyang to drive between the United States and South Korea during our negotiations with North Korea over their nuclear program.

Our interest in Russian economic and political reform is obvious. Accordingly, the Administration's initial support for Boris Yeltsin as the most important reform leader was understandable. Where that policy went awry was in its sole focus on Yeltsin's political survival. This focus brought it into conflict with other salient U.S. interests in Europe, while it offered no hedge against its possible failure should Yeltsin lose power.

The Administration's Russia policy has become isolated from its policies for Eastern Europe and NATO. History instructs us about the danger of leaving a security vacuum in Europe. At this moment of uncertainty and instability in Russia, leaving states unallied and vulnerable to intimidation and aggression invites future conflict in Europe.

The Administration maintains that the success of Russian reform is a better guarantee of security and peace in Europe than is NATO expansion. But it is not in our power to ensure the success of reform in Russia. Only Russians can do that. We can assist their success, but we cannot ensure it.

Moreover, Russian reform and NATO expansion are not incompatible. We can expand NATO and integrate Russia into Europe without offering NATO membership to Russia. Nonaggression treaties, joint peacekeeping missions, and assistance for Russia's democratic and free-market transition are means to accomplish this without rendering NATO anachronistic.

I want to talk briefly about a country that wasn't on the President's itinerary, but should have been—China. Nowhere is the strategic

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incoherence of the Administration's statecraft more apparent. Our diplomacy has been fragmented as officials from the Commerce Department, USTR, Defense and various bureaus of the State Department pursued different, and often conflicting agendas in China. (Chicken-export lobbyists lately gained brief control over our Russia policy, but I will leave further exploration of that event for another speech.) Moreover, the wounds the President inflicted to his credibility—as he mishandled MFN and the Lee Teng-hui visit—have done untold harm to the relationship that will be the central preoccupation of the world for many years into the future.

Lastly, I want to make reference to another topical foreign policy mistake which also reveals the leadership flaws of the incumbent administration: the recent disclosure that the Administration acquiesced in, and possibly facilitated Iranian arms shipments to Bosnia. Currently, the media and Congress are focusing on whether that action was illegal. Such a focus may overlook the policy's more important security implications.

President Clinton campaigned for office by denouncing the arms embargo against Bosnia. As President, his expressed intent to keep his campaign promise encountered stiff resistance from Russia and our European allies. Rather than exert maximum leadership to persuade others to join in lifting the embargo or conceding that he had been mistaken, the President chose to allow Iran to arm the Bosnian Government. Consequently, the President allowed an Iranian presence in Bosnia that threatens the security of our troops stationed there, and, even worse, did enormous harm to our ability to enlist our allies in efforts to isolate Iran internationally. The legality of such a policy may be suspect. But what is beyond dispute is the stupidity of a policy that risks our larger security interests for the sake of avoiding a difficult diplomatic problem.

That concludes my analysis of President Clinton's "stylistic differences" with Senator Dole. Now, I would like to make the affirmative case for a return to Republican statecraft.

Republican Statecraft in a Dole Administration

I anticipate that when we get to the Q&A, someone will inquire about the resurgence of isolationism among Republicans. I believe that concern has been a little exaggerated, but it is not entirely untrue. And I have, on many occasions, criticized isolationists wherever they abide.

There is evidence of isolationism in the views of some of the new Republican members of Congress. Those who have expressed such views are fewer in number than media reports have indicated. They are, in the main, members of the House of Representatives. I have not noticed any resurgent isolationism among Republican Senators, even among the freshmen.

I do not consider this a uniquely Republican phenomenon. To the extent that isolationism is on the increase, it is a national phenomenon. Republicans who have succumbed to its attractions are simply mirroring the views of some of their constituents. The causes of this phenomenon are, in part, a mistaken assumption that in the wake of the Soviet Union's collapse, we need not be internationally engaged any longer. It is also attributable to the President's mismanagement of foreign policy and his failure, by words and actions, to make a case to the country for our continued leadership in the world. For many newer members of Congress, Somalia, Bosnia and Haiti have been the major foreign policy crises of our time. That is the President's fault.

I genuinely believe that restoring Republican control over foreign policy will restore American appreciation for American leadership abroad. Let me outline what Republican foreign policy should be in a Dole Administration.

As President, Bob Dole will restructure the foreign policy establishment to more effectively serve American interests. He will prioritize our interests and integrate our policies to serve those priorities. He will exercise foreign policy leadership from the Oval Office to prevent the fragmentation of our statecraft by single-issue advocates.

He will eliminate duplicative agencies of our foreign policy establishment, integrating their functions into the State Department. He will redirect U.S. foreign assistance to serve American interests and not unrealistic notions of sustainable development in countries that are unwilling to make the transition to free markets.

He will make no promise or threat which does not protect an American interest and which he is unprepared to enforce.

He will strengthen alliances to serve our mutual security. The United States is most effective in the defense of its security as an alliance leader. This view does not mean that we should forswear acting unilaterally when interests and circumstances warrant unilateral action. But it does recognize that we extend our influence when we act in concert with others. This view further recognizes that an alliance leader has special responsibilities. We must be realistic about our aims and priorities, and the interests of our partners. We must appreciate the constant need for active consultations, and we must be willing to compromise on some points, but remain firm on core objectives. Above all, we must be steady.

A Dole Administration will focus on our primary interests in maintaining stable balances of power in Europe, East Asia, the Western Hemisphere and the Middle East. It will integrate security and economic policies to support opportunities to extend the reach of market economies and open societies.

In sum, President Dole will seek to consolidate an international system encompassing our primary areas of geopolitical interests based on our concepts of security and economic norms. This will include his support for NATO enlargement.

He will seek to integrate Russia and China into the system by persuading them to adhere to the norms of the system. Should they resist, he will be prepared to act in concert with our allies to guard the system against whatever threats they may pose to our interests.

Bob Dole will not act out of a blind con-

ceit for American power, but in deference to American interests because he perceives in those interests a convergence rather than a conflict with our values. He understands that the defense of our security enhances the prospects for the success of our values. I am confident that his restoration of resolute American leadership will be welcomed not only by the American people, but by a world that has suffered from its absence these last three years.

John McCain is a Member of the U.S. Senate (Republican, Arizona).

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CHARLES S. ROBB

Real Security Challenges Require Serious Investments

YOU'VE JUST HEARD from the man who I believe has more influence on the Dole campaign—and could have more influence on a Dole presidency—than any other elected official in America today. I can assure you I do not have the influence with the Clinton Administration that my friend John McCain has with Senator Dole and would have with a Dole Administration, but I'm delighted to share my views—and my concerns.

My main concern is that, given challenges I believe are real, I am not sure the United States is making the dollar investments in its national security needed to address some of the critical problems of tomorrow. If we want to be the “balancing wheel” in Asia and help forge a new security order in Europe, self-serving rhetoric about being the sole remaining superpower won't suffice. The United States needs to tangibly demonstrate its commitment to peace and stability to these regions in manpower and force structure.

Before turning to investments in our defense base, I would like to speak briefly about President Clinton's recent trip to Korea and Japan and about U.S. China policy—matters also addressed by John McCain.

Clinton Trip to Japan and Korea

The President's trip this past week to Korea and Japan (before continuing on to Russia) confirmed that we stand shoulder-to-shoulder with our two key allies in the Pacific. Yesterday in my office I had a lengthy conversation with a senior Administration official who accompanied Secretary of Defense Perry and then

the President in Northeast Asia this past week. The trip paid some significant dividends.

Our security commitment to Asia begins with our alter ego in the Pacific, Japan. The most important development from the Japanese side during this recent trip was our agreement to give back Futenma Air Station within 5-7 years, which seemed extremely unlikely as recently as two weeks ago. (Prime Minister Hashimoto had raised Futenma with the President when they met for the first time earlier this year in Santa Monica, California.) In exchange, the United States will have expanded access to Kadena Air Base—through enlarging aprons, adding a heliport and some new facilities there—and that has Marine Corps Commandant Chuck Krulak, who has about 20,000 Marines on the island, believing that, as we downsize in Okinawa, we'll be improving our force structure without sacrificing readiness. We plan to strictly limit flight times in Okinawa and to shift live-fire exercises elsewhere. That will begin to address some of the most serious local concerns. Governor Ota (who about three years ago visited me in my office in Washington to discuss his concerns) seems to have signaled his approval.

Japan agreed to continue \$5 billion in “host nation support,” and we will be actively examining “cross-servicing issues” that will allow U.S. forces to operate from Japan on a regional basis to safeguard broader interests, rather than just defending Japan exclusively. That is a significant development. The Administration official who visited me yesterday said that he took only one note at last Sunday night's meeting between Defense Secretary Perry and the Prime Minister: “Hashimoto tickled pink.”

Across the Sea of Japan, Seoul has agreed to unconditional talks (slightly different than the position taken before) with Pyongyang. The North Koreans have not thrown cold water on the quadripartite talks proposal, while China has not ruled anything out. Meanwhile, the United States will proceed in discussions with the North on missile-related issues, and continue separate talks on POW/MIA matters.

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With all this progress it seems to me pretty hard to argue that the current Administration is backsliding in Asia. We hear charges that President Clinton's policy in Asia is reactive, ad hoc, inconsistent. But I think the Clinton record (100,000 troops remain committed to the region, the measured response to China's bullying of Taiwan, the continuing Cobra Gold exercises with Thailand, Kangaroo military exercises with Australia) demonstrates that the United States is in Asia for the duration.

U.S. Policy toward China

It is becoming increasingly clear that we will all be sharing the stage with China in the decades ahead. My sense is that security tensions will continue to ebb and flow in the Pacific, with China at the fulcrum of events. The psychological warfare last month in the Taiwan Strait is a case in point. Cassandra-like speculation about U.S.-China relations (you will be seeing plenty of it in the U.S. presidential race) misses the point of where we are today.

In a short few weeks, the Congress will consider legislation to eliminate MFN for China. My sense is that the House will probably pass the resolution to end MFN, but the Senate won't—or if it does, not by enough votes to override a Presidential veto. Scoop Jackson Democrats (of which I consider myself one) will join with moderate Republicans to provide the necessary margin. The “bookends” in each party—the liberal Democrats and conservative Republicans (with some notable exceptions such as John McCain)—will join together, in one of those odd marriages we occasionally see, to vote against MFN for China. The MFN debate will showcase the larger presidential debate and provide a good test of Majority Leader Dole's ability to keep his Republican colleagues in line, assuming he doesn't “stray” himself. It'll be a tough issue politically for both major Presidential nominees—and it might be an even tougher issue if Ross Perot gets in.

The Senate is already more partisan and divergent than I've ever seen it, with centrist

thinking less likely to carry the day. The ideological wings of the two parties are creating legislative sclerosis. But this is one issue on which I hope we can still work together. Restricting MFN, in my judgment, would be short-sighted to say the least. We already trade more with China than we do with longstanding trading partners France and Italy. U.S. exports to the mainland have grown at an average rate of 22 percent over the last five years. That's a faster growth rate than any other major country we trade with, and the gargantuan promise of China's future market makes many of our Fortune 500 companies salivate.

Admittedly, candidate Clinton put President Bush on the defensive in 1992 by repeatedly accusing him of “coddling” China's dictators. He has absorbed a hard lesson in *realpolitik* diplomacy with the Chinese since then. I have urged him to continue to pursue a regular dialogue at the highest levels and to seek to restore personal civility with the leadership of China. Indeed, I urged him to hold some sort of a summit during his recent trip.

U.S. policy toward China continues to be a “work-in-progress” at this stage, and I am sure that Bob Dole will describe it as such during the coming months. Not that Bob Dole or anyone else has a magic bullet to improve ties with Beijing. There simply are no easy answers. Regrettably, as was the case in our Presidential campaign in 1992, reasoned judgments on China will take a backseat to political rhetoric.

Investing in Energy Security, Diplomacy, Aid

Two-thirds of the world's proven oil reserves are controlled by Gulf states, and President Bush led the multilateral coalition into the Gulf War five years ago for the right reasons: securing critical energy resources and restoring the territorial integrity of Kuwait. One of my key concerns is whether the United States is investing adequately in its future energy security. (A timely report on this issue is before us at this meeting.) I thought the Gulf War would put a big enough scare into us to work a lot harder than we have to diversify our energy resources.

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Unfortunately that has not been the case. In fact, funding for U.S. research and development into fuel cells (a promising alternative to petroleum) is being slashed by the Congress. In contrast Japan is increasing its fuel cell budget by 20 percent, and the Europeans are considering doing the same. Our Department of Energy's advanced transportation technology budget is being trimmed 30 percent in 1996. Renewable energy funding has been shaved by the same amount, with reductions of 60 percent planned by the year 2002. Congress' decision to substantially reduce funding for critical oil-replacing and energy-efficient technologies risks pushing our trade deficit in oil even higher. Estimates are that the United States will be importing about \$100 billion in oil annually 10 years from now. If we're going to reduce the geo-economic risk of depending on the Gulf we need to invest now in fuel cells, bio-fuels, photovoltaic products and other cutting-edge technologies to begin making progress.

The corrosive effects of failing to invest in our national security are not limited to our Department of Energy. Consider what we're doing to our State Department. For the first time in our history there was no Foreign Service entrance exam given in the last two years. Roughly 20,000 individuals usually apply for a few hundred spots in the elite U.S. Foreign Service. If we use the excuse of budget cuts for failing to recruit the "best and brightest" minds for our diplomatic corps, what does that say about the prospects for the future of U.S. leadership in foreign affairs? We close important consulates around the world based on a reduced budget, and continue to emasculate our foreign aid program. Measured as a percentage of GNP the U.S. foreign aid contribution now ranks behind Portugal, Finland, and Ireland. The U.S. Agency for International Development reports that foreign aid was cut by one-third from the mid-1980s through 1994. Yet Congress is pushing a plan to reduce "foreign operations spending" an additional \$1.7 billion over the next five years. Former Secretary of State George Shultz remarked on occasion that it "takes money to

conduct foreign policy." We're cutting to the bone in foreign affairs; and the long-term consequences of these kinds of self-inflicted wounds should not be underestimated.

Defense Investments

Still, it is one thing to wreak budget havoc in the energy and foreign affairs accounts, but quite another to jeopardize your national security by gratuitously underfunding your defense base. Are we planning to spend enough future defense dollars to, for instance, ensure that we still have the "best damn Navy in the world" (Secretary Perry's words just a couple weeks ago) and a continued 100,000-man force in the Pacific? I don't think so. The geopolitical and strategic tectonic plates are still shifting on the European continent and determining the modalities of a new "security compact" beyond NATO will be difficult and painstaking. It will be even harder if the United States is unwilling to invest in long-lead procurement platforms (particularly ships and aircraft), power projection capabilities, and force structures to continue to ensure peace and stability in Europe.

Consider some of the demands on the U.S. military in the last few years. Since 1989 the number of troops deployed on contingency missions to places such as Haiti, Somalia, Rwanda, Macedonia, and Bosnia has gone up 500 percent. Consider that since 1991 the Pacific-based U.S. Seventh Fleet has been cut from 250 ships to 215 and its complement of sailors and marines from 250,000 to 215,000. Consider the trend in "teeth" and "tail"—"teeth" consist of strategic and general-purpose fighting forces (including airlift and sealift) and the rest is "tail." In 1985 the dollars spent on "teeth" and "tail" were about equal, which is generally considered the measure of a ready force. Today less than two-fifths of the defense budget goes to "teeth." And the trend is for that fraction to continue downward to one-third or less.

Consider that we are not replacing our ships fast enough. The current rate of replacement

would require that we keep some vessels in service for 50 years or more (that's completely unrealistic) to maintain an overall naval strength of roughly 350 ships (our current goal). Consider the "graying" of our air fleet. Top fighter aircraft, the F-15s and F-16s, were designed in the 1970s. Our Air Force projects that, by 2006, the average age of its fighters will reach 19.2 years. That means some planes in the fleet will be 40-42 years old.

Joint Chiefs Chairman General Shalikashvili believes that "We have been living on past modernization. But now it is time to terminate that." I certainly agree. We are risking long-term readiness with a procurement budget stuck at approximately \$39 billion. We need to invest in our military's future and that means spending more dollars on procurement.

We need to take a creative approach to financing and equipping a modern military force capable of defeating any army in the world. Leveraging technological advantages (by expanding the range and accuracy of our weapons and the effectiveness of support equipment) may allow us to reduce the number of troops and logistics operations. It has been suggested by the Chief of Staff of the Air Force that the next generation fighter aircraft may be so advanced that we might be able to get by with less. I believe we can do a lot more with unmanned aerial vehicles. We need to take a long hard look at the weapons systems on the drawing board for the 21st century and scratch off that list hardware that we don't absolutely need as part of our core military force structure.

I agree with Senator McCain that it's time to review our strategy to win two simultaneous major regional wars and to maintain so many forces at the highest level of readiness, but I differ with him in some respects. I believe our future command and force structure has to remain capable of executing nearly simultaneous Major Regional Conflicts (MRCs). But due to continuing problems of affordability (that won't be going away anytime soon), we need to keep a sharp eye on the economics of building a modern military force structure.

One idea I am exploring is the creation of a highly ready, highly mobile force for the first MRC, and another force that can be ready within 90 days to tackle a second MRC. That should make it less costly to operate the second force. I believe it is a prudent risk to assume that a second MRC should afford us enough warning time to bring the second force up to full readiness. In this regard, a full review of our reserve forces is necessary.

The new force structure would have to be highly flexible, so it could adjust easily to changes in threat. With more centralized basing, the force would be a "get-up-and-go" outfit. It would be lighter, and would have greater lethality and better C⁴I capabilities (command, control, communications, computers, intelligence). It would rely more on allied help in ground actions—and on air in the early stages of a campaign. And it would need much more airlift, sealift, and prepositioning of weapons and materiel than we have today.

In addition, because we know the principal threats for the foreseeable future and should have sufficient warning of any impending change, we should focus more on longer-term investments—for example, in information warfare and the recapitalization of military hardware. We need to take a fresh look at how well our structure complements our strategy. I believe we're top-heavy in combatant commands and can achieve savings by paring them from the current 9 to 7 or less. There are several approaches to this that I find reasonable. All of them presume that the combatant commands are structures to support the warfighters (the "teeth") and not for the "tail." Functions such as transportation do not need to be afforded such status. Savings could also be achieved by combining the Space Command and the Strategic Forces Command.

Even though it's not popular among some of the newer Members of Congress, I believe it's also time to take our heads out of the sand and be realistic about the need for peacekeeping forces. We ought to have a division-sized force ready to handle select, nontraditional opera-

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tions like Haiti, Rwanda, and Bosnia. This division ought to comprise soldiers whose military occupational specialties ensure they are highly skilled in the sorts of tasks that we've faced in each of these contingencies. We cannot (and should not) attempt to act as the world's policeman, but that sensible acknowledgement of the limits of U.S. power cannot and should not deter us from acting when necessary when it is the United States, and only the United States, that can end aggression and bloodshed.

Achieving a consensus in Congress on these types of missions, is becoming increasingly difficult and partisan. The House of Representatives chose not to even have a recorded vote on sending troops to Bosnia, given its near certain rejection. John McCain's "profile in courage" was absolutely vital on the floor of the Senate to getting the measure approved. Quite frankly, I don't believe Majority Leader Dole could have gotten enough votes to support the Commander-in-Chief's decision to deploy without John McCain, who rose above whatever partisan gain might have accrued to him by taking a different course of action.

Incendiary battles in the Senate and House are likely to continue on these kinds of issues. I certainly understand the concern and reticence of colleagues when the President sends troops to Haiti, Bosnia, and elsewhere. There are serious risks. But we cannot shrink from the role that only the United States of America can play in making peace work in faraway lands, when America is the only nation with the capacity to lead the effort. In Bosnia, the President ultimately made a choice in favor of leadership over isolationism, in favor of standing with our NATO allies not abandoning them, in favor of morality rather than accepting more genocidal slaughter.

U.S. world leadership depends on a credible strong defense base to meet the challenges of tomorrow. The Nimitz and the Independence may be back in the Taiwan Strait again. Preventing a Libyan chemical weapons plant from coming on line will be no easy feat. With the expan-

sion of NATO's ranks comes additional military responsibilities, raising Moscow's ire. And issues of terrorism, ethnic conflict and the like will be with us for a long time. World peace and stability come at a stiff price. The United States needs to be prepared to make the down payment now, and we're not doing that at the present moment. It is obviously not too late to change, but we need to get started. If our allies are going to depend on us to do our part we've got to be credible and ready. To do that (to paraphrase George Bush's inaugural address) we're going to have to have both the will and the wallet.

Charles S. (Chuck) Robb is a Member of the U.S. Senate (Democrat, Virginia).

ROY MACLAREN

NAFTA is Part of Canada's Transformation

FOR EACH OF THE PAST three years Canada's exports, whether in industrial or agricultural products or in services, have been at record levels—and they show no signs of flagging. For example, Canadian exports to the United States increased by over 20 percent in 1994 and 14 percent in 1995. Exports to Mexico, our other NAFTA partner, grew by 30 percent in 1994 and, despite the peso crisis, by 8 percent in 1995.

How did we get there? Behind the myriad of variables contributing to our export success is the central fact that the Canadian economy—and Canada in general—has undergone a fundamental transformation, even a revolution, in the way that we relate to the world. Today we are more competitive, more productive and, perhaps most importantly, more outward-looking than at any point in our history. Canada has quite literally turned itself inside-out.

The transformation, moreover, is not merely economic, although productivity and export growth is perhaps the most tangible measure of these changes. The real revolution is psychological. Our collective mind-set is now increasingly open, our focus increasingly global. Canadians have come to recognize that the challenge of globalization is not merely to manage technological and geopolitical change but to embrace it.

Fiscal Revolution and

Reduction of Trade Barriers

Why? The two principal reasons are fiscal policy and the reduction of trade barriers. In singling them out, one must acknowledge that other elements have no doubt contributed substantially, including the fact that inflation in Canada has been near zero for several years. But the basic point that I want to make is that fiscal and trade policies march together; that our commitment to open trade regimes fueled our fiscal revolution, and our fiscal revolution in turn enabled us to compete internationally and to achieve the record export levels I have just noted.

In trade policy, Canada committed to freer trade globally in the Uruguay Round and regionally in NAFTA almost at the same time. Our confidence in doing so was the greater as a result of the industrial adjustments that we had already undertaken as a result of the U.S.-Canada Free Trade Agreement. When we first contemplated embracing 75 percent of our total exports in a regional rules-based free trade agreement, there were not only fears that we were eschewing the traditional Canadian commitment to globalization in favor of restricted continentalism, but there were also widespread misgivings that the Canadian economy and Canadian worker would prove vulnerable to the "great sucking sound" to the south. That did not occur. Even those industries generally agreed to be especially vulnerable—wine, furniture and garments among them—have proven to be both resilient and, more importantly, innovative in seeking export market niches where hitherto (content as they were with their domestic market) they had not ventured. Partly as a result of such enterprise, such animal spirits, Canadian exports to the United States and Mexico have soared—it is not too strong a word—as indeed have their exports to Canada.

Two Points of Concern

The news then, after almost 30 months of NAFTA, is very good indeed. It is not, however, universally good. I shall mention two

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points of concern and then draw several positive conclusions.

The first of the two points of concern about NAFTA are the continuing disputes that arise over the application of national trade remedy practices—primarily anti-dumping—in a free trade area. It is absurd that in a free trade area without commercial borders, border measures are still applied. Common competition policy must be the answer in a free trade area, as it is in any national economy. The sooner we make progress toward common competition rules—both on the global plane and especially on the regional—the better.

The second—and I trust temporary—problem that has arisen in NAFTA is that despite the existence of a pristine clear accession clause, we collectively seem incapable of welcoming even a country so admirably equipped to accede as Chile. In the hope of facilitating the early NAFTA accession of Chile, I instituted some months ago the negotiation of a bilateral free trade agreement with Chile.

Concluding Observations

I now want to offer several concluding observations:

1. Canada's membership in NAFTA as well as in the Uruguay Round have done exactly what many of us had hoped they would do. Canada has become more productive, more internationally competitive. Other factors have certainly played a part, but freer trade has unquestionably been a leading force making for our improved competitiveness.

2. The need to compete finally forced upon us the inherent condition, the imperative, of getting our fiscal house in order. Despite warning signs, the debt and deficit were slow to become top-of-mind issues with the Canadian public. Then, rather suddenly, all that changed. People came to understand that the problem had reached a genuinely critical juncture; that endless deficits really did have something to do with Canada's high real interest rates; that higher government spending really did translate into higher taxes,

the tolerance for which had reached its limit; and that deficits at 8 percent of GDP—soon I'm pleased to say to be at only 2 percent—were a major brake upon our export potential. This amounted to a crucial turning point in our national psychology. Without some such shift in the public mind-set, it seems to me that democratic societies cannot come fully to grips with what needs to be done to solve a debt problem. NAFTA and the Uruguay Round certainly contributed to that crucial turning point in our national psychology.

3. Our experience in NAFTA has also given us the confidence to contemplate an acceleration to global free trade. Here in Canada, I have begun to advocate—so far in vain—the unilateral abolition of all our industrial tariffs, especially since 80 percent or more of our trade is now tariff-free. We shall at least abolish all nuisance tariffs shortly, I'm pleased to say. The regional experience of NAFTA has begun to contribute to a healthy skepticism in Canada towards our residual tariffs, partly as a result of our recognition that to tax imported inputs for incorporation into manufactured products to be exported to our NAFTA partners makes no sense at all. I said a moment ago that there were widespread misgivings in Canada, when the original U.S.-Canada Free Trade Agreement was being negotiated, that we were turning our back on our multilateral traditions and embracing a narrow continentalism. To the contrary, what we have been able to do at the regional level has given us greater confidence about what we can do at the global level. As other regional groupings emerge across the world—in the Asia-Pacific or the Americas, to name but two—I trust that a greater commitment to and confidence about global free trade will prove to be a universal experience, and that the new World Trade Organization will be the beneficiary. One such regional initiative should be Trans-Atlantic, but that is another story.

Roy MacLaren was until January 1996 Minister of International Trade in the Chrétien Government. On July 1 he became High Commissioner in London.

NAFTA's Positive, Limited Effects

MY TOPIC IS how the U.S. economy has fared since our high-octane Congressional debate on the North American Free Trade Agreement (NAFTA) in November of 1993. More specifically, I've been asked to address the international competitiveness of the U.S. economy today, the effects of the NAFTA, and finally whether an increasing regionalism is likely to characterize the U.S. economy as we look ahead.

U.S. Economy and Trade Expansion

Let me start with a snapshot of the U.S. economy today as compared to 1993, our point of reference. Although the economy grew modestly in both 1995 and 1993 (about 2 percent), business investment in 1995 was much more robust and stock prices jumped 37 percent from 1993 reflecting much stronger corporate earnings. Inflation was roughly the same for both years (about 2.5 percent), and since 1993 our budget deficit has declined.

Fueled by strong demand for U.S. products and continued domestic expansion, total U.S. trade (which includes earnings and payments on foreign investment) hit a record \$2.2 trillion in 1995, up 38 percent from 1993. In 1995 we imported \$895 billion worth of goods and services, with capital goods and industrial supplies and materials leading our foreign purchases (reflecting both our increased economic output and our investment in the economy). Our exports for 1995 hit a record high of \$784 billion, up 22 percent from 1993, fueled by (1) escalating demand in the developing world, especially Asia (excluding Japan) and Latin America (excluding Mexico), the two fastest growing regions of the world; (2) continued recovery in the industrialized world, particularly Europe and Canada; (3) a com-

petitively valued dollar; (4) broad recognition of the improved competitiveness of U.S. products (last year, for example, for the second year in a row, the World Economic Forum ranked the U.S. as the world's most competitive economy); and (5) reduction of trade barriers, multilateral and regional, of which the NAFTA was the most controversial.

NAFTA and Its Effects

In assessing the effects of the NAFTA on the U.S. economy, let me start with a word about the actual content of that Agreement. It covers precisely the same issues as did the Uruguay Round Agreements but in every area it went further. For example it eliminates, not just reduces, tariffs on all industrial products. It guarantees unrestricted agricultural trade in a period of 15 years between Mexico and the United States, the first trade agreement to remove all such barriers. It opens a broad range of services, including telecommunications and financial services. It provides the highest standard of protection for intellectual property that has been achieved in a trade agreement. And it provides clear rules to protect the international investor.

As a result of the NAFTA's market-opening provisions, all three countries experienced very substantial trade expansion in 1994, the first year that the Agreement was in force. That year, U.S. and Mexican exports jumped 20 percent—each country shipped more than \$50 billion to the other, setting a bilateral trade record. Similarly, shipments between the United States and Canada increased 14 percent, which was slightly ahead of the average growth of exports by the U.S. worldwide.

Unfortunately, these positive outcomes have been overshadowed by Mexico's financial turmoil, which became front-page news with the December 1994 peso devaluation. Since then, U.S. opponents of the NAFTA, on the left as well as the right, have pointed to Mexico's problems as clear-cut evidence that the United States never should have entered into the Agreement, and now should with-

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draw. But the provisions of the NAFTA had absolutely nothing to do with Mexico's financial difficulties. We can agree that policy mistakes were made by the Mexican government, but that fact does not support the proposition that the NAFTA is detrimental to any of our nations' interests. Indeed quite the opposite is true. Despite the severe contractions of the Mexican economy, in 1995 U.S. sales to Mexico were higher than in any year prior to the NAFTA, and the second-highest year on record. The NAFTA has protected U.S. exports from the type of restrictions that Mexico imposed during its 1982 economic crisis, which cut our sales by half (it then took a full six years for U.S. exports to Mexico to return to their pre-crisis levels). By encouraging Mexico to remain increasingly open, deregulated, and competitive, the NAFTA will help Mexico recover, which in turn will help it become, once again, a vibrant trading partner.

Now having said all that, given the roughly \$7 trillion size of the U.S. economy (relative to Canada's roughly \$550 billion economy and Mexico's roughly \$250 billion economy), the tangible effects of the NAFTA's market-opening provisions on the U.S. economy are much, much smaller than either NAFTA's proponents or opponents often claim—nor has it had any tangible, significant effect on countries outside the region, which worried so much while the negotiations were taking place.

Still it is not an exaggeration to claim that the NAFTA did more than stimulate trade throughout North America. The Congressional ratification in November 1993 breathed new life into the stalled Uruguay Round multilateral trade negotiations, encouraged forward momentum on the Asia-Pacific Economic Cooperation initiative to liberalize trade and investment throughout the vast and rapidly growing region of the Pacific Rim, and put hemispheric liberalization at the top of the agenda at the December 1994 Miami Summit (where for the first time 34 hemispheric leaders committed to negotiate a free trade agreement for the Americas, by the year 2005).

**Trade is Engine for
Growth and Better Jobs**

Our trade initiatives, both multilateral and regional, have made and will continue to make a very positive difference to our economy, for trade is the engine driving U.S. economic growth and creating better jobs. Although multilateral liberalization has a wider impact because it involves over 100 trading partners, regional liberalization very often is broader, deeper and swifter, and can stimulate emulation outside the region. I would expect U.S. trade policy in the future to include both global and regional initiatives, for the United States needs access to markets in every region of the world.

U.S. growth would have been negative in the fourth quarter of 1995 without the record sales of goods and services to foreign buyers all around the globe. Today, roughly a third of the U.S. economy is international. With fewer than 5 percent of the world's population, the United States produces more than a fifth of the world's output and constitutes the world's largest multinational investor. So our interests in trade and investment are and will continue to be global.

Developing countries, particularly those in the Asia-Pacific region and in Latin America because of their economic ascendance, increasingly are likely to contribute to U.S. export growth. These two regions together currently account for 27 percent of total U.S. exports. Their future development needs mesh extremely well with U.S. pre-eminence in the production of many capital goods and industrial inputs.

A significant risk to our continued economic growth is the escalating unease in the United States about opening our home markets, particularly to lower-wage countries. Trade (and the NAFTA in particular) has become the popular scapegoat for the economic uncertainty that has grown with corporate downsizing, necessitated by extremely rapid globalization, keen competition and technological change. A March *Wall Street Journal*/NBC survey found that nearly two-thirds of Americans

believe that free trade agreements cost more U.S. jobs than they create, and by better than a two-to-one margin, Americans believe that the NAFTA has had a negative impact on American jobs. In recent months these misconceptions have been nurtured by populist campaign rhetoric attacking free trade agreements—particularly the NAFTA—as a way to exploit the deep anxieties that Americans have about job security and wage stagnation. Too often, I could even say most often, these attacks have gone unchallenged by trade supporters.

With the dramatic decrease in the cost of transportation and the lowering of trade barriers, our international opportunities have never been brighter. A recent study completed in Washington, D.C., by the Institute of International Economics and the Manufacturing Institute documents that companies which export enjoy higher growth, experience fewer failures, create more jobs, pay better wages and offer greater job security than those that do not export. So our challenge is to convince Americans that efforts to open markets constitute a proven way for our nation to tap into these new and expanding opportunities which enhance job security and improve their wages.

Carla A. Hills, U.S. Trade Representative in the Bush Administration, is now Chairman and Chief Executive Officer of Hills & Company.

CLAUDIO X. GONZALEZ

Mexico is Moving Forward, with NAFTA's Help

IF YOU HAD INVITED a Mexican speaker two years ago, we probably would have been extremely, non-realistically bullish about what was going on in Mexico. If you had invited us one year ago, we probably would have been extremely pessimistic and bearish. I think we can give you a more balanced view today.

NAFTA is Working

NAFTA, we believe, has been a huge success for Mexico, the United States and Canada. When Carla Hills was involved in negotiating NAFTA, we frequently talked about the win-win-win characteristics of NAFTA. I think we are starting to see that this is the case in real life.

The acid test for NAFTA occurred in 1995. You have to test these kinds of treaties in bad times. Mexico's GNP dropped by 7 percent during 1995. U.S. and Canadian exports did not drop as much as you would expect. Roy MacLaren just indicated that Canadian exports, starting from a smaller base, were up; and U.S. exports were down much less than you would have expected. As Carla Hills already stated, in the 1982 crisis in Mexico, U.S. exports dropped by half from one year to the next. Mexico treated its balance-of-payments problem by closing off its market and by raising import duties. U.S. exports took six years to come back to the pre-crisis level. In 1995 in contrast, U.S. exports were down by less than 9 percent (in an economy that was falling by 7 percent) and were still about \$5 billion higher than pre-NAFTA levels. Mexico did not close off its borders, and U.S. exports are already starting to recover in 1996. In contrast, exports from Europe and Japan to Mexico were down by almost 40 percent during 1995. Mexico implemented the sec-

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ond and third rounds of NAFTA tariff cuts after the crisis struck; and when Mexico raised duties on various products after the crisis came upon us, it exempted obviously all NAFTA products. Three-way trade among the NAFTA partners is now over \$120 billion, and growing again in 1996.

Mexico buys 74 percent of all of its imports from the United States while the U.S. only buys 8 percent of its imports from Mexico. Still, in an election year in the United States, the noise level has been high. It subsided somewhat after Mr. Buchanan got trounced, particularly in South Carolina. Textile interests on the one hand and high-tech and foreign investment interests on the other hand are very present in the state of South Carolina, and the victory by Senator Dole was quite convincing—as happened also in various other states. However, the noise level will come back, particularly if a certain Texan comes back into the race. So we have to be prepared to make the case very clearly that NAFTA is working and that NAFTA is a success. During good times, as it was designed to do, it drives U.S. and Canadian export growth. And in bad times, it limits the drops in exports. Looking further, NAFTA will help create the sustainable growth economy in Mexico which will help ease many other problems, including the emigration pressures.

Locking in Reform

One of the key objectives of NAFTA was to lock in Mexican trade and economic reforms, and this is happening. Obviously a lot of us think that what happened in Mexico in late 1994 was an avoidable crisis; certainly a crisis of such large proportions was avoidable. (One of these days we'll write up what happened during the grossly mishandled and botched transition from one government to the other.) Anyway, the crisis occurred, and immediately many voices were heard in Mexico blaming NAFTA for the crisis. Nothing could be further from the truth. One of the reasons Mexico is coming back so much more quickly, particularly compared to any other of our crises in the last three decades, is pre-

cisely because we are a different economy—and we are a different economy in large part because of NAFTA.

President Zedillo has been called a “light” President by some of his detractors in Mexico, but there is nothing light about him. He has stayed the course very firmly, very convincingly, despite many moments and temptations to change course during the initial stages of the crisis during 1995. The medicine has been tough, but the guiding principle has been that we are an open, market economy now and have to perform as such. This means we have to carry out continuously sound and transparent economic policies. We have to continue and deepen structural reform in our country. We have to increase our internal savings rate. And we also have to be very attractive to foreign savings and to foreign investment. This is happening in Mexico, and one of the big reasons is because we are now an open, market economy—and we are so because of NAFTA.

Results are occurring. The economy has started to grow in the second quarter of 1996. Employment is growing again, albeit much more slowly than we would like. Inflation is dropping. Interest rates are also coming down. Exports continue to grow at a substantial double-digit rate. (They grew more than 30 percent during 1995 and will probably grow, from a larger base, close to 20 percent during 1996—at least the first three months of 1996 indicate this growth rate.) Our current account has been balanced very, very quickly. Investment is growing, both national and foreign investment, at very strong rates—more than 40 percent over 1995. Government accounts are in balance, and this has been a strong underpinning for the lowering of inflation and our starting to turn things around much more quickly than in earlier crises in Mexico. Access to international financial markets has been achieved much more quickly than at any time in the past after this kind of balance of payments situation. Privatization continues to be implemented. Deregulation is going forward. Judicial reform is being implemented. All of this by a “light” President!

Electoral reform is also moving forward. During 1995, at the height of the economic crisis, 17 different state gubernatorial electoral process occurred in Mexico (including in Chiapas and in Michoacán, the home state of the left-of-center presidential candidate in Mexico); and all of these electoral processes were carried off peacefully and with increasing democratic participation. Very importantly, social security reform has also occurred in our country, particularly the aspect of individual savings accounts. Fiscal reform and the lowering of taxes are underway. Major internal market and export opportunities are presenting themselves in Mexico, more rapidly every day.

The overall situation is certainly much better than it was twelve months ago, and is certainly headed in the right direction. And NAFTA is one of the principal reasons and drivers.

Substantial Challenges

However, Mexico is not without challenges. We do have some very substantial challenges. Our financial system, as you would expect, is not in good shape, coming out of this crisis. I think this is the single biggest immediate challenge that we have, because it is going to be a great obstacle to growth as the next months go on. We have to find some solutions that will avoid this happening—and it isn't going to be easy. The cost of capital is still quite high, even though it is coming down as inflation is coming down—and the Bank of Mexico, which is now an independent body, is making its presence felt more and more every day in monetary policy. We have to increase internal savings. We have taken some of the basic measures to do so, however this will take time and we have to continue to be very attractive to external savings and investment in our country.

External accounts will present a challenge once growth is reestablished, particularly when the Mexican economy starts to grow at 5 percent or better rates, as expected in 1997 and beyond. Obviously it is very important to have stable financial inflows to back up what will undoubtedly be a negative current account because

of the growth needs within our country.

That is why sound economic policies are so mandatory in our total situation. And obviously we still have much to do in structural reform, in our educational system, in continuing our judicial reform, and in achieving an increasingly competitive economy that generates jobs. This is the key issue in Mexico at present: the generation of jobs. We have a very uneven income distribution in our country, and the only way to start tackling it is to create more jobs.

Finally, and very very important in this whole challenging situation, is a successful transition in political reform to a much more democratic system. Obviously this is being watched very closely within the country and outside of the country. The *New York Times* has sometimes said something is wrong in Mexico because the PRI is winning all of the elections. Now the *New York Times* is saying something is wrong in Mexico because the PRI is not winning all of the elections. Obviously there is some middle ground here that we're going to have to achieve, and we are in the transition phase.

* * *

In sum, Mexico, I believe, is headed in the right direction. Despite the huge crisis, the country has held together and is starting to move forward. We have very committed and convinced leadership that has demonstrated it is staying the course. But we are still very vulnerable because we are in transition from the country that we have been to the country that we want to be. Development in Mexico will not be in a straight line; however, I believe Mexico provides major growth opportunities, and the present is a very good positioning moment for investment.

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...WE ARE IN
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SECTION 9
EUROPE'S
FUNDAMENTAL CHALLENGES

HERVE DE CARMOY

Economic and Welfare State Reform While Moving to EMU

A SUPERFICIAL GLANCE could lead external observers to the conclusion that on the economic, monetary and social fronts, there is and will be "nothing new in Western Europe"—the title of a famous book—in the near future. OECD projections (see Table 1) seem to corroborate that misperception.

I propose to analyze what lies behind these figures. What are some of the forces at work? What are some of the momentous political decisions being taken, which may alter the economic, social and political landscape of Europe before the turn of the century? EMU and the European welfare states will be at the center of our thought process.

My presentation will be in two parts. We will first review economic developments within major European countries. Then we will probe into the hidden part of the iceberg, the nature of the political scheme that is unfolding.

Germany

Germany is both a key country and the center of a monetary and economic zone which includes Austria, Belgium, the Netherlands and Denmark and now extends beyond the EU to the Czech Republic and Slovenia. This is illustrated by the fact that short- and long-

term interest rates in these countries, over a protracted period of time, vary little (between 0% and 1%) from German interest rates. That linkage, combined with the reality of the intertwining of these economies with that of Germany, suggests that we may already have at work a small-scale version of EMU in Europe.

What happens to the German economy—a three trillion DM economy—is important in terms of EMU in its broadest sense and in terms of the social dimension of the European Union. The OECD projections in Table 2 require a few comments. In spite of a rate of capital formation 30 percent higher than that of Great Britain, the German economy is in quasi-stagnation and unemployment is high. However, the public deficit will have been brought well within the Maastricht criteria by 1998.

Several factors explain the differential in performance in economic growth and unemployment with the United Kingdom (and with the United States). Two are worth a special mention:

- First is the evolution of the exchange rate of the DM. The volume of German exports has a negative sensitivity to prices of 0.5, which means that an increase in prices of 10 percent reduces volume by 5 percent. A year ago the DM appreciated by 28 percent in relationship to the dollar, by 27 percent in relationship to the lira, by 17 percent in relationship to the pound. These rates of appreciation have been more than halved since then but their impact on economic growth rates and unemployment has been far from insignificant.
- Second, under the label *Standort Deutschland*, Germany is implementing fairly radical policies in terms of deregulation, public deficit reduction and the overhauling of "corporate Germany" (as evidenced by the changes in Bayer or in Mercedes). This quiet revolution is happening a decade later than in the United Kingdom and the United States. As is normal in that kind of process, the economic and social costs are borne upfront,

GERMANY IS IMPLEMENTING FAIRLY RADICAL POLICIES IN TERMS OF DEREGULATION, PUBLIC DEFICIT REDUCTION AND THE OVERHAULING OF "CORPORATE GERMANY"...

TABLE 1
European Union: Basic Economic Indicators

	1995	1996	1997	1998
GNP growth (<i>volume</i>)	2.9%	2.6%	2.7%	2.8%
inflation	2.9%	2.6%	2.6%	2.7%
unemployment (% of active population)	10.8%	10.5%	10.3%	10.1%

Source: OECD

TABLE 2
Germany: Basic Economic Indicators

	1994	1995	1996	1997	1998
GNP growth (<i>volume</i>)	2.9%	2.1%	2.4%	2.7%	3.0%
inflation			2.0%	2.1%	2.0%
unemployment (% of active population)	10.0%	9.6%	9.3%	9.1%	9.0%
public deficit (% of GNP)			3.1%	3.0%	2.3%

Source: OECD

TABLE 3
France: Basic Economic Indicators

	1995	1996	1997	1998
GNP growth (<i>volume</i>)	2.7%	2.2%	2.7%	3.0%
inflation	1.8%	2.0%	2.1%	2.0%
public deficit (% of GNP)	5.0%	3.9%	3.0%	3.0%

Source: OECD

with the corresponding impact on GDP growth and unemployment.

The United Kingdom

The contrast with the performance of the United Kingdom is significant.

- In the United Kingdom, the GNP growth rate has been higher than Germany for the last two years, by more than 20 percent. The OECD projects that the U.K. growth rate for the next three years should at least match that of Germany.
- On a five-year basis, unemployment will have gone down by a good 2 percent as a result of shrewd monetary policy and unemployment policies and a reduction of the active population.
- The public deficit, which was at 7.8 percent of GNP a few years ago, is projected by the OECD at 2.8 percent in 1997.

There is a saying that all roads lead to Rome, or to Brussels in its twenty-first century version! The path taken by Great Britain deserves therefore a special mention. Not surprisingly, the United Kingdom has been inspired by the United States. Like America between 1980 and 1990, the U.K. has carried out simultaneously four fundamental changes:

- It has been more audacious in the timing and implementation of deregulation, from telecommunications to water, from gas to financial services. The same can be said about privatization. The last *coup d'état* was done without blinking an eye, when the first track of railroad was leased to a French private company (which must say something about either the French or British Rail).
- The United Kingdom has also gone a long way towards cleaning up its boardrooms. Throughout the country, shareholders have made their voice heard and eased out management when it was less than competent.
- Like in the United States, the United Kingdom has created a fiscal environment conducive to the reemergence of a new class of

entrepreneurs, of the Branson type.

- Finally the social cost of that deep a revolution has been softened by exchange rate adjustments, to the greatest benefit of Great Britain.

Paradoxical as it may sound, the United Kingdom seems well positioned now to take on a leading role in Europe. We should adopt the attitude to the U.K. that Mrs. Thatcher adopted to President Mitterrand: "I do not listen to what he says. I look at what he does." In the case of the U.K., facts speak louder than words.

The United Kingdom meets most of the Maastricht criteria. In addition it has made major strides in carrying out its internal revolution, at an acceptable social cost. So it has a legitimacy in terms of democratic and political tradition and domestic modernization, and that legitimacy allows it to play a leading role in Europe. But will the other powers in Europe, notably Germany and France, let it?

Italy

Italy provides a transition between the United Kingdom and France:

- Its GNP growth rate has been higher than that of Germany, by more than 20 percent, for 1994 and 1995. It is projected to match Germany in 1996 and 1997.
- Its public deficit will be going down from 9.6 percent to 6 percent of GNP (and it could be erased if Italian interest rates were to decrease permanently by 3 percent).
- The level of unemployment appears to be declining moderately, but the recent changes in statistical calculation methods invite us to be cautious.
- Finally, like France, Italy enjoys a healthy current account surplus, which should grow to \$30 billion in 1997, from \$15 billion in 1994.

So Italy might well be ready for EMU two to three years from now. The story of Italy is

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a repeat of that of other European countries, including Spain and Portugal. More belatedly than the United Kingdom, but in keeping with its tri-millennium tradition, Italy has carried out Herculean tasks in terms of pension and tax reforms, deregulation and privatization. It is also overhauling its industrial base. Numerous changes in boardrooms have taken place with a view to accelerate the re-engineering of Italian industry. Like the U.K., Italy has protected its industry and cushioned the social cost resulting from the above-mentioned transformations by devaluing its currency.

France

France has a 7 trillion Franc economy with remarkable convergence with Germany, be it in GNP growth, inflation or even the public deficit (see Table 3). The balance of trade between France and Germany is in equilibrium and, in contrast to Germany, France's current account balance is likely to be positive (\$15-20 billion for the next three years, as last year).

Like the rest of Europe, but later than the United Kingdom, France is carrying out massive internal reforms. The British may have to suffer some painful problems with their "mad cows," but the French are slaughtering battalions of sacred cows. Social security, health care, pensions, education, military industry, railways, and telecommunications are all being either revamped, deregulated, privatized or overhauled. The revolution is rapid, brutal and requires opening up many battlefronts at a considerable human cost.

The Hidden Part of the Iceberg

In that sense, France, like Germany is no different from the rest of Europe, except for the hidden agenda, or what I called earlier the hidden part of the iceberg. What differentiates France and Germany from some of the other European countries is their common political commitment, across the entire democratic political spectrum, to the common European currency, as the lever to accelerate

the political integration of Europe. It is the continuation, with another means, of the process initiated in 1952 when coal and steel were privileged as the symbol and reality of European unification. Forty-five years later, France and Germany are committed to money—with its broad basis, for it concerns every citizen and every organization—as the trigger for another leap forward in the European integration process.

This is a political decision, with very significant social and economic consequences. In a first phase, it appears plausible that unemployment will rise and that the gap between rich and poor will widen, especially as the welfare state will be slimmed down to meet the Maastricht criteria on public deficits. In fact, the high social price of further European integration through EMU has been tacitly accepted, as illustrated by the absence of implementation of the Delors Plan for reduction in unemployment through large European public works.

Because of the political decision to use EMU for furthering political integration in Europe, the social price may be even higher than it was for instance in the United States, where it proved to be significant. We all know that over the last 20 years the average earnings of the lowest-paid workers in the United States fell by 18 percent, while the after-tax pay of U.S. management increased by some 60 percent. On the other hand, America created 20 million jobs, while in Europe unemployment rose by the same figure.

Europe will have to devise its own home-made solution to keep the momentum toward closer political unity through EMU while re-engineering its industrial base and its welfare state systems. Europe—notably France and the DM-zone countries—would be well-advised to be inspired by certain aspects of the American experiment, lowering the price of less-skilled labor as a better human and financial policy than paid unemployment.

Pragmatism will be of the essence, for the risk of ripping apart the national social fabric

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is not a gratuitous hypothesis. The December strikes in France, with one million people out in the street, are a useful reminder of the tensions caused by that evolution.

This may be why the social ambitions of Europe are presently at the center of the French position on the future of Europe. The French position serves a domestic purpose, by placating the opposition on an issue which belongs to their natural agenda. But it also suggests an alternative to the free-trade zone notion of Europe of which the United Kingdom is a proponent, as well as to a Federal Europe supported by Germany. Sometimes, like their Canadian friends, when the French cross the road they stay in the middle. What have they found in walking to the middle and stopping? They have found a confederal Europe, with substantial self-government, and a common currency.

In conclusion, Europe is changing at a wrenching pace and change has become more difficult to handle in social and political terms. But let there be no doubt: The European Community will not become an industrial museum. It will alter its welfare states and attempt to deepen its unification process by using EMU as a catalyst.

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KARSTEN VOIGT

Reform and Enlargement of NATO and the European Union

AFTER THE REVOLUTION of 1989, the goal to overcome the division of Europe can only be achieved by primarily focusing on the enlargement of hitherto Western institutions like the Council of Europe, NATO, and the European Union—plus, but this is no longer at the center like it was during the time of détente policies, the strengthening of pan-European institutions like the OSCE. Because Russia could become a member of the Council of Europe and because the importance of a membership in the Council of Europe was more psychological than economic and geostrategic, the enlargement of the Council of Europe went relatively smoothly and provoked relatively little controversy. The enlargement of NATO and the EU is bound to be different. Both are institutions with which Russia can cooperate and with which Russia eventually could be associated, but into which Russia—in any foreseeable future—cannot be integrated.

Historically, the threat to the security of Europe arose not from the military strength of Central and Southeastern European states, but from their rivalries and from the threat to them from their strong neighbors, Russia and Germany. The states in that region cannot overcome their security problems through arms build-ups; and it is highly probable that a re-nationalization of their policies would be accompanied by growing tendencies towards competitive national arms build-ups. The enlargement of NATO and the enlargement of the European Union into this area will cost money. (I have seen studies on that from the Congressional

Research Service and from RAND.) But the political and financial costs of non-enlargement will be higher than the costs of an enlargement. To a limited degree NATO, and to a much larger degree the European Union, have to reform themselves to be able to absorb new members from Central and Southeastern Europe. But most of these reforms will have to be achieved anyhow, whether those institutions are enlarged or not.

Two Arguments for Enlargement

We have already heard a lot of arguments in favor of enlargement of NATO. I will add two arguments which normally are not mentioned.

One is a German argument, but it's not only a German argument. The eastward enlargement of NATO and the European Union should and will complete the multilateral integration of Germany, which is already completed in the west. This multilateral integration places a political and institutional obligation on Germany to take its neighbors' interests into account when furthering its own values and interests. Each of Germany's eastern neighbors expects greater cooperation from Germany than other European Union and NATO members are able and willing to offer. The eastward enlargement of the European Union and NATO will hinder bilateralization in German policy towards these eastern neighbors—which would otherwise be a problem for Germany's neighbors in the east and the west, and ultimately for Germany itself. In addition, all Germany's eastern neighbors except Russia are in a relatively weaker position in bilateral cooperation. Like the integration with its western neighbors during the Cold War, the complementary integration of Germany with its eastern neighbors after the Cold War is necessary to prevent the resurgence of a two-fold problem endangering Europe's security—namely, Germany's relationship with its neighbors and those neighbors' relationship with Germany.

The second argument involves Russia. NATO needs a good relationship with Russia and, in a different way, also with Ukraine. The pre-condition for such a relationship is the integration

of the smaller countries in-between. For if the United States or NATO as a whole or Germany specifically, cooperates with Russia more closely than today—and I am in favor of that—while at the same time rejecting the desire of those smaller nations to join Western institutions, the whole region would shiver. And only with them being members in those integrated structures will they feel self-confident enough to cooperate more closely with Russia themselves.

Needed Reforms More Difficult in EU

Reforms are needed inside NATO. Some reforms have already been implemented—like the Rapid Reaction Corps. Some other reforms will be decided upon in the June meeting in Berlin—like the Combined Joint Task Forces (which is already practiced in Bosnia but has not been formally accepted) and the giving up of certain command structures. I think it is relatively easier to achieve those reforms in due time inside NATO.

It's more difficult while also being more urgent to have those reforms inside the European Union. There is a consensus that the European Union should be enlarged to the east. But there is also a consensus that reform inside the European Union is needed. We need reform in the institutions, in the decision-taking process, in the regional funds, in the structural funds, and especially in the agriculture sector. All those reforms are needed anyhow, but they are also important as a pre-condition for an enlargement of the European Union. If those reforms are not implemented, the European Union will not be capable of integrating new members.

The Process of EU Enlargement

In the next few years it will be very important to speed up getting the East European countries closer to the European Union. They are now accommodating in the juridical sphere. We have a couple of agreements to open the markets for steel, textiles, and agricultural products. These agreements will come into effect in '96 and '98. Most of these countries already carry on the majority of their trade with Western Europe

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already. (Poland, for instance, has more than 50 percent of its exports and imports now with the European Union.) This process of opening the market of the European Union should be continued and even speeded up.

The clear question is: when can new members be accepted? Many people in the European Union say all the reforms which I mentioned have to be decided upon and implemented before the new members can be let in. Some are even saying that all the economic reforms needed to make those countries really competitive have to be implemented (not only decided) before those countries can be in. This would then practically mean that those countries will become members after the year 2000.

Others are suggesting a certain transition period, like we had with Spain and Portugal. The problem with this is that we now have a single market in the European Union. This internal market is now so liberal that the transition period which was possible with Spain and Portugal will not work. The economies of the new members would be ruined by being exposed to the competition of Western markets.

* * *

In conclusion, it's very obvious that these two institutions—NATO and the European Union—need reform, but it's easier to let new members in earlier in NATO than to let them in earlier in the European Union. Both elements of enlargement, although linked, are not automatically coupled with one another in terms of the time framework. We should start with those countries which could be let in earlier, and we should start with those institutions which could be opened earlier for East European members.

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SECTION 10 JAPAN IN SEARCH OF A NEW FRAMEWORK

YOICHI FUNABASHI

The Politics of Security Policy

I HAVE BEEN INSTRUCTED to focus on the Japanese political framework, particularly the politics of security policy. I just flew in last night from Okinawa, where I stayed for four days after covering President Clinton's trip to Korea and Japan and his meetings with President Kim Young-sam and Prime Minister Hashimoto. The agreement which President Clinton forged with Prime Minister Hashimoto was a really high mark for the U.S.-Japan relationship. That relationship, which has been drifting in the past five or six years, now seems to be getting to the right track. The definition of the U.S.-Japan security relationship which they agreed in their mutual declaration is really the starting point of mutual effort and cooperation between the United States and Japan in a radically different international environment.

Okinawa

I had a good conversation with Governor Ota of Okinawa Prefecture, one of the most powerful politicians in Japan right now because he has the power to block the leasing of U.S. bases in Japan. And without his full commitment and cooperation to the return of the U.S. bases in this most recent agreement, implementation would be very difficult. He was basically positive on the agreement, on the return of Okinawa bases, although he still seemed to be cautious about the actual outcome. (More than 75 percent of U.S. bases in Japan are concen-

trated on that small island, and 23 percent of these bases will be returned to Japan over the next 5-7 years.)

Certainly the Okinawans are happy to get that land returned, but at the same time there are some strong opponents of the recent agreement on the island. They feel that the base structure essentially remains. U.S. bases are still very much concentrated in Okinawa. And the intrusiveness of the noises and the exercises is unbearable. They feel that they are victimized, that they are the ones who have suffered from those problems which the Japanese government and U.S. administration have not been able to come to grips with sufficiently in the years since Okinawa's return to Japan in 1972.

Yet Governor Ota talked about his future vision of Okinawa. He wants to make Okinawa another hub of the booming Southeast Asian maritime sphere. Okinawa has already started exchange programs with Fujian Province in China. Last year a delegation of more than 200 business people from Fujian visited Okinawa, and this year Okinawa will dispatch a huge delegation to Fujian. Their relationship with Taiwan is very close. They are now starting a business forum with Taiwan and the Philippines. They want to make Okinawa a free port, bringing in the foreign investment not only from the Japanese mainland but from other Asian countries. In other words, Governor Ota said that he would like to see Okinawa emerging as a part of the East Asia economic miracle—perhaps not dissimilar to Okinawa's history in the 15th, 16th, and 17th centuries when Okinawa was independent and thriving as a part of a sort of East Asian Hanseatic League. Okinawans have been very active and energetic in the Pan-Pacific area. Recently President Alberto Fujimori of Peru was a guest, because there are two Okinawan-Peruvians in his cabinet. The Okinawans have 125 self-designated envoys to various countries. So they count on the Okinawan diaspora to support Okinawa's economic development. In the past they just talked about this, but now they realize that it is achievable.

The reaffirmation of the U.S.-Japan security relationship and return of bases (including the Futenma airfield) to Okinawa are a real boost to the current Japanese administration, particularly Prime Minister Hashimoto. We have not seen political leaders personally charged in such a visible manner as he has demonstrated to accommodate on the base issues and to pursue the stronger relationship needed between the United States and Japan, particularly since the Gulf War era.

Regionalization of Japan's Foreign and Security Policy

Let me focus on the search for a new framework more specifically, particularly two frameworks related to security and foreign policy emerging in the coming years.

The first one is the regionalization of Japan's foreign policy and security policy. What I mean by regionalization is Japan's new effort and reorientation of foreign policy to link the traditional bilateral relationship between the United States and Japan to Japan's new and larger role in the Asia Pacific region. That process has already been underway. With the new spirit and agreement between two countries, I think that direction will be more clarified and articulated, and that the momentum will gather.

However, Japan also will be more confronted with political constraints in Japan. The Japanese Constitution bans collective self-defense and has presented constant political obstacles to Japan's further commitment to regional security. It is the major reason that Japan and the United States have not been able to pursue more vigorous, meaningful mutual cooperation on regional security. Japanese opinion leaders seem to have shifted, from reservations about Japan's commitment to regional security to a somewhat more embracing stance in the most recent years. Yet this constitutional and political constraint will remain.

The divisiveness of the issues may highlight the divisions in the current coalition government. Some argue for strengthening Japan's role in regional security and for allowing Japan

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to interpret more liberally the conditions and constraints of the Constitution. Others have been very reluctant to go down that path.

This is not only a political and constitutional problem, but also a strategic issue. There are some other regional powers, particularly in Beijing, who have watched closely the development of the debate, particularly the constitutionality issue. And China has not hesitated to express its suspicion of the new rationale of the U.S.-Japan security relationship, suspecting that Japan and the United States are trying to shift the containment of the Soviet Union into the containment of China. This is another factor that Japanese policymakers will have to take into account.

Engaging China

Another framework that I would like to mention is the engagement of China. The rise of China forces Japan to reexamine its own foreign policy. Government officials do not admit that their new rationale for the U.S.-Japan security relationship is aimed at China. However, it is no secret that the China factor, if not a China threat factor, is an underlying factor pushing both countries to reaffirm and redefine the U.S.-Japan security relationship.

China has accepted the U.S.-Japan security relationship since the early 1970s. Yet, most recently they have become nervous about the new direction of the U.S.-Japan security tie, in large part because they feel it would encourage Japan to pursue the re-militarization of Japan's security policy, and push for military power.

Japan has viewed China as an occasional bully, such as when it recently used old-fashioned gunboat diplomacy over the Taiwan Strait. That already posed serious dilemmas for Japan's China policy which evolved and progressed since the early 1970s, the China policy which can be called an integrationist policy, designed to engage and integrate China into the international community by extending yen loans and promoting APEC and supporting the Beijing Olympics. Japan's bridging

role to re-engage China, particularly after the Tiananmen incident, has also been a part of this.

The foundations of this integrationist policy are now challenged in Japan as the people have felt more keenly the challenge and even risks from China. I hasten to add that Japan has not seen China as a threat; and there is a strong tendency, particularly among the older generation, towards cultural and psychological affinity as well as guilt feeling towards China. However among the elite and the younger generation, views about China have been much more critical and they are more cautious about Japan-China friendship. We have been witnessing the erosion of the strong China lobby, across the board among the younger generation of politicians, the bureaucrats (whether Ministry of Foreign Affairs or MITI), the media, and even the business community. Japanese politicians will have to take account of those more critical voices from their constituencies.

New Political Dynamics in Japan

Finally, let me briefly touch on the new political dynamics in Japan. Japanese politics has lost its foundation in the past several years, since the end of the Cold War. The deep distrust of the political class in the public is very much visible. Politicians and business leaders were the first target (since the late 1980s), which brought the downfall of the Takeshita Cabinet and the others. Since the early 1990s, the bureaucracy (particularly the Ministry of Finance, the mightiest of mighty Kasumigaseki bureaucracy) was made a target. Our media is now the target. In a way, the sort of Trilateral Commission regime in Japanese domestic politics is the target now. And all this has deepened the apathy and even cynicism in the public. I think one of the reasons for this is that the people feel betrayed by the inaction and lack of commitment on the part of the Japanese "reformist" politicians. These politicians have argued for reformist agendas in the past five or six years, yet have been a total failure. That has caused a strong populist sentiment.

Moreover, we have been witnessing strong anti-tax sentiments, as the Japanese have felt diminishing expectations of their future, the future of Japan's economy. They have been more critical of any move by the politicians to cope with tax reform and tax issues. I think that could upset this delicate coalition government of the Hashimoto Cabinet as they turn to raising the consumption tax rate from 3 to 5 percent in the fall.

There are only two heroes among the Japanese politicians. One is the Minister of Health and Welfare, and the other is the Governor of Miyagi Prefecture. The reason why they have gained so much popularity, compared to that very bleak picture of the other politicians, is that they have only been interested in exposing the dark side of bureaucracy, the abuse of power in bureaucracy, whether it's in central government or in local government. So, Japanese politicians have been forced to be preoccupied with domestic politics. They have seen the dismantling of the political framework of the past forty years. Yet we have not seen any sign of the new political framework to be built on the relics and ravages of the old regime.

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TOYOO GYOHTEN

The Economic Framework

Near-Term Improvements

I AM PARTICULARLY PLEASED to speak this year instead of last year, because a year ago the Japanese economy was battered by a series of unlucky incidents, so to speak. We had a devastating earthquake, which knocked two percent off our GDP in a

few minutes. We suffered very much from the overshooting of the exchange rate of the yen, which appreciated vis-a-vis the dollar by more than 20 percent within less than four months. There was also a looming crisis in the financial services industry as the result of the collapse of the property market. At any international gatherings, the only thing I heard were words of condolence.

By now the weather map of the Japanese economy seems to have improved considerably. The yen's overvaluation was pretty much corrected by the concerted efforts of Trilateral monetary authorities and the reduction in our external imbalance. As to the bad loan problem of financial institutions, although a lot of hard work is still to be done, at least the strategy and framework for the solution of the problem have been established. In other words, the institutions which constitute the main body of our Japanese banking industry—money-center banks and regional banks—have actually started to write off or provide adequate provisions for these non-performing loans. And for smaller, weaker institutions (such as credit unions or farmers cooperatives), some kind of public support (either the injection of tax money or some assistance from our central bank) will be provided in order to protect their depositors. Of course, during this process, considerable reorganization will take place in our financial industry.

There are growing signs of an economic recovery. Production, investment, consumption are all rising, and corporate profits are improving. Reflecting that, the stock market has been quite bullish recently. The majority view now is that for 1996 our GDP growth rate may reach something between 2 percent and 2.5 percent, and hopefully 3 percent for next year. Just a few days ago the IMF released its latest *World Economic Outlook*, which puts the Japanese growth rate for '96 and '97 as the highest among G-7 countries.

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bution has been negative. Our external surplus has been declining rather rapidly, and this year our current account surplus will be less than 2 percent of our GDP. This reduction of our surplus was achieved by a very sharp increase of imports (almost 20 percent on an annual basis) and much slower growth in exports (less than 10 percent).

In order to maintain this momentum of recovery, it is my strong view that the current macroeconomic policy stance—that is, easy monetary policy and stimulative fiscal policy—needs to be maintained. The near-term prospect is reasonably good.

Medium- and Long-Term Pessimism and Optimism

But how about the medium- and long-term? Views are split between pessimism and optimism, but there is a common recognition in Japan that the Japanese economy in the future has to operate in a new framework. Speaking more precisely, this means that the Japanese economy, first of all, has to undergo extensive change in its industrial structure. Secondly, the *modus operandi* of the Japanese market, for both the private sector and the government, needs to change. These changes are absolutely necessary for us now because we are faced with increased competition as a result of, first, a stronger yen and high wage costs at home; second, the rapid advance made by East Asian economies in manufacturing; and third, U.S. dominance in the information technology and financial services industries.

With this common recognition, the point of departure for pessimism and optimism is whether or not you think Japan can successfully carry out the transformation. Pessimists argue that the changes will inevitably imply the almost total relinquishment of the traditional Japanese employment system, corporate culture, business-government relationship, etc. They are afraid that Japan will not be able to do it, that Japan will be able only to continue piecemeal, mediocre steps. As a result, aged population and industrial hollowing will set

in. This is rather a bleak picture.

Optimists argue that there is still abundant entrepreneurship in Japan, as evidenced by mushrooming, successful new ventures and the very serious restructuring efforts made by many corporations already. Optimists argue that if deregulation is adequately carried out, and if the exchange rate remains reasonably stable, there is a good chance of success. (The current range of exchange rates, between 100 and 110 yen per dollar, is not intolerable for any Japanese businessman.)

If we succeed in carrying out this transformation, the Japanese economy will thrive as an integral part of the regional economy, closely linked with the Asia Pacific economy through a multi-level division of labor. I—frankly speaking—am inclined to be an optimist, but in order to play it safe I'd like to hold my answer until next year's meeting in Tokyo.

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