

**BILDERBERG  
MEETINGS**

**RYE BROOK  
CONFERENCE**

**10-12 May 1985**

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**NOT FOR QUOTATION**

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## LIST OF PARTICIPANTS

### HONORARY SECRETARY-GENERAL FOR EUROPE AND CANADA:

VICTOR HALBERSTADT\*  
Professor of Public Finance, Leyden University

### HONORARY SECRETARY-GENERAL FOR THE UNITED STATES:

THEODORE L. ELIOT, JR.\*  
Dean, Fletcher School of Law and Diplomacy at Tufts University

ITA	GIOVANNI AGNELLI**	President, FIAT S.p.A.
USA	DWAYNE O. ANDREAS	Chairman, Archer-Daniels-Midland Company, Inc.
NOR	JOHAN H. ANDRESEN	Chairman and Chief Executive Officer, Tiedemann Group
AUS	HANNES ANDROSCH*	Chairman of the Managing Board, Creditanstalt-Bankverein; Former Vice-Chancellor and Minister of Finance
USA	HANS H. ANGERMUELLER	Vice Chairman, Citibank N.A.
USA	GEORGE W. BALL**	Former Under Secretary of State
POR	FRANCISCO PINTO BALSEMÃO	Former Prime Minister; Director, "Jornal Expresso"
CAN	THOMAS J. BATA	Chairman, Bata Ltd.
USA	JACK F. BENNETT*	Director and Senior Vice President, Exxon Corporation
NOR	EIVINN BERG	Ambassador and Permanent Representative, Norwegian Delegation to NATO; Former State Secretary
TUR	SELAHATTIN BEYAZIT*	Director of Companies
USA	JOHN C. BIERWIRTH	Chairman, Grumman Corporation
TUR	M. NURI BIRGI	Ambassador at Lärge
ICE	BJÖRN BJARNASON	Assistant Editor-in-Chief, "Morgunbladid"
CAN	CONRAD M. BLACK	Chairman, Argus Corporation, Ltd.
USA	BILL BRADLEY	U.S. Senator, New Jersey
USA	NICHOLAS F. BRADY	Chairman, Dillon, Read & Company, Inc., Former U.S. Senator (New Jersey)
USA	ZBIGNIEW BRZEZINSKI	Herbert Lehman Professor of Government, Columbia University; Former Assistant to President Carter for National Security Affairs
USA	WILLIAM P. BUNDY**	Former Editor, "Foreign Affairs"
USA	LOUIS W. CABOT	Chairman, Cabot Corporation
ITA	UMBERTO CAPPUZZO	Chief of Staff, Italian Army
GRE	COSTA CARRAS*	Member of the Board, Greek Shipping Cooperation Committee
FRA	HÉLÈNE CARRÈRE D'ENCAUSSE	Professor, Institut d'Etudes Politiques de Paris; Professor of History and Political Science of the Soviet Union at the Sorbonne

SPA	JAIME CARVAJAL URQUIJO*	Chairman, Banco Hispano Industrial	USA	VERNON E. JORDAN, JR.*	Partner, Akin, Gump, Strauss, Hauer & Feld; Former President, National Urban League
SWI	KASPAR V. CASSANI	Senior Vice President, IBM Corporation; Chairman, IBM World Trade EMEA Corporation	GRE	BASIL KAFIRIS	Governor, Agricultural Bank of Greece
SPA	JUAN LUIS CEBRIAN	Director and Editor-in-Chief, "El Pais"	FRG	KARL KAISER	Governor, Research Institute of the German Society for Foreign Affairs
INT	A. W. CLAUSEN	President, The World Bank	TUR	JAK V. KAMHI	Chairman of the Board, Profilo Holding A.S.
POR	JOSÉ MANUEL TORRES COUTO	Secretary-General, General Trade Union UGT	UK	GEOFFREY C. KENT	Chairman and Chief Executive, Imperial Group, PLC
FRG	RALF DAHRENDORF	Professor, Konstanz University (School of Social Sciences)	USA	HENRY A. KISSINGER*	Former Secretary of State; Professor, Center for Strategic and International Studies, Georgetown University
USA	KENNETH W. DAM	Deputy Secretary of State	UK	ANDREW KNIGHT*	Editor, "The Economist"
BEL	ETIENNE DAVIGNON	Former Member, Commission of the European Communities	INT	EMILE VAN LENNEP	Former Secretary-General, OECD
USA	MURRAY H. FINLEY*	President, Amalgamated Clothing and Textile Workers Union, AFL-CIO	UK	LORD LEVER OF MANCHESTER	Former Cabinet Minister and Financial Secretary; Former Member of Parliament
IRE	GARRET FITZGERALD	Prime Minister of the Irish Republic	LIE	H.S.H. PRINCE HANS-ADAM VON LIECHTENSTEIN	Chairman of the Managing Board of Directors, D.S.M.
FRA	JEAN FRANÇOIS-PONCET	Former Minister of Foreign Affairs	NET	HANS B. VAN LIEMT	Minister of Finance
FRA	MICHEL FRANÇOIS-PONCET	Chairman, Paribas North America	POR	ERNANI RODRIGUES LOPES	President, The Council on Foreign Relations, Inc.
USA	CHARLES GETCHELL*	Partner, Gray & Wendell; Rapporteur Bilderberg Meetings	USA	WINSTON LORD*	Senior Partner, McCarthy & McCarthy; Chairman, Royal Commission on the Economic Union and Development Prospects for Canada
FRA	MICHEL GIRAUD	Senator; President, Regional Council of Ile de France	CAN	DONALD S. MACDONALD*	President, CB Media Ltd. and Publisher, Canadian Business; Former Member of Parliament and Minister of National Revenue
USA	DONALD GREGG	Assistant to the Vice President for National Security Affairs	CAN	ROY MACLAREN	President, The Brookings Institution
USA	WILLIAM E. GRIFFITH	Professor, Political Science Department, Massachusetts Institute of Technology	USA	BRUCE K. MACLAURY*	Vice Chairman, Liquid Air Corporation
CAN	FRANKLYN GRIFFITHS	Professor, Center for Russian and East European Studies, University of Toronto	USA	JACQUES MAISONROUGE	U.S. Senator, Maryland
SWE	STEN GUSTAFSSON*	Chairman of the Board, Saab-Scania AB	FRG	CHARLES MCC. MATHIAS, JR.*	Minister of State, Ministry of Foreign Affairs
ICE	GEIR HALLGRIMSSON*	Minister of Foreign Affairs	FRG	ALOIS MERTES	Director, French Institute of International Relations; Professor of Economics, Ecole Polytechnique
SWI	HANS HECKMANN	Executive Vice President, Member of the Executive Board, Union Bank of Switzerland	FRA	THIERRY DE MONTBRIAL*	Professor of Monetary Theory and Policy, and Director of the Institute of Economics, Bocconi University, Milan
USA	HENRY J. HEINZ II**	Chairman, H. J. Heinz Company, Inc.	ITA	MARIO MONTI*	Director of Finance, Canton of Fribourg; Former M.P.
SWE	MATS HELLSTROEM	Minister for Foreign Trade	SWI	FÉLICIEN MOREL	Editor-in-Chief, "Berlingske Tidende"
FRG	ALFRED HERRHAUSEN*	Managing Director, Deutsche Bank A.G.	DEN	NIELS NØRLUND*	Ambassador to NATO; Former Foreign Minister
USA	JOHN J. HORAN	Chairman, Merck & Company, Inc.	TUR	OSMAN OLCAY	Director, International Institute for Strategic Studies
USA	ROBERT HORMATS	Director, Goldman Sachs International Corporation; Former Assistant Secretary of State for Economic and Business Affairs	INT	ROBERT O'NEILL	
FIN	JAAKKO ILONIEMI	Member of the Management Board, The Union Bank of Finland; Former Ambassador to the U.S.			
UK	MARTIN W. JACOMB	Vice Chairman, Kleinwort, Benson Limited			
BEL	DANIEL E. JANSSEN*	Member Executive Committee, Solvay & Cie, S.A.			
USA	JAMES R. JONES	U.S. Congressman, Oklahoma			

INT USA	JEAN-CLAUDE PAYE RICHARD PERLE	Secretary-General, OECD Assistant Secretary for International Security Policy, U.S. Department of Defense
USA USA	LELAND S. PRUSSIA ROZANNE L. RIDGWAY	Chairman, Bank of America U.S. Ambassador to the German Democratic Republic
USA	DAVID ROCKEFELLER**	Chairman, Chase Manhattan Bank International Advisory Committee
INT UK ITA NET	BERNARD W. ROGERS LORD ROLL OF IPSDEN** GUIDO ROSSI H. ONNO RUDING	Supreme Allied Commander Europe Chairman, S. G. Warburg & Co., Ltd. Lawyer Minister of Finance, Chairman of the Interim Committee of the IMF
ITA	GIOVANNI SARTORI	Albert Schweitzer Professor in the Humanities, Columbia University
USA ITA USA	RICHARD M. SCAMMON MARIO SCHIMBERNI BRENT SCOWCROFT	Director, Elections Research Center President, Montedison Vice Chairman, Kissinger Associates; Former Member of President's General Advisory Committee on Arms Control
FRA	E. ANTOINE SEILLIÈRE*	Director-General, Compagnie Générale d'Industrie et de Participations
UK SPA FRG USA	PATRICK SHEEHY JAVIER SOLANA MADARIAGA THEO SOMMER* HERBERT STEIN	Chairman, BAT Industries, PLC Minister of Culture Publisher, "Die Zeit" Senior Fellow, American Enterprise Institute
UK	NORMAN TEBBIT	Secretary of Trade and Industry; Member of Parliament, Member of the Prime Minister's Cabinet
CAN SWI	PIERRE ELLIOTT TRUDEAU VICTOR UMBRICH**	Former Prime Minister Member of the Advisory Board, Ciba-Geigy Ltd.; Mediator, East African Community
NET	JOOP M. DEN UYL	Parliamentary Leader, Labour Party; Former Prime Minister
AUS UK NOR USA	FRANZ VRANITZKY MARK WEINBERG NIELS WERRING, JR.* JOHN C. WHITEHEAD	Minister of Finance Chairman, Hambro Life Assurance, PLC Senior Partner, Wilh. Wilhelmsen Chairman, International Advisory Board, Goldman Sachs & Co., Inc.
FRG USA FRG	NORBERT WIECZOREK JAMES D. WOLFENSOHN OTTO WOLFF VON AMERONGEN**	Member of Parliament President, James D. Wolfensohn, Inc. Chairman of the Board of Management, Otto Wolff A.G.
CAN FRG USA	BERNARD WOOD MANFRED WÖRNER EDWIN H. YEO III	Director, North-South Institute Minister of Defense Managing Director, Morgan Stanley & Company, Inc., former Under Secretary of the Treasury

UK	LORD YOUNG OF GRAFFHAM	Minister without Portfolio; Member Prime Minister's Cabinet
ITA	PAOLO ZANNONI*	Director, Department of Political Analysis, FIAT S.p.A.

#### IN ATTENDANCE:

UK	JOHN HENNINGS	Organizer, 1986 conference; Former High Commissioner in Singapore
USA AUS	CHARLES W. MULLER GEORG ZIMMER-LEHMAN	President, Murden and Company Managing Director, Creditanstalt-Bankverein

#### RAPPORTEURS:

USA USA	CHARLES GETCHELL GRANT F. WINTHROP	Partner, Gray & Wendell Communications and Public Relations Consultant
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#### LIST OF ABBREVIATIONS:

AUS	Austria
BEL	Belgium
CAN	Canada
DEN	Denmark
FIN	Finland
FRA	France
FRG	Federal Republic of Germany
GRE	Greece
ICE	Iceland
INT	International
IRE	Ireland
ITA	Italy
LIE	Liechtenstein
LUX	Luxembourg
NET	Netherlands
NOR	Norway
POR	Portugal
SPA	Spain
SWE	Sweden
SWI	Switzerland
TUR	Turkey
UK	United Kingdom
USA	United States

\* Member of the Steering Committee  
\*\* Member of the Advisory Committee

## INTRODUCTION

*This report was prepared by Grant F. Winthrop and Charles Getchell, joint rapporteurs. The various individual interventions summarized in the "Discussion" sections have been grouped according to subject matter, and do not necessarily follow the exact chronological order of the actual discussions.*

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The thirty-third Bilderberg Meeting was held at Arrowwood of Westchester, Rye Brook, New York, on May 10, 11, and 12, 1985. At the request of Mr. Walter Scheel, Chairman of the Bilderberg Meetings, who was unable to attend because of the serious illness of his wife, Lord Roll of Ipsden opened the conference, and Mr. Giovanni Agnelli presided over the closing session.

There were 113 participants from 19 European nations, the United States, Canada, and various intergovernmental organizations. They came from government, politics, business, industry, finance, trade unions, diplomacy, the law, education, journalism, the military, and institutes specializing in national and international studies.

All participants spoke in a personal capacity, without committing in any way the organizations or governments to which they belonged. As usual at Bilderberg Meetings, in order to permit frank and open discussions, no reporting of the conference sessions was allowed.

In opening the conference, Lord Roll conveyed to the participants Mr. Scheel's regret at not being able to attend and his best wishes for a successful meeting. In addition, he read the text of a message of thanks and good wishes to the American people, to be sent on behalf of all those at the Bilderberg Meeting to the President of the United States.

Lord Roll observed that this year's conference was taking place just a few days after the fortieth anniversary of VE day. Out of that event had grown the NATO Alliance, and Bilderberg, while not formally a part of the Alliance, had been born alongside it. In its 32 meetings, Bilderberg had proven its value by bringing together, in an environment conducive to the free and open exchange of views, those people who had to create and carry out policy, make decisions, and form opinions in the countries of North America and Western Europe.

The agenda was as follows:

### I. DIVERGENT SOCIAL AND ECONOMIC TRENDS IN THE ATLANTIC WORLD

Moderator: David Rockefeller

Discussion panelists: Ralf Dahrendorf, Richard Scammon and Herbert Stein (all authors of working papers)

### II. HOW SHOULD THE WEST DEAL WITH THE SOVIET BLOC?

Moderator: Andrew Knight

Discussion panelists: Zbigniew Brzezinski, Hélène Carrère d'Encausse (author of background paper), Karl Kaiser (author of working paper), and Manfred Wörner

### III. THE STRATEGIC DEFENSE INITIATIVE

Introduction: Richard Perle

### IV. HOW SHOULD THE WEST DEAL WITH DEVELOPING COUNTRIES?

Moderator: Daniel Janssen

Discussion panelists: Lord Lever of Manchester and Edwin H. Yeo III  
(both authors of working papers)

### V. CURRENT EVENTS: THE U.S. BUDGET AND THE EUROPEAN PERSPECTIVE

Moderator: Theo Sommer

Discussion panelists: James R. Jones, Charles McC. Mathias, Jr.,  
H. Onno Ruding

### VI. OPERATING THE ALLIANCE

Moderator: Giovanni Agnelli

Discussion panelists: Etienne Davignon and Brent Scowcroft (authors of  
working papers) and Jean Francois-Poncet

### I. DIVERGENT SOCIAL AND ECONOMIC TRENDS IN THE ATLANTIC WORLD

\* \* \* \* \*

"Social, Economic and Political Developments in Europe and America"

*Working Paper Prepared by Ralf Dahrendorf,  
Professor, School of Social Sciences, Konstanz University*

Europe means above all difference. There is probably a European interest which is the motive force of what progress has been made towards European integration. There are also certain underlying socio-political and socio-economic developments which can be traced in most, if not all European countries. But in reality, differences in history, in the conditions of economic development, in political structure and in cultural heritage are what matters to people above all. This is the grain of salt with which the following general comments have to be taken.

One major socio-political development may well link most OECD countries, including those of Europe and North America. A century of struggles for citizenship rights for all has been largely successful. Everywhere, equality before the law has been followed by universal suffrage and further, by the setting up of a social state which guarantees that citizenship is more than an empty promise. From bourgeois societies dominated by a privileged class of those with property, power and opportunity, modern societies have turned into citizens' societies in which the overwhelming majority can hope to live a worthwhile life. At least two-thirds of all people in the OECD world are citizens in this emphatic sense of the word.

However, more recently, two new developments have complicated the picture. At one end of the social scale, a growing number of well-trained and often able younger people (the "yuppies", or young urban professionals among them) have become impatient with a sense of stagnation and stifling equality in the citizens' society. They demand the revival of the values of achievement by tax incentives, greater flexibility of social and economic structures, a new social Darwinism which creates the conditions for the survival of the "fittest". These new achievers are usually associated with the service and information industries, or rather "post-industries", because they espouse many of the post-industrial values described by Daniel Bell.

At the other end of the scale, the society of citizens has begun to marginalize, if not define out a growing number of people. Unemployment is the most striking illustration of this process. The "natural"—which really means structural—rate of unemployment seems to stabilize at not much less than ten per cent. More and more unemployed have been in that condition for a year or more, so that they are no longer eligible for unemployment benefits. Marginalization by unemployment has been aggravated by the treatment of ethnic minorities, the condition of inner cities, and, most seriously, the state of social suspense in which many young people are held. It is as if those who are "in", are closing ranks in order to protect their status, which means that those who are not or not yet "in" are condemned to becoming a new underclass. This is a class of restless individuals, a kind of *lumpenproletariat*, liable to threaten law and order and form a reserve army of riots and rebellions. The size of this underclass varies. It is not one-third of the population (as those imply who describe modern societies as "two-thirds' societies"), but it is larger than ten per cent everywhere.



The political consequences of such developments lead us straight into the world of difference. There is probably, in the OECD countries of Europe and North America (as well as some others), a large middle ground of those who believe that prevailing conditions permit sufficient improvement to be fundamentally desirable and worth defending. There is also an impatient political wing which wants change, including supply-side economic policies, incentives for initiative and achievement, support for elite education, law and order, perhaps a new patriotism to go along with the values of achievement. Then there is the situational, disorganized, but serious threat to social order by the underclass and those who claim to speak on its behalf; there are demands for a more social state, if not for a total transformation of the system.

But these forces are expressed very differently in different countries, depending on their peculiar political structures. In Germany, the scramble for the centre is still pronounced. All major parties are eager to conquer the middle ground. As a result, the new political wings flutter as much outside the official world of politics as inside it. Britain, on the other hand, has a more eccentric political tradition. Both traditional parties have in fact been run from their respective extremes for a number of years. There has even been a sense that the middle ground has been deserted; this has given rise to the formation of the Liberal-Social Democratic Alliance, but also strengthened the hands of more traditional Disraeli Tories and even the Labour right. Many other countries display variants of these two themes, with specific national traditions and issues complicating the picture.

It is important to add that while the political center is likely to remain dominant for some time to come, it has become essentially a defensive force. The wings represent more aggressive groups, including the Greens in Germany who give voice to a generation of young opponents of the system, the National Front in France which expresses the impatience of the new achievers, but also many in the middle ground who are motivated by perceived or real threats to law and order; the Glistrup antitax voters in Denmark who are frustrated with the rigidities of the prevailing system; the aggressive New Left in a number of countries. Times ahead will not be quiet politically. Above all, there is likely to be as much action at the margin or outside political institutions as within them.

The eminently agreeable condition sustained by the large middle ground of OECD societies is also responsible for what has been described as the sclerosis of modern societies. This has many aspects, but the most important single one is probably the ambivalence of the social, or welfare state. It was the keystone of the creation of citizens' societies.

But it also involved a heavy tax burden as well as the setting-up of bureaucracies which put us all in that "iron cage of bondage" which Max Weber foresaw seventy years ago. The social state has taken as much liberty as it has given equality. The dilemma today is how we can undo the damage without re-creating the conditions of deprivation which gave rise to the social state in the first place.

The sclerosis of modern societies is strengthened by the interests of groups. Mancur Olson has vividly described the coalitions of special-interest groups which make innovation difficult. Trade unions are by no means the only organizations which contribute to the growing rigidity of real wages, conditions of employment, systems of taxation, even principles of economic policy. Whether these rigidities make for an actual "decline of nations" (as Olson claims), may be debatable. But it is certain that they are obstacles in the way of those technical developments, or rather their application, which form the basis of lasting prosperity in the developed world.

It is often said that social rigidities are much greater in Europe than in the United States. "Eurosclerosis" has become a widely used catchword. The observation is probably correct, but requires two qualifications. One is that such rigidities are by no means absent in the United States, nor is their presence confined to the East Coast. The other qualification is that the very tradition of rigidities in Europe has led to the development of mechanisms of coping which are not always ineffective. "Concerted action," "co-determination," "social partnership" can be elements of sclerosis, but they may be instruments of change as well.

A time of change is often a time of fear. A time of fear, however, makes confident international co-operation more difficult. This is clearly true so far as the process of European co-operation and integration is concerned.

Several factors combine to suggest a less than sanguine prognosis for European integration in the coming years. Widespread defensiveness and the consequent tendency to look inward is one of them. There is also the reaction against the "big is beautiful" obsession of the 1960s; decentralization is the order of the day. Then there is simply disappointment with what has been achieved so far. (All these factors are at work in the United States, and in American attitudes to international arrangements and organizations as well.) The net result of such trends is not only a new patriotism, but the beginning of a new nationalism and a new isolationism as well.

In the case of the European Community, the main danger is that it will become an organization for the cushioning of decline. Already, it is most active with respect to declining industries like agriculture and steel; its funds and rules are used to protect rather than to innovate. New developments take place at the margin of the institutions of the Community or entirely outside them. The European Monetary System (EMS) is an example of the former, the European Roundtable of businessmen one of the latter.

The weakness of the European Community is all the more serious in view of the decomposition of the post-war international system. Europe has to organize itself not only as a response to the European interest, but also as a kind of second-best response to questions raised on the wider international plane. However, this requires a counter-cyclical orientation on the part of those in power. Too many seem to look inward at a time at which we are less and less able to afford this luxury.

This is a gloomy analysis at a time at which optimism rather than dependency is in demand. A conjunctural desire to get out of a decade of long faces and worried questions combines with the silver lining of the new opportunities of the "information society" and an understandable pride in the accomplishments of the citizens' society to make people want to look up and forward.

Even in Germany, there are signs that the generation of Greens will be followed by one of happy achievers. This new mood of optimism is clearly highly desirable. However, self-congratulation and pride in past achievements are not enough. The new buoyancy will last only if it helps us cope with the major issues of the day. On the basis of the analyses sketched in this paper, they can be put in a series of questions:

- How can we set rigid societies and sclerotic economies on a new path of movement which is more than the costly luxury of a Darwinian struggle for survival?
- How can we safeguard full and effective citizenship rights for all without the expensive cage of bondage of the bureaucratized welfare state?
- How can we cope with unemployment in view of the fact that the work society of old will not return, and that neither growth nor schemes of job creation will solve the problem?

- How can we guarantee law and order without abandoning the liberal advances of the last decades?
- How can we open the boundary of the society of citizens to those who now remain at or outside it, including many of the young?
- How can we make sure that the principle, "as much decentralization as possible, as much centralization as necessary", is taken seriously in both its parts, and notably that there is a new understanding of the exigencies of international co-operation?

Practical answers to these large questions will inevitably fall short of what is desirable and even necessary, but any step in the right direction is preferable to the worsening sclerosis of societies dominated by a hardening and defensive majority.

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### "Some Aspects of the American Political System"

*Working Paper Prepared by Richard M. Scammon,  
Director, Elections Research Center*

Last November the American political system produced an overwhelming re-election victory for Republican President Reagan. At the same moment in time it gave Democrats their fifteenth consecutive majority in the national House of Representatives. To those accustomed to parliamentary systems, disciplined national parties, and at least some degree of alleged ideological unity, some words of comment might be helpful. The classic example of the American voter's tendency to spread himself all over the political landscape took place in 1968, the year the electors of Arkansas gave their support to a Republican for Governor, a Democrat for Senator, and an Independent (George Wallace) for President of the United States. And this is not uncommon. Last November President Reagan carried some 90 per cent of the Congressional districts in the eleven Southern states. At the same time, a majority of Democrats were elected from the South to serve in the House of Representatives.

Basically, this circumstance evolves from the fact that American "label parties" are far more federal in nature than is the Republic itself. The national party does *not* determine who runs for the Senate or for the House or for local offices. These nominations are determined almost entirely by so-called "primary" elections. These elections, held some months before the General Election in November, are not restricted to dues-paying, card-carrying party members. Any citizen who so wishes may say he is a Democrat, and thereby be entitled to vote in choosing the Democratic party nominee for any available office. In the Congress today all members are either Republicans or Democrats, but the label means whatever the member may wish it to mean. Moreover, once elected, members may or may not follow the leadership of their party group in a legislative body. Since they are first nominated, and second elected, by a large mass of local state or district voters, it is to this mass they must look for re-election, not to a national party ideology or to a national party apparatus nor to a national party leader.

This local control, plus the non-parliamentary and non-PR character of American politics, has meant that on most public issues compromise is a more likely winner than a stronger ideological party dogma on either side. Not always; sometimes there is a

"hundred days" for President Roosevelt or a "first year" for President Reagan. But indeed, caucus organizations of members are common, especially in the House—a Black caucus, an Hispanic caucus, a Farm caucus (cotton, peanuts, tobacco, corn-hog, dairy, wheat, etc.), a Northeast caucus—these and many others tend to unite common interests of members across party lines (if any).

Of course, on many issues there is a "White House" line, or policy—on deficits, on MX missiles, on Central America and the like. But these policies are only incidentally Republican (or Democratic).

"Voting the District" is so common in American political practice that a Detroit congressman (of either party) who supported unlimited import of Japanese automobiles would be regarded as more than a little off his rocker. But, since local interests of this sort tend to compete with one another in varying parts of the country, a mid-point tends to develop in support of a centrist solution to problems.

Within this context, then, the results of the 1984 voting were not abnormal. Mr. Reagan won re-election by a very substantial majority indeed, carrying virtually every segment of the population saving only black, Jewish and Hispanic voters. Within the rest of the electorate, sex, age, education, income, occupation, religion . . . none of these provided Mr. Mondale with a majority. There were differences, of course; women voted for Mr. Reagan less than did men, trade union families less than non-trade union families, low income less than high income. But he won them all, saving only the blacks (10 per cent Reagan), the Jewish (35 per cent Reagan) and the Hispanic (35 per cent Reagan).

Though this victory has suggested to some a new alignment of American politics, this seems unlikely. As has been suggested, the Democratic label has had a majority in the House for 30 years. Since the beginning of the modern Presidential era in 1952, with the election of General Eisenhower, Republicans have won the White House six times, the Democrats only three. Moreover, each Republican elected for the first time for the Presidency (Eisenhower, Nixon, Reagan) has won re-election and won it with an increased majority. Since the Roosevelt era, the only elected Democrat who tried for a second term was Jimmy Carter—he lost. So this anomaly might continue for years. It may be illogical, but it exists . . . and it continues.

Nor do many voters see anything unreasonable in this arrangement. Few may divide their ballots as did the Arkansas voters in the election of 1968, but every Democratic Senator re-elected last fall was elected in a state carried by President Reagan . . . and Mr. Mondale's home state of Minnesota (the only state the Democrats carried for President) saw an incumbent Republican Senator re-elected.

There are many proposals for change in the American political system . . . a longer term for the President, campaign finance reform, changes in the Presidential nominating process . . . but almost never is a voice heard for either Parliamentarianism or for tightly disciplined political parties. What may change in the next 15 years of American politics—as indeed it has changed in the past 40—may be the group relationships which sustain the "normal" pattern of party support. With all that has been said about voters shifting around, it is still true that in circumstances where other things are equal, the party label does have a considerable pull. If not, it would not be possible to say that some of the strongest bases of Democratic Party voting have been in the South, Roman Catholics, and, since Franklin Roosevelt, blacks and blue-collar white workers. But other things are not always equal, especially for the Presidency. This is the only office in America in which the parties express themselves through a single individual candidate. You cannot give a Presidential candidate's left arm to the liberals and his right arm to the conservatives, though you may certainly elect liberal

*Democratic* House Members in the North and conservative *Democratic* House Members in the South. With this in mind, it is not surprising to note that in three of the last four Presidential elections (excepting only the Carter victory in 1976) blue-collar white workers, Roman Catholics and white Southerners have voted Republican for President.

In the political future Republicans will obviously try to extend their Presidential primacy down as far as they can. Democrats, in reverse, will try to win back for the head of the ticket those elements of past support which have left them.

Special targets will be younger voters (the maturing postwar baby boom), women and Hispanic voters, plus always the enlarging middle class.

Basically, America's next half-generation of politics will rest upon this post-New Deal middle class. Many would claim that the greatest success of the New Deal was in creating this new middle class, the more so as the occupational shift of American life moves from arm-and-hammer to service trades and public employment. The decline of trade union membership, particularly in heavy industry, is well-known. Perhaps not so well known is the massive postwar increase in higher education availabilities to those who cannot afford to "go away to college", but *can* manage living at home and attending a possibly less-prestigious state or community college. For this group, the key to the rise into the middle class is the mass availability of a college degree.

Two areas of geographic movement may also shape new party loyalties by the year 2000. The American population is moving south and west and there seems to be no reason for this tendency to alter. In fact, recent surveys of new job opportunities in the next decade indicate that 25 of the 30 expanding-job metropolitan areas will be in the south and west, only five in the east and midwest.

In Presidential elections this area of the country has been strong for Republicans and in 1984 none of the top ten Democratic jurisdictions were in the south or further west than Minnesota. This has not been true in Congressional voting, but here the members elected, whatever their party label, take on the programmatic view of their constituents.

Secondly, the impact of the older core cities, especially in the east and midwest, is declining. The share of the state's vote cast in such cities as Boston, New York, Philadelphia, Baltimore, Cleveland, Detroit, Chicago, St. Louis and the like is substantially below what it was a generation ago and the number of the members of the House from these core cities tends to drop after the realignment of House seats which follows each decennial census. Since these cities are strongly Democratic, many of the middle class are apparently moving out physically and rightward politically.

Further, the nature of the new citizenship changes. Mass immigration today tends to come much more from Latin America than from Europe or Africa. As these immigrants become citizens and as their children are born as citizens, they will become an increasingly important segment of the electorate. This is a group to which Republican leadership extends many invitations to activity. Over a third of the Hispanic vote for President was given to Mr. Reagan last fall, and, while the Republican strategy does not eliminate the black voter, it appears to find more useful targets among Hispanics.

But whatever the planning, demographic or otherwise, of political strategists of both parties, these next political years cannot be easily catalogued or easily projected. It is quite conceivable that the Republican hold on the White House might weaken or that the Democratic hold on the House of Representatives might weaken. These are not the likely courses, but they are certainly possible. The appeal of many campaigns above and beyond the party label directly to the individual voter, both in primary and general elections, cannot be overestimated. Label loyalty still exists but it can be

shaken on questions of leadership, issue images, the workability of the economy, and even the personal character of the candidate.

The only certainties of these next years appear to be the predominance of accommodation and centrism. One observer put it that most frequently in America the extreme is the extreme center.

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### "The American Economic 'Miracle'"

*Working Paper Prepared by Herbert Stein,  
Senior Fellow, American Enterprise Institute*

Four years ago I began a paper for the Bilderberg conference with these remarks:

"There is no need to approach the present economic problems of the industrial democracies in a mood of despair or crisis. Our generation lived through an economic miracle, which went on for almost twenty-five years after World War II. Now we are in an age of reality, and the contrast with the period of the miracle is naturally disappointing. But the reality is, after all, not so bad."

Things seem to have changed in the four years since then. Once more there is talk of an economic miracle. Specifically, there is talk of an American miracle, in which Europe has conspicuously not shared. So one way of looking at our subject today is to consider whether there has indeed been an American economic miracle and if so why Europe has not participated.

The word "miracle," although commonly used in this connection, is really not very appropriate. "Miracle" refers to an event whose cause is unknown and may be supernatural. But those people who claim that there has been an American economic miracle have no doubt about what caused it. They believe that they did.

I am going to talk mainly about developments in the United States and then offer some brief comments on why European experience has been different.

Recent American economic history breaks rather conveniently into two periods, one from 1960 to 1973 and the other from 1973 to 1984. The dividing year, 1973, is the last before the oil shock. Perhaps for that reason, but not necessarily, it divides periods of better and worse economic performance.

The second period, taken as a whole, was inferior to the first in almost every respect. Real output (GNP) increased by 4.2 percent per annum in the first period and 2.5 percent per annum in the second period. Output per hour and per person rose less than half as fast in the second period as in the first. The average rate of inflation more than doubled. In the first period the rise of output was half as large as the rise of total spending; in the second period only one-fourth of the rise of spending generated an increase of real output. Between 1960 and 1973 unemployment fell from 5.4 percent to 4.8; by 1984 unemployment had risen to 7.4 percent.

The one dimension in which the performance of the second period was not worse than that of the first was the rise of employment. Employment rose at exactly the same rate—1.9 percent per annum—in both periods. This is somewhat surprising, because the strong rise of employment in the last ten or 14 years is often considered one of the main signs of the American economic miracle.

The slower rise of output in the second period was not due to lack of demand. Total

spending rose faster in the more recent period—9.2 percent per annum compared with 7.7 percent. The cause was the slowdown of productivity growth. There are many factors that probably contributed to that slowdown. These include a smaller increase in the ratio of capital to labor, various consequences of the sharp rise in energy costs, diminution of the gains to be realized from transferring resources out of agriculture, the rise of marginal tax rates and the economic and psychological consequences of the inflation. We do not know the relative weights to assign to these factors and there is a common belief that the factors we can reasonably measure do not supply an exhaustive explanation. There is a true mystery left in the slowdown of productivity growth.

The rapid rise of employment in the second period could be explained by the slow growth of productivity. Given the growth of output the rise of output per worker explains the growth in the number of workers. But that is arithmetic, not economics. The rise of output was not given. If the rise of employment had been less the rise of output would have been less, although not necessarily in the same proportion. In fact, one might expect that with productivity rising less rapidly employment would also have risen less rapidly, because the employment of labor would have been less profitable. This, of course, points to the key factor—which is the wage rate. If American workers had been able to insist on real wages rising by 2.5 percent per annum, as they had done between 1960 and 1973, there would have been much less increase of both employment and output between 1973 and 1984. In fact, real wages hardly rose—by only about one-tenth of one percent per annum—between 1973 and 1984.

This point should be obvious but it is commonly overlooked. We have fallen into the habit of asking why this economy creates jobs whereas other economies do not. But economies do not create or fail to create jobs—aside from cyclical fluctuations. Workers willing to work for a wage that does not exceed the value of their productivity create jobs. The increase of employment from 1973 to 1984 in the U.S. was simply a measure of how many such workers there were.

The years 1973-1984 taken as a whole were certainly not a miracle, although they were to some extent a mystery. If there was or is a miracle it began sometime in the latter part of that period. That is, the miracle would have occurred in the years after 1979 or 1980 or 1981. This makes the claim difficult to analyze, because we are dealing with a period so short that the trend is mixed up with the business cycle. It is hard to tell whether we are looking at a change in the trend of the economy or only at the expansion phase of a business cycle—an expansion that may be a little stronger than the average but not dramatically so. The shorter the period we look at the more miraculous it seems—but the more likely we are to be observing only a cyclical phenomenon. Analysis of our recent experience is also obscured by the intrusion of partisan claims. Many who assert that there has been an economic miracle are also claiming that there has been a Reagan miracle, or, even more specifically, a supply-side miracle.

The performance of the U.S. economy has certainly been better in the latter part of the 1973-1984 period than in the earlier part. Total output rose somewhat faster in the “good” years, 1980 to 1984, than in the “bad” years, 1973 to 1980, but not by much—2.7 percent per annum compared to 2.3 percent. The big and critical difference has been in productivity. From 1973 to 1980, for example, output per hour in the private business sector rose by only six-tenths of one percent per annum; between 1980 and 1984 it rose by 2.1 percent per annum. And of course, the inflation rate has been much lower in the last few years than it was between 1973 and 1980.

Until the last six or nine months it appeared that employment had risen less rapidly after 1979 or 1980 than it had risen earlier, but a recent surge in employment has raised

the growth rate close to that in the period before 1979. The only respect in which there seems to be deterioration is in the unemployment rate which, at a little over 7 percent, is still higher than in 1978 or 1979. But we have been living with a rising trend of the unemployment rate for some time, and the recent increase in the trend is not greater than we had been experiencing.

Does all of this constitute an economic miracle? In my opinion, the answer to that is no. We have had an unusually rapid recovery from an unusually deep recession, but our present level of output is not exceptionally high relative to previous pre-recession levels. The annual rate of increase over the past three, four or five years is still below our longer-term increase. Until a year ago there was much disagreement among economists about whether, aside from cyclical factors, we had yet surpassed the low rates of productivity growth experienced from 1973 to 1979. Probably the preponderance of the evidence was in the negative. Today the appraisal would be a little different, after the good performance in 1984. But still, the most one could claim is that the growth of productivity has been better than in our worst years 1973-1979 but is still not up to our postwar average.

That is an improvement not to be dismissed as insignificant. We do not know all the causes of the improvement, any more than we know the causes of the previous slowdown. The shift of the energy position probably had something to do with it, as did the lessening of the need to devote capital to cope with environmental and other regulations. In my opinion the deep recession of 1981-82 had much to do with the improvement of productivity. It shocked American management and labor into a realization of the need for self-help on the productivity front as they had not been shocked for a long time. In many important industries that shock was intensified by foreign competition, which was in turn strengthened by the rise in the exchange rate of the dollar.

The big supply-side tax cut of 1981 had little to do with the rise of output and productivity. There is no evidence that the tax cut has raised either the rate of saving or the supply of labor, as had been claimed it would. Meanwhile, the big budget deficit to which the tax cut contributed reduced American saving available for private investment. The tax cut did increase the after-tax return to investment in the United States and made this a good place in which to invest. As a result a larger part of the world's saving was invested in the U.S. Thus we had in total a fairly high rate of investment, despite the deficits, but the rate of investment owned by Americans was fairly low. This investment in the U.S. owned by foreigners would yield product that appeared in our productivity statistics but that belonged to foreigners. (I have more to say about that later.)

What comes closest to a miracle is the reduction in the inflation rate, from 13 percent in 1979 to 4 percent in 1984 as measured by the Consumer Price Index. Few people in 1980 or 1981 would have predicted that by this time, after two and a half years of recovery and with the unemployment rate down to 7.2 percent, the inflation rate would still be 4 percent. This achievement was largely due to the sharpness of the 1981-82 recession and to the evident determination of the Federal Reserve and the Administration not to try to pump the economy back to high levels prematurely and at the cost of renewed inflation. The rising exchange rate of the dollar also contributed to the achievement.

We have made progress on a number of fronts, but there is still a distance to go and continued improvement is not assured. Although this is not the Garden of Eden it is nevertheless said to contain a number of serpents that threaten tranquility. Specifically there are the four intertwined “imbalances”—the U.S. budget deficit, the U.S. trade

deficit, the U.S. capital inflow and the high exchange rate of the dollar. It is desirable to try to disentangle these serpents, especially because the effort provides a transition to discussing the economic situation in Europe.

The U.S. decided in 1981 to raise defense expenditures, to cut taxes, especially to cut taxes on the return of capital, and by implication to run a large budget deficit. This decision would have certain consequences for the distribution of output and income in the U.S. If the U.S. were a closed economy without international trade or capital flows, the consequences would be as follows: There would be an increase in the output devoted to defense and to consumption, and an increase in the activity in defense and consumer goods industries. Despite the tax cuts intended to stimulate investment there would be less private investment than there would otherwise have been, because the deficit would be absorbing part of the private savings. The high demand for capital resulting from the deficit and from the pro-capital tax cut would raise interest rates. There would be a shift of income to savers who supply capital. There would be a shift of income from wage earners. Their productivity would be held down by the growth of the capital stock and they would have to pay some of the taxes to service the Federal debt.

Despite recurrent fears over the last few years, there was nothing in this picture to prevent a recovery or cause a recession. It involved a change in the composition of output, not a depression of the total. It would not prevent a rise of employment as long as workers were willing to accept the slower growth in their real incomes that was implied.

If the deficit was more than of a certain size this process could not go on forever. (The knowledge of economists seems to consist entirely of a list of things that cannot go on forever.) The deficit adds to the debt which adds to the interest burden which adds to the deficit and so on. If the deficit is initially too big this cumulation leads to larger and larger deficits and debts relative to GNP. If continued, that would absorb not only all private net savings but also all private gross savings, so that in the end the capital stock would be reduced to zero. Presumably even a short-sighted government would change course before that point was reached. A deficit of less than the critical size, in a growing economy, could go on forever, with a stable ratio of debt to GNP but with slower growth than if the deficit were smaller.

Since the U.S. is not a closed economy, this whole scenario is being acted out on a larger stage. The U.S. budget deficit reduces the world's total investment. But our tax changes favorable to investment have attracted a large part of the world's total investment to the U.S. So we have a larger net capital inflow. Total investment in the U.S. is larger than in the closed-economy case, but more of that investment is owned by foreigners. The capital stock owned by Americans is no larger than without the inflow. Similarly the capital stock in the rest of the world is lower, but the rest of the world owns more capital in the U.S. The capital stock owned by the rest of the world is no less than it would have been, but more of it is located in the U.S. The gains that U.S. savers would have obtained are now shared with savers around the world, who earn higher interest than they would otherwise have earned. The losses that U.S. workers would have suffered are reduced and spread to workers elsewhere, who have smaller capital stock to work with. The inflow of capital to the U.S. raises the exchange rate of the dollar and causes a net inflow of goods and services.

Nothing in all this requires stagnation or high unemployment in the rest of the world. There will be less investment in the rest of the world but also higher net exports and more accumulation of assets in the U.S. The composition of output in the rest of the world, and the distribution of income, will be different, but the level of output and real

income need be no different. There need be no increase of unemployment, if workers accept the real wages that the slower rise of productivity requires.

We may or may not like this distribution of the world's output and income, which supports investment in the U.S. and exports elsewhere, and raises capital incomes and restrains labor incomes. But it is not a prescription for stagnation and unemployment.

Let me turn now briefly to Europe (by which I mean OECD Europe). The basic facts are these. The rate of increase of total output fell after 1973 in Europe as it did in the U.S. The European fall was great and has shown much less sign of revival than in the U.S. The European rate of increase of productivity was greater than the American before 1973 and fell as in America after 1973, but has remained higher than in the U.S. The rate of growth of demand—of GNP in current marks, pounds, francs, and so on—has fallen in recent years but has remained higher than in the U.S.

The big problem, of course has been the failure of employment to rise, and the consequence big rise of unemployment. This was not due, in any reasonable sense, to inadequate demand. From 1981 to 1984 total demand in Europe rose by 9.8 percent per annum, but total output rose by only 1.4 percent per annum, or about 14 percent as much. Almost all of the increase in demand was dissipated in higher prices. Neither was the stagnation of employment due to inadequate productivity, which was still rising faster than in the U.S. We are back, at last, to the classical explanations of unemployment. There is unemployment when workers will not work for a wage that is supported by their productivity. If there is any American miracle, it is that we rediscovered that first.

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## DISCUSSION

The German author introduced his paper with the observation that there was a broad similarity among the countries of the Atlantic world in "all essentials of social, political, and economic development." They had experienced forty years of peace, and they were governed by stable democratic institutions and the rule of law. The overwhelming majority of their people enjoyed effective citizenship rights and the highest standard of living ever.

Yet there were problems. Prosperity and stability notwithstanding, there had emerged in our populations an underclass—a significant number of people who did not enjoy the benefits and opportunities our societies had to offer. Three important developments accounted for this. First, it had become apparent that certain groups could no longer benefit from the services of the welfare, or social, state. Financially, the social state was no longer viable. And the extreme bureaucratization of social services had rendered them impersonal, eclipsing the individual qualities they should have. Second, the increasing preoccupation with economic developments had led to a tendency not to recognize minorities, and to a cessation of the important attempts that had been made earlier to confer full citizenship on them. The third factor was the phenomenon of "boom unemployment," in which significant economic growth and significant unemployment existed simultaneously. This unemployment could not be explained in traditional terms, nor could we cope with it in the traditional ways. In short, there was now a boundary in our societies below which a fair number of our

people were living. It was not a group with revolutionary potential, but it was a disturbing indication of our inability to give all people a decent life.

Another disturbing contemporary phenomenon was what some commentators had labelled "sclerosis"—the extreme difficulty we seemed to have in producing a sense of initiative and forward motion in our societies and economies. The rigidities giving rise to this condition existed both in the U.S. and Europe, though they were more pronounced in Europe, where the social safety net was tighter, the bureaucracies larger, the immobility of the people greater, the special interest groups more powerful, and wages "stickier." In the U.S. there was a tendency to believe that a return to traditional American values would solve the problems and lead to progress. In Europe, there were different ideas of how to break out of the rigidities—the ideas of alternative political groups, of those who believed in new technologies, and of those who hoped to revive a new entrepreneurial spirit in Europe—none of which, the author felt, had yet shown much promise.

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The author of the working paper on the American political system pointed out that the political systems of the U.S. and Europe were very different, not just in the sense that the American system was non-parliamentary, but different at the "fundamental level of electoral method." American political parties were "disorganized, inchoate, and weak." They were controlled from the bottom up. That politics in America was essentially local was observable in the process of nominating candidates among whom the electorate chose. In this process, a series of "centers" predominated, such as Congressional districts and states. Congress was an amalgam of these centers, which, in all their great diversity, were where American political expression took place.

In the U.S., public opinion was basic to the political system. But it was also malleable. For example, public opinion had traditionally held that foreign aid was the first thing that should go in reducing federal expenditures. That this had never happened illustrated that public opinion could be channelled and led. Yet its primacy was paramount and its essentially personal and parochial nature had to be remembered in any discussion of divergent trends in the Atlantic world.

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In his introductory remarks, the author of the paper on the American economy sought to provide a perspective on the current combination of high U.S. budget and trade deficits, the strong dollar, and heavy capital inflows. This situation was caused in part by U.S. actions and in part by developments abroad. In the U.S., advocates of cutting taxes and increasing defense expenditures had not expected a large budget deficit to occur as a result. As it turned out, they had made three erroneous assumptions: that cutting taxes would increase revenue, that there would be more room for making cuts in the non-defense part of the budget than there actually was, and that the transition from a high inflation to a moderate inflation economy could be made without going through a recession. In addition to tax cuts and higher defense outlays, changes were made in the tax code which increased the after-tax return to capital and made the U.S. a more attractive place to invest.

At the same time, investment abroad, especially in the developing countries, was becoming less attractive. Unwise governmental policies and the actions of "over-uberant" bankers had led to disinflation and disinvestment. And economic policies which had rendered Europe less able to adapt to a disinflationary world had reduced the attractiveness of investing there.

In the U.S., all this had led to high interest rates, a large net capital inflow, and high net imports. The rate of investment in the U.S. relative to GNP was also high, but very little of it was owned by Americans.

Many had viewed these developments in the U.S. economy with great concern. The budget deficit, it was feared, would abort or at least weaken and shorten the recovery, cause inflation to return, and slow down economic growth. The strong dollar and high net imports would result in a sluggish economy, damage industry, and turn the U.S. into a service economy. It was also said that U.S. policies were inhibiting Europe's recovery and impoverishing the LDC's.

But, continued the speaker, the budget deficit had not stopped or weakened the recovery or caused inflation. The increase in imports had not depressed the economy. While some industries had been hurt, there was no evidence to suggest that the U.S. was losing goods production; statistics indicated the opposite was true. U.S. policies were not causing stagflation in Europe. Rather, they were changing the composition of European output, giving Europe a low investment, high net export economy. In general, the deficit was shifting income distribution in the world from labor supplier to capital supplier by reducing the stock of capital with which labor had to work. This was bad for the LDC's, which were labor suppliers.

The speaker's prescription for action was to avoid protectionist measures and the temptation to intervene in the capital markets. Europe had to adopt measures to promote its revival, and the LDC's had to take steps to attract capital. The U.S. had to reduce its budget deficit to avoid increasing further the ratio of debt to GNP. However, there were, concluded the speaker, "worse things than budget deficits."

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Addressing the question of social welfare policies, an American speaker felt that his country was in a "period of retreat." After an era of extraordinary changes for the better in terms of conferring rights on those previously denied them and benefits on those at the bottom rung of the social ladder, the current policy seemed to be "benign neglect." Many Americans who had themselves been helped by government assistance programs were now indifferent to the plight of the poor and the dispossessed. While political rhetoric on the subject of social expenditures focused on the poor, the unemployed, and those on welfare and food stamps, the fact was obscured that 80 percent of the total federal welfare expenditure went to the middle class, while only 14 percent went to low income recipients.

It was the speaker's view that it was not beyond the government's fiscal capacity to sustain the cost of current social services. While it was perhaps true that the bureaucracy had gotten out of hand to the detriment of the programs and constituencies, the problem was manageable. Certainly the number of recipients had expanded beyond what was originally intended; we needed to find out why and what to do about it.

The social welfare situation was very different in Europe, said a German. In almost all European countries, the cost of social services was too high, with built-in increases no country could cope with, no matter how strong its economy. The bureaucracy of the social state had to be thoroughly dismantled. Too many people were receiving in transfer income as much as they had paid in taxes, less the costs of bureaucracy. A substantial reform of the welfare state was needed so that benefits could be provided at an affordable cost.

Europe, argued a Briton, had gone "too far down the welfare state road." His country was striving to reverse direction. Of the U.K.'s £130 in public expenditures, £40 billion went to pensions and other cash benefits, £18 billion to medical care. There

were 2.3 people of working age to each person retired; the ratio would change to 1.8 to one by the year 2030. Welfare beneficiaries could ultimately outnumber the payers, which, the speaker believed, would endanger the democratic process. Revolutionary action was more likely to come from the "oppressed minority of those left paying than from the increasing majority" of recipients.

Another British speaker felt there was a direct link between the level of welfare payments and the rate of unemployment. There was a disincentive effect when people could get 80 to 90 percent of their take-home pay in the form of welfare.

It was a Dutch participant's view that the high benefits and resulting high costs of social programs in Europe contributed to high labor costs, and to a flight to the "black market." In fact, the unemployment situation was perhaps not as bad as the statistics indicated, because they did not include this hidden part of the economy. Because of this and because of the high level of benefits from the social welfare system, it was not likely, the speaker concluded, that the underclass would become revolutionary in its attitudes.

Other speakers were more concerned about the revolutionary potential of the underclass. Its very existence was, in a Dutch participant's opinion, "politically explosive." The potential for revolutionary attitudes would increase as the underclass became more politically aware. A German pointed out that, in his country, the highest unemployment rates were among 20- to 24-year olds—those just completing their education or vocational training. This was a literate group that was beginning to question the traditional values of society, which, in its view, did not offer the opportunity to share in the benefits of society. The established political parties had to recognize the potential for radicalism and address the question of values. The problem of youth unemployment was also very significant in the U.S., said an American. The U.S. had not been successful at dealing with the difficulty its young were having in finding entry-level employment. There would be serious social implications if those who could not get entry level jobs continued to fall ever farther behind. This was a particular problem in the inner cities and could lead to social confrontation.

The question of youth unemployment prompted an Austrian to wonder whether our countries' educational and vocational training programs were equipping the young with the qualifications necessary for today's jobs. In spite of high unemployment in Europe, it was still difficult to find qualified people to fill many jobs.

An Italian viewed with alarm the "fatal" prospect of continuing high unemployment in Europe. Partly to blame was the "inelasticity of the system," and also the "psychological inelasticity" of the worker. It was harder to change jobs in Europe than in the U.S. Before 1980 Italy had had an export labor force; since that time it had imported a million workers from other countries, yet it still had 10 percent unemployment. Significant investments had been made to keep alive industries that should have been allowed to die, while not enough had been invested in new job-creating industries. In Europe, the speaker concluded, things that should die did so too slowly; things that should be born were born too slowly.

In assessing the difference between the employment situation in Europe and the U.S., it was necessary, pointed out an American, to recognize fundamental differences in the environment in which job creation took place. One element was bankruptcy laws, which, in the U.S., allowed people to be risk takers. They could start a business, fail, go bankrupt, and then start all over again. In Europe, bankruptcy laws were restrictive and discouraged risk taking. Another factor was that the duration of unemployment was far longer in Europe than in the U.S. Recent productivity improvements in Europe had occurred because there had been a great deal of capital investment at the expense of labor; because of restrictive labor laws, businesses were trying to avoid hiring new workers.

It was a German speaker's conclusion that we no longer needed as much per capita employment to produce and increase wealth. There was a declining need for work at the level we could afford to pay for it. The problem then became how to guarantee peoples' sense of self worth. A Canadian wondered if we needed a new means of structuring peoples' lives the way work had done in the past.

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The discussion of the structural impediments faced by Western societies and economies and their potential political consequences prompted a German speaker to provide an analysis of the political situation in the Federal Republic. The three classical parties—Christian Democrats, Social Democrats, and Liberal Democrats—still polled over 90 percent of the vote. The Liberals were far from dead, and seemed to gain new life at each election. The once seemingly unstoppable growth of the Greens was over; their strength at the polls had never exceeded 10 percent. Indeed, they were viewed by many younger people as a party of 30- and 40-year olds. Many young people were neoconservative and regarded the Greens as "peddlers of horror scenarios bearing no relationship to reality."

Would the Social Democrats return to power in the 1987 election? And would the West Germans leave the Alliance and adopt neutralism, pacifism, and anti-Americanism? The speaker thought not. There would be no change in 1987. For one thing, the political cycles in the Federal Republic were long: there had been 17 years of Christian Democrat chancellors (1949-1966) followed by 13 and a half years of Social Democrat rule, lasting until 1982. Furthermore, the Social Democrats were exhausted and disorganized, with no new programs and new leaders yet visible. The CDU was, on the other hand, "pragmatic, realistic, and opportunistic." Already there were voices within the party calling for a new distributionary policy. It was the speaker's conclusion that the party would shift "quickly and subtly enough to insure Chancellor Kohl's reelection in 1987."

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Commenting on the American economic working paper, a French speaker agreed with the thesis that unemployment occurred when workers would not work for a wage level supported by their productivity. The U.S., despite a period of low productivity growth, still had one of the world's most productive economies. And it had made recent productivity gains by automating, robotizing, and emphasizing quality. Europe, on the other hand, was competitive today only because of the high dollar. Although fluctuations in the dollar rate were hard to predict, European industry should assume a decline in the dollar's value of 15 to 20 percent in the next three years. The challenge facing Europe was, then, to become a low cost producer; only this would stop "Eurosclerosis." And no European country alone could be competitive; only together could Europe compete effectively with the U.S. and Japan.

An Italian agreed that high real wages were an important factor in causing stagflation and unemployment in Europe. But wage moderation alone would not solve the problem. It was also necessary to cut non-wage labor costs and to increase aggregate demand. Direct wage costs in Europe and the U.S. were not so different. Europe had to bear, in addition, indirect labor costs associated with institutional rigidities. It was perhaps more important to change these constraints than to simply moderate wages. There was also a link between demand and unemployment, the speaker continued. There had been a significant increase in unemployment between 1981 and 1984, when contractionary policies were in effect in many European countries. The time had come for those countries that had had some success at controlling deficits and inflation to implement less restrictive demand policies.

A Spaniard doubted that wage moderation by itself had created jobs in the U.S. or would do so in Europe. Other major institutional changes had to be made. In a Dutch speaker's view, these changes would include attacking the inflexibility and immobility of labor markets, including the lack of differentiation in wage rates and rigid dismissal procedures, and lowering the labor costs brought about by the high benefit level of existing social welfare programs. But, he went on, such changes would be difficult to make because a fundamental difference between the U.S. and Europe was that many in Europe were more concerned about the distributionary aspect of wealth and national income than about increasing national wealth for the benefit of all.

Two speakers voiced skepticism that either wage moderation or increased flexibility and mobility of labor would reduce unemployment and promote economic growth. A German pointed out that, with wages "stagnant" in his country in recent years, there had been productivity gains, but no new jobs. A Dutch participant felt that the size of its population gave the U.S. a different kind of economic dynamism. The mobility of capital and labor that characterized the U.S. was not possible or desirable in Europe.

Several speakers felt the economic situation in the West was a good deal more complex and called for more urgent action than the discussion indicated. A Briton rejected altogether any fundamental connection between economic growth and the "indisciplines" of the social state. The real hindrances to growth were the absence of a system to provide stability in the world's currencies and the lack of a "coherent policy" to finance world deficits. It was these failures in Western economic strategy that had "disrupted progress toward interdependent prosperity."

It was an American's view that a crisis was brewing in the international economic system, as evidenced by growing debt and great instability in exchange rates and interest rates. Yet we seemed unprepared to take any action to head off the crisis, merely because it was not yet imminent. We needed some mechanism to anticipate crises before they happened and to take action.

In this vein, another American felt that the economic working paper "painted too innocuous a picture of the effects of U.S. budget deficits." The paper overemphasized the "frictionlessness" with which resource shifts, internal and across national boundaries, could be accomplished. The budget deficit and its effect on exchange rates and international trade had speeded up the need for difficult adjustments that societies had to make to adapt to new technologies. The robust recovery and expansion in the U.S. had been based on a borrowing from the future that was "unsustainable, undesirable, and unnecessary."

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In concluding the discussion, the author of the American economic paper made the following observations. (1) There was no declining need for human work; rather we had an increasing supply of unemployment. We had created conditions whereby the effects of unemployment were not as bad as they used to be for those who were unemployed. We had adequate demand, but were unable to convert it into an increase in output and employment. The problem was in the factors determining the cost of production. (2) The international monetary system had in fact worked quite well in the last four or five years. It had adapted to and reflected fundamental changes in the world economic system. To intervene would not solve the world's economic problems.

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## II. HOW SHOULD THE WEST DEAL WITH THE SOVIET BLOC?

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*Working Paper Prepared by Karl Kaiser,  
Director, Research Institute of the German Society for Foreign Affairs*

1. The election of Gorbachev has brought a man to the helm of the Soviet Union who has a good chance of leading his country into the twenty-first century (what Western leader today can be expected to have such a chance?), and who is likely to leave a personal mark on Soviet society comparable to the long reign of Stalin or Breshnev.

The conservatives in the Soviet Union have understood that the country's second rank as superpower is only tenuously based on military power and that consistent economic failure, which Breshnev hoped to overcome through economic cooperation with the West, will eventually endanger the Soviet power position at home and abroad. Only thorough reform of Soviet society can preserve her status as a world power and that will be Gorbachev's mission.

Domestic change is likely to combine with external flexibility. Western, notably American, media, so easily beguiled by a Soviet leader's smiles, good manners and an attractive wife, welcome though they are, will soon discover that Gorbachev will fight for his country's interests as toughly as his predecessors, but in all likelihood with great astuteness. With "peace offensives" by him—SDI opening new vulnerable flanks in the West—he will represent a greater challenge than the ineffective and dying leaders of the past, now mourned with nostalgia by some in the West. The party is over.

2. The "Soviet Bloc" that Stalin and his successors created no longer exists. Besides the split with China, considerable variety has seeped in both with regard to the degree of internal liberalization and differences in foreign policy. Moreover, overseas areas of influence have been added. A Western policy that treats the Soviet power sphere as one unit while neglecting the internal differences is likely to forego major opportunities (and to underestimate its own successes of the past).

3. If a superpower is defined by its capacity to create and sustain an international order that can accommodate the interests of lesser powers, only the U.S. can claim that status. But during the recent past a loss of generosity towards the developing world and an excessively confrontational mood and rhetoric vis-à-vis the Communist world have somewhat undermined the old role. An American and Western policy is needed that offers a realistic and genuine chance for a long-term improvement of relations with the Eastern countries.

4. At the heart of our policy vis-à-vis the Soviet Union lie two questions:

- a) What changes can we expect of the Soviet Union?
- b) Can we influence it from outside?

a) After almost seven decades of Soviet history and one decade of Soviet handling of detente in the 1970s, past experience should guard against unrealistic expectations of change. What is likely to remain more or less constant?

- The Soviet Union's one-dimensional character as a system based on military power and the rule of the party elite;
- Her yearning for over-insurance with all the problems it creates for her environment.



It would be unrealistic, if not naive, to expect her to undergo significant liberalization in this century or to voluntarily withdraw from existing power positions in Europe or Asia. Policies based on different assumptions are likely to suffer deep disappointments, notably plans for a Soviet withdrawal from Eastern Europe or for a neutralized and re-united Germany.

b) Can Soviet behaviour be influenced from outside? Libraries have been filled supporting both sides of the argument. I believe there is some margin for impact, though a rather small one, and it only exists inside the limits designed above. A Soviet Union accepted as a world power and engaged in a constructive dialogue on a broad front is more likely to follow minimum rules of international stability than under conditions of Western siege, implementing a "management of decline."

In order to preserve and recreate the economic and social prerequisites of a world power, the Soviet Union has to implement change and reform for many years to come, more radical than at any time after World War II. There is, therefore, a chance for a reactivated Western policy in economic areas. However, such a policy of engagement is likely to succeed only if it is combined with firmness on essential Western positions, as shown, for example, on the issue of intermediate nuclear forces.

5. A policy of economic and technological cooperation with the East reaches its limits where it violates the rule of not delivering military technology to an adversary. Some of the restrictive measures undertaken in recent years were overdue. But the totality of restrictions now seriously threatens to curtail the free exchange of goods and know-how *within the West* and to create tensions among Allies.

6. Europe's line of division created by the Yalta Agreements or, depending on one's perspective, by their non-implementation, is going to stay for a long time, even if the strengthening of human rights of the autonomy of Eastern Europe's nations remains the West's ardent wish and policy. An overt strategy calling for a Western repudiation of Yalta, as Zbigniew Brzezinski recently did in *Foreign Affairs* and *Europa-Archiv*, may even strengthen resistance to desirable change. There is a bitter lesson of many post-war attempts to increase autonomy within the Soviet bloc thus acting against the Soviet requirements of security as defined above: they end in a blood bath or political repression.

Evolution is possible only within certain limits. Those Europeans, notably Germans, treated almost with contempt at the time by Americans, when they reluctantly accepted Jaruzelski's military intervention as the lesser evil, turned out to be right in the end: without his measures, Soviet (and East German) military intervention would have caused a blood bath with unpredictable consequences for East-West relations; today Poland has the highest degree of liberalization or, in other words, the lowest degree of political repression of any country in the Soviet orbit. Surely Western (including European) pressure helped as well, but on the December 1981 measures, the West was divided.

7. A policy that violates essentials of Soviet interests is likely to be blocked by Soviet resistance, if necessary by the Red Army. Change that takes place, however, within (1) a framework with some Soviet participation, or (2) in a frame of reference that the Soviets cannot totally reject, has a chance of producing evolution towards more autonomy and human rights. The CSCE process is an example of the first, economic cooperation an example of the second approach. A lower state of international tensions is a prerequisite—though no guarantee—for evolution within the Communist countries outside the Soviet Union. Finally, *gradual* evolution is the only kind of change likely to produce results desirable to the West.

8. A policy of differentiation is necessary vis-à-vis Eastern Europe: Wherever steps toward human rights (e.g., Poland) or more autonomy in foreign policy (e.g., East

Germany or Rumania) are possible, they should be quietly supported. Public distinctions between "good" and "bad" countries (as Vice President Bush used them in his Vienna speech) are counter-productive and an obstacle to evolution. Discretion and subtlety are the prerequisites for movement. The leaders of Bulgaria, Czechoslovakia, East Germany, Hungary, Rumania (and also Albania) are of advanced age. Therefore, change is to be expected in these countries and will require careful attention along these lines.

9. A reduction of the American presence in Europe, as advocated by Zbigniew Brzezinski, may possibly support a similar move of the Soviet Union in Central Europe but it does not guarantee it. Given Soviet priorities, it is rather unlikely, in fact. Greater unification of Western European security policy is an end in itself and not likely to decrease Soviet presence. Schemes that advocate Western unilateralism project onto the Soviet system Western values and behaviour patterns which are partially alien to it. There are no majorities in Western Europe supporting the notion of an independent Europe with a dramatically reduced U.S. presence in order to induce the Soviet Union's withdrawal from Central Europe. A neutral re-united German is unfeasible since the Soviet Union is unlikely to release East Germany, and since the West Germans, except for a small minority, do not want to expose themselves to the hair-raising risks of such a course.

10. The Soviet Union is above all a military power. Her reckless exploitation of the détente period for a vast arms program demonstrates her priorities. On INF she suffered only a partial defeat, for her weapons are there today and Western Europe is more divided. But her one-dimensional policy has stretched her resources to a danger point unprecedented in peace time. Here lie chances for an imaginative Western policy.

11. President Reagan's Strategic Defense Initiative may offer the chance of a new mix between defensive and offensive weapons and thereby of increased stability. It should therefore be explored. To the Soviet Union it both offers opportunities and represents a challenge. SDI and its public presentation in the West discredit a strategy ("immorality of nuclear deterrence", "elimination of all nuclear weapons," etc.) that the West will need to preserve peace for the rest of this century, thus opening new opportunities for Soviet propaganda, aggravated by the ambivalence of SDI for internal Alliance relations. Moreover, the forthcoming negotiations may recreate the same dilemmas as were met in the INF negotiations: the Soviets are likely to use the Western public process to gain the results which they failed to achieve at the negotiating table.

Simultaneously SDI represents a tremendous challenge to the Soviets: the danger of U.S. superiority, a leap in the arms competition of unprecedented, indeed critical, proportions to the Soviet Union, a dramatic innovative advance of Western technology. These elements may combine with possible disadvantages to the West, or a mutual recognition of the advantages of shared strategic defense, to produce the basis of future agreement. But the road to that result will be long and rugged.

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For years a heated debate divided people concerned with the future of the USSR (statesmen, experts): how to deal with the Soviet bloc, and primarily with Moscow, in order to turn the Soviet regime towards more moderate attitudes at home and in international life? Two major points are discussed with respect to this debate: economic relations and political/military orientations. As regards the economic and trade relations with the Eastern bloc, two opposed ideas are at the bottom of the debate. On the one side, some experts assume that through economic exchanges and technological assistance, the West will be able to enhance the position of those who, in the USSR, are in favor of dramatic reforms, which eventually would create the preconditions for a liberal turn of the Soviet system. (Samual Pissar is the best example of such an attitude.) On the other side, some experts claim that, through trade the West is subsidizing the Soviet economy and giving Moscow the means for transferring more resources to the military sector. Instead of encouraging the moderate or reformist tendencies in the USSR, trade and technological assistance would end in support to the toughest and more conservative part of the Soviet hierarchy. (Pipes is one of the major representatives of this trend.)

As regards the military/political dimension, the dispute more or less follows the same lines. Those who support détente and a lower military effort in the West in order to develop similar tendencies in the East (the so-called "Soviet-doves") are opposed by those who assume that détente and relaxation in the arms race have always resulted in some Soviet adventurism (Angola, Afghanistan) and in an increase in Soviet military power. (The SS-20s were deployed in a period dominated by the SALT arrangement.) The whole discussion, in order to be understandable, should be placed in the framework of the major debate over the nature of the Soviet regime, and over the nature of linkage between its domestic and foreign policies. In the late sixties and in the seventies, the assumption was of a Soviet regime getting rid of its ideological basis and turning out to behave like every modern power especially in its international policy (Hough). The present decade is characterized by the revival of the more traditional view that the Soviet regime could not transform itself, that its very essence is unchanged, and that expansionism is the major consequence of that. Expansionism is explained either as rooted in the essence of the Soviet regime, committed for ideological reasons to a world-wide revolutionary design (Pipes), or as a consequence of Soviet domestic problems, some of them being a part of the Soviet state organization itself—the multi-ethnic state—some of them being more circumstantial—economic and present social troubles. All these factors account for the militarization of the system, the continuous development of a military force, which in turn produced military ambitions abroad. It is not possible to answer the question how to deal with Moscow, without putting the Soviet domestic problems—political, imperial, economic—in their present context.

For years, it was assumed in the western world that the major Soviet problem was the political succession. The choice of successive ailing and aged leaders was seen as a manifestation of a political system unable to solve the question of the political power and of its transfer from one leadership to another and from generation to generation. Every unexpected Soviet move—invading Afghanistan, downing a South Korean aircraft—was assigned to a shaky and divided leadership and fed the assumption of a hawkish group, acting on its own initiative in order to enhance its position in the struggle for power. The last "succession episode," which gave power smoothly to a

representative of a new political generation, demonstrated that the Soviet system was able to solve this chronic problem. Even the two previous transitional successions (Andropov and Tchernenko) helped to institutionalize the mechanisms of succession and to get rid of some of its "psycho-dramatic" aspects. Clearly, the system is workable: losing power, struggling for power, being defeated, are no longer tragedies. The once defeated Tchernenko (1982) and Gorbachev (1984) turned their defeat into victories during the second round of the political succession. Moreover, every Soviet candidate to leadership, before coming to power, had elaborated a more or less similar program for the use of the Western world. After the alleged pro-détente stance of Brejnev, Andropov was identified (via Mr. Arbatov) as a "Western" and reform-oriented man; when succeeding him, Tchernenko was presented as Brejnev's heir, which also pointed to his détente postures. Presently, Mr. Gorbachev has built up the reputation as a technocrat, mainly concerned with economic reforms and ready to face the West with open-mindedness and good will. During the last 10 years, Soviet political life was seen in the West as characterized by its division between two political postures, opposing a pro-détente political leader, to a tough, conservative, hawkish, military and heavy-industry establishment. This view prevailed during the whole period in spite of the fact that Brejnev presided over the Afghan invasion and Andropov withdrew from strategic negotiations.

The Soviet Union went back to Geneva only after President Reagan's re-election. Obviously the succession problem has been solved in the USSR without troubles. A new generation is on its way to replace, step by step, the dying cohort. But the Gorbachev leadership will have to face many political problems which could affect Soviet foreign behavior. First, we know from Soviet history that the leader in charge of supreme power needs several years to establish his authority over the whole system. Brejnev, as an example, was not in charge of the major foreign policy problems until the early seventies. Until 1971, Kosyguine was the "partner" responsible for the Western world, Podgorny for the Third World; Brejnev was in competition with Kosyguine, Podgorny and Chelepin at home, and started promoting his own clients in order to extend his bureaucratic sphere of influence. The span of time needed for consolidating power at home will tend to discourage any Soviet leader from taking initiatives—foreign or domestic—which could endanger his position with the party apparatus ("Nomenklatura"). Moreover, in the very near future, Mr. Gorbachev will be concerned primarily with the reshaping and rebuilding of the decision-making system. Because of a lasting transitional period, of an ailing leadership (Brejnev was in poor health as far back as 1976), the Politburo, which worked smoothly in a collective way under the wise arbitrage of Mr. Brejnev, became less efficient, more divided, less coherent. Indecisiveness, contradictory or dispersed initiatives, became common. The need for recreating conditions for a coherent and unchallenged decision-making system is obvious; past experience has taught us that it is not an easy task. And this requires attention and time which will probably prevent more spectacular initiatives.

The workability of the political system is far from being the sole problem for the new Soviet leadership. The present state of the Soviet economy is also a source of trouble and concern. Recent figures for Soviet economic performance by the end of the eleventh five-year-plan period show a gloomy picture, a slowdown marking the whole period since the mid-seventies. In spite of a slight improvement in the industrial and agricultural sectors in 1983-84 (as shown by Soviet data), stagnation characterizes the state of the Soviet economy and prospects for the near future are not bright. As regards the growth targets for the 1981-1985 plan-period, all growth data point to figures below the original targets and the real growth of GNP has been of the order of 2.5 percent a year. The energy sector is particularly troublesome. In view of the

continued lag in its nuclear power program, the Soviet energy balance is still problematic. Output of the three main primary fuels has barely surpassed Soviet domestic energy usage, which is estimated to have grown at an annual rate of about 2.4 percent (1982-1983). In other words, the Soviet Union has managed to increase net energy exports slightly in addition to buying Middle Eastern oil (mainly for arms) and re-exporting it. The output of oil, however, was down marginally in 1984; an increase in energy exports in 1985 as called for in the annual plan, and the increase of 2 percent in oil production and 1.6 percent in coal production planned for 1985 look optimistic. The Soviet leadership is continually calling for more energy conservation, showing great concern with respect to this problem. The question related to this general economic slowdown, is whether any changes have occurred in priorities between the end uses of output for consumption, investment and defense. The Minister of Finance, Garbuzov, announced an increase of 12 percent in the official defense budget between 1984-1985 (*Pravda*, Nov. 28, 1984); such information is economically meaningless, it is certainly a gross understatement of the real Soviet defense budget. Defense spending was decreased (at least officially) in 1977 and 1981, to signal a peace-seeking attitude; in 1984, it was increased to show a determination to match American efforts. Such data are to be understood more as a signalling device than as a measure. The American Defense Intelligence Agency assumes that Soviet defense spending began to grow at an annual rate of at least five percent a year as early as 1983. As regards priority for consumption, Baibakov, the chairman of the Gosplan, stressed that the manufacturing sector is to grow faster than total industry and that planned growth of industrial consumer goods is to be marginally faster in 1985 than that of industrial production of producer goods. Such claims suggest that there has been a slight consumption-oriented shift, which is especially obvious in housing policy.

Many contradictory statistics and claims suggest that the Soviet policy-makers are faced with diverse pressures which leave them little room for maneuver.

To the poor economic performance one should add an explanation and a complementary problem, the deficiencies in economic mechanisms. Some authors (e.g., the academician Fedorenko in *Ekonomicheskaja Gazeta*, January 1985) have pointed to weakness in the way management is using the automated control system (*Automatizirovannaja sistema upravlenija*, or "ASU".)

A chain of attack is developing against the researchers who are not sustaining the impetus towards practical application of their research; against the economists who are not trying to educate management personnel; and eventually against the industrial ministries themselves, obstructing ASU-programs in their sectors. The main problem obviously lies in the way the information is collected. The Soviet computer systems do not have the capacity to handle the problem, at the present level of centralization. Moreover, the ASU has been unable to produce a significant improvement in informational flows. Soviet industry was much more successful in assimilating computerization and mathematical methods at the level of the production process than at the level of economic planning. It has to be borne in mind that the old reformers—Liberman, Nemchinov, Kanterovitch—used to link *introduction of mathematical methods and decentralization*, in order to turn the economy towards more efficiency. In the later years of the Breznev period, there was a euphoric mood about the possibilities for rationalizing central planning by means of computerization. But the issues of *centralization and decentralization* were not talked about.

When one looks now at the economic deficiencies in the USSR, one has the feeling of being back in the early sixties. What are the prospects, in such a gloomy situation, for some dramatic initiative due to Gorbachev's fresh authority? Two elements are

running in favor of such initiatives. First, a large part of the Soviet elite—economic and even bureaucratic—expects and may even welcome some real changes in economic policy. Second, Gorbachev's age provides some assurance that he will be around long enough to make his policies stick. The options available to him are: changes in priorities, or changes in organization. The first option seems to be quite restricted. There is, however, the possibility of seeking benefits to be gained from trade.

This would involve returning to more active cultivation of trade with the West, either at the expense of trade within Comecon, or by efforts to expand Soviet foreign trade in general. Gorbachev's visit to Britain in December 1984 suggests that he appreciates the practical importance of East-West trade. As far as organizational changes are concerned, the kind of change most frequently discussed is a reform of the Hungarian-type, that would free enterprises to pursue profits in a market-like system, choosing their supplies and competing for customers.

But such a reform seems uneasy to put in practice in the Soviet environment. First, the issue of economic decentralization has not been discussed in the USSR for years, and everybody seems eager to avoid it. The Soviet establishment obviously thinks that the party would lose political power in a decentralized economy. Unlike the East European Communist parties, the Soviet elite knows that in case of slipping out of the party system, there would not be an "elder brother" for keeping them in power by force. Powerful interests identifying themselves with the existing system, including regional party secretaries, military, and branch ministry officials, are probably opposed to any dramatic organizational change. To impose a reform on such opposing groups, Gorbachev would need a very strong personal position, and the support of a coherent Politburo. Presently, Gorbachev has to develop his own power base and authority, and to get rid of the "old guard" in the leadership.

Moreover, there is no clear evidence that Gorbachev is personally inclined towards "market socialism." Indeed, there was some interest shown in the Soviet hierarchy during recent years in the Chinese reform experiment. And the relative warming in Soviet-Chinese relations (Arkhipov's recent visit to China and the signing in December 1984 or an agreement on trade and technical cooperation between the two countries point to a better relationship) could facilitate a discussion in the USSR about the Chinese pattern. Peking could contribute, as have Budapest and East Berlin to the Soviet search for new economic ideas. But to what extent is the Chinese way relevant and acceptable in the USSR? If it is too early to discuss this issue, because of insufficient evidence about the Soviet judgment on the Chinese attempt, one should note that the political tension and obstruction on the part of the party cadres and local apparatchiks are part of the Chinese picture. And this could also be food for thought in Moscow, where this kind of obstructionism has always doomed decentralizing reform. The open debate in China about the fierce bureaucratic opposition to reform, on the other hand, could give comfort to those favoring reforms in the USSR, by showing them that such attitudes can be openly discussed.

Some changes are less problematic and they could be of some help to the Soviet economy. First, the new leadership could implement limited reforms, as in some East European countries, to reduce the number of centrally-planned targets; it could also transfer some detailed economic decisions to lower levels.

Second, another means to deal with Soviet economic failures would be to revive the Andropovian-style emphasis on law, order and discipline, and to generally impose on people a more hard-working behavior. Third, agriculture could become a sector for innovation or, at least, real improvement through the encouragement of the private

sector and the development of the "contract brigades" and "normless teams" recently introduced on many Soviet farms (the Bulgarian example could be of some relevance here). Not so long ago, Gorbachev favored this system. Finally, there could be a more general relaxation of the restrictions on small-scale private enterprises in the services and craft sectors. The East European example could encourage the Soviet leadership to move in this direction. Such a change, even the slightest one, could have an effect on the morale of the labor force and help cut back the effort currently directed towards illegal private enterprise.

None of these measures would deeply transform the Soviet economy, but they would reinforce the image of Gorbachev as a practical manager, seeking for change in the tradition of Yuri Andropov. So everything points to a lengthy transitional period, during which Gorbachev's efforts will be mainly directed towards building up his political power, with some practical economic measures aimed at improving the state of the Soviet economy (a modest improvement of consumption levels is a political necessity) and a certain amount of reliance on the benefits of foreign trade. Dramatic economic reforms are likely to be left to the distant future, when the party apparatus, and more generally the Soviet establishment, will be more confident about Gorbachev's ability to combine modernization and the interests of the system without threatening the stability of the system as a whole. The present "conservative" attitudes of Mikhail Gorbachev, as regards the whole set of reforms and social problems, was evidenced by his first message to the Soviet people. Elected on March 11 as General-Secretary of the party, Gorbachev expressed his views the same day and two days later in his two speeches to the CC Plenum (March 11) and to the funeral ceremony (March 13). The message conveyed by the Soviet press on March 15 (*Pravda*, *Izvestia*, *Sovetskaiia Rossia*, *Krasnaia Zvezda*) with extensive quotations was unmistakable. As *Pravda*'s headlines put it clearly, "much work lies ahead"; and *Izvestia* reminded the citizens that "work is the sole means for developing our social wealth." Labor-discipline, order, effective measures for repressing any violation of discipline—these were the main themes developed by the new General-Secretary. All this suggests that, as in the first Andropovian period, the need for a dramatic economic reform will be discussed at length; but as for practical measures, the party will rely primarily on this attempt to drive society towards more personal efforts.

Political consolidation and economic issues are not the sole questions Mr. Gorbachev faces. Of tremendous importance to his power are the *imperial* issues. The leadership presently faces a deeply troubled situation at both levels of its empire, inner and outer. The question of the inner empire is linked with all major aspects of the Soviet global situation—demography, public health, the economy, priority choices. In order to understand the issues at stake, one has to keep in mind certain fundamental facts.

First, the Soviet Union has to deal with a North-South issue inside its own borders. The USSR—with a population of 273.8 million as of January 1984—has its *North*, with developed Slavic, Baltic and other European populations constituting 77 percent of the total population (1979 census), with an average natural increase in the seventies of 0.56 percent a year. At the same time, the Soviet Union has its *South*, made up of people of Turkish-Moslem origin, located primarily in Central Asia and the Caucasus. This South represents 22.7 percent of the population (1979 census), with an average natural increase in the seventies of 2.14 percent, i.e., four times that of the North (in Central Asia the increase rate is 3.29 percent a year, or 5.4 times that of the North.)

This demographic explosion has occurred in spite of significant economic development and educational progress. It coincides with the demographic depression of the North (where the small growth is due mainly to the population structure and not to the

fertility rate which is slipping below the replacement rate). Such an uneven population development in the USSR has many negative consequences. First, the Soviet population as a whole is increasing at a slower pace than expected and needed for economic purposes. This slowing down in the general population growth is aggravated by evidences of a decaying health situation in the USSR.

As Murray Feshbach demonstrated, the Soviet population is experiencing some unexpected demographic trends: increased infant mortality, and increased mortality among males in the prime working and military ages. Surprisingly, male life expectancy declined sharply in the seventies. Alcoholism seems to be largely responsible for such a turn. And the last research data provided by Feshbach suggest that, by the early eighties, female alcoholism was also increasing and accounting for mortality in the female population. All this points to serious health problems in the USSR, affecting the youth and primarily the population of the *North* which is exposed to alcoholism, while Islamic law tends to prevent the population of the *South* from becoming addicted to alcohol. This factor help to reinforce—from the viewpoint of morale—the South versus the North.

The ethno-demographic balance in the USSR is creating a Malthusian conflict between food and population, the North being responsible for the bulk of the industrial and agricultural production of the country. The Soviet Union is also facing the dilemma of adjusting the needs of labor forces for employment. The labor force is concentrated mainly in the South, but it is required in the developed North. During the last decade, the regime proved unable to solve the problem by moving the surplus Southern labor force into the labor-deficit areas. Everything was tried to encourage such moves (threats, material and morale incentives, legal regulations) and everything failed. The Southern populations claim their right to remain in their birth places and demand a shift in economic priorities, to bring industrial investment into their underdeveloped areas. The issue of the Siberian rivers project—diverting them towards Central Russia or Central Asia—evidenced this deep conflict between local and global Soviet economic choices. So far, the Soviet regime has been more or less able to resist pressures from the South; but it is questionable how long it can maintain such a North-oriented policy with an increasingly unbalanced population, with a deficit labor force in the North, and with a troubled political situation along the Soviet Islamic borders, which could have a spill-over effect on Soviet Islamic areas, especially if the regime continues to turn a deaf ear to their economic demands. The classical conflict between major priorities—consumption, investment, defense—is increasingly complicated by this second conflict between global and national-regional priorities.

The political effects of this population discrepancy cannot be ignored. First, there are some prospects for Eurasian apartheid. The Soviet regime is quite concerned about the possibility of the eventual depopulation in the North by early in the next century. Such a situation is already creating an explosive trend, in the rising nationalism of all ethnic groups.

If national tendencies were quite visible in the South in the sixties and in the seventies, by now this trend is at work in the North, and primarily among the ethnic Russians. The official majority group—the Russian one—is aware of its very ambiguous position. Officially, it is the "leading" group, and as such, the privileged one. In fact, the Russians have an overwhelming feeling of having paid the price for developing the South, and of having received nothing in return but hate and contempt. An increased demand for concentrating efforts on the North, for developing some kind of *North* or *Slavic* area with Slavic solidarities, is thus emerging.

The national picture cannot be improved when such diverging trends are at work (rising Russian and Slavic nationalism versus rising Southern nationalism and some

kind of Islamic revival), and the new leadership will find difficulties in restoring the idea of a *Soviet community*, linked by common goals.

Other explosive problems, partly linked with this divided population, are declining social mobility, and difficulty in financing the welfare state, especially its social security components. The demographic explosion in the South and the demographic depression in the North both lead to an increasing share of consumption in the national income, a discrepancy in capital levels, and a rise in the price of resources relative to the price of human input. These in turn impose new constraints on economic growth and technological advancement, and eventually reduce the standard of living.

These problems occur at a time when the Soviet Union is faced with increased troubles in its outer empire, and their attendant burden on the economy. Maintaining Soviet rule in Poland, and more generally in the East-European empire, facing the costs of military operations in Afghanistan, of military aid to Third World Soviet-oriented countries (e.g., Angola, Ethiopia, South Yemen, Nicaragua, etc.) of supporting Soviet-related activities through proxy states—all this represents an increasing cost for the Soviet system, at a time when it has trouble facing its own needs and priorities.

Indeed the Soviet leadership is trying to reduce the costs of its outer empire by different measures (automatic working of the pricing formula in the Comecon countries, where the prices of Soviet exports—especially crude oil and petroleum products—were, by the end of the seventies, rising more sharply than prices of Soviet imports). As regards some client states, Moscow is trying to recover through partial payments as much as it can for its military and technical services: for example, Afghanistan has to provide the USSR with natural gas. But, in spite of this effort to reduce the economic burden for maintaining its grip on partner or friendly countries, the USSR is bound to support them economically when their situation endangers the whole system. The present Polish and Rumanian situations point to such an additional burden for Moscow.

At this juncture, one should raise the question of the benefits Moscow might derive from such a costly outer empire involvement. Are these increased burdens, competing with Soviet domestic needs in a period of scarce resources, compensated for by dramatic advantages? The outer empire is valuable from many points of view.

First, it provides the Soviet regime with a new kind of legitimacy. Having failed its pretense of creating a modern Soviet economy and society ("catch up and surpass the U.S." is a forgotten goal!), the regime has lost its domestic legitimacy. But by exporting revolution, it could claim that it is fulfilling its major historical duty and it could find in the cost of this duty a justification for maintaining economic and political restrictions at home. Even if the price paid for such a political benefit for the system is a high one, competing with domestic needs, and even in the present stage with the military needs which are a condition for the expansion of the Soviet empire, it is not easy to see how the system could reverse this trend.

The troubled situation prevailing in countries bordering the inner empire—westward (Poland) and southward (Iran)—causes the traditional Soviet defensive concern to feed Soviet *aggressive* tendencies. The USSR is trying to extend some kind of *buffer zone*.

The ambiguous relationship between defensive-concerns and aggressiveness is likely to enhance the latter, in view of the increasingly troubled situation in all sectors of Soviet domestic life. Indeed, Mikhail Gorbachev may well try to escape the usual tendency towards solving domestic bottlenecks by developing aggressive postures, and may turn instead towards a long-term effort aimed at a fundamental reform of the

Soviet system itself, to achieve a social consensus based on satisfaction and not on a mix of intimidation, corruption and cheating. But Khrushchev's example points to the difficulty of such a choice.

A last issue to be looked at is foreign policy. To what extent will Gorbachev be able or willing to change Soviet foreign policy, in order to focus his efforts on domestic problems? Should the West expect a new Soviet behavior, due to innovations or shifting priorities?

As regards prospects for a shift in Soviet priorities from foreign policy and military efforts to economic reform, I have already stressed how dubious such a shift would be in the short run. If we turn towards Gorbachev's own views, the question to be raised is the following one: is there some evidence of Gorbachev's views on foreign policy? His willingness to accept invitations from abroad suggests that Gorbachev does not intend to leave foreign policy outside of his activities, concentrated as it used to be in Gromyko's hands during the last few years. It also suggests that foreign policy will retain a high priority on his agenda.

But apart from these general prospects, and from the new style Gorbachev has shown when meeting foreign partners—more western and business-like, less traditionally expressed—it should be admitted that very little is known about Gorbachev's views on matters of foreign policy. In his rare comments on such issues before coming to power, Gorbachev used to repeat the general Soviet positions: that the world is divided into two opposed and struggling systems; that the Soviet Union is favoring detente and military strategic parity with the U.S.; and that it is the American policy which is always responsible for the strained international climate.

After his nomination to the General-Secretariat, Gorbachev was more explicit on many issues, but the conclusions which can be drawn from his March 11 speech and his numerous meetings with foreign leaders during the funerals are contradictory. On the one hand he provided the world with "openings," with respect not only to China but to East-West relations, too. By not postponing the Geneva talks on account of Tchernenko's funeral, or the Gromyko-Dumas meeting in Moscow, by quickly accepting Western invitations (primarily the one to visit France), Gorbachev clearly signaled his interest in arms talks and in an improvement in relations with the West. At the same time, he provided his partners with more elaborate and sometimes tougher messages.

As regards the Western world, his reluctance to commit himself to a summit meeting with President Reagan, his warm attitude towards West Europeans, and his reiteration to the West European leaders of Soviet hostility to any space militarization, could serve notice of a Soviet intention to drive a wedge between the members of the Western alliance.

The toughest messages have to do with the Eastern bloc and with Afghanistan. By claiming that Moscow would enforce the "socialist community" and develop all forms of cooperation among its members, Gorbachev made it clear that he does not intend to weaken East European solidarity. Such an insistence on the fraternal links of Communist countries, at a time of deepening differences between Moscow and its partners about the terms on which the Warsaw Treaty would be renewed, was an unmistakable notice that the Soviet doctrine was unchanged and unchangeable. As regards Afghanistan, Gorbachev spelled out clearly the Soviet position, which is as tough as usual, and probably even tougher. The search for a "political solution" which would leave Afghanistan free from outside influence, the notice given to Pakistan that any continuous interference in the Afghan situation would be dangerous for Pakistan itself, the stress on the link between Soviet security in Afghanistan and Soviet behavior in Nicaragua, all point to continuous toughness in this area.

Are initial Western expectations about a new era in Soviet foreign policy bound to be disappointed? Up until now, Mr. Gorbachev has not encouraged them, and has on the contrary hinted at a certain amount of continuity in foreign policy, even though the continuity may be presented in a more modern and practical ideological form. But Soviet interests seem to be unchanged so far.

To conclude, many domestic factors—the economy, demography, deep social dissatisfaction, the collapse of moral values—evidence the need for a complete reform of the Soviet system. As a corollary, a more flexible foreign policy is now needed in order to orient efforts towards the domestic needs, and to enlist foreign support, in terms of trade and technology transfers. But at the same time, other domestic factors—the time needed for consolidating Gorbachev's power, the bureaucratic obstruction which in the past prevented reforms and eventually got rid of Krushchev, the depth of national opposition and opposed interests—all point to the need to yield to the elements of power, at home and abroad. And, for such reasons, continued emphasis on military priorities and a more active and even aggressive foreign policy are to be expected.

Confronted with these opposing trends, all of them correlating domestic and foreign policies, how should the West behave? And can it hope to influence Soviet developments?

As regards Soviet power—and primarily military power—the West should bear in mind two major factors characterizing Soviet behavior. First, the USSR has built up its global power, and has deployed its SS-20s in Europe in a period of strategic parity with the U.S., and in the condition of détente. The successful strategic negotiations (SALT I) and the signing of the Helsinki final accord have not deterred Moscow from changing the balance of forces to its advantage. Second, in the last ten years, the USSR behaved aggressively in Angola, Mozambique and Afghanistan at moments when the U.S. was unable to intervene. The political pessimism and tendency to withdraw from the world scene in the aftermath of the Vietnamese war and of Watergate, accounted for the Soviet's risky game in 1975. President Carter's hesitant policy, and the hostage crisis which focused U.S. attention on Iran, explain the Soviets' aggressive behavior in Afghanistan at the same time. The lessons to be drawn from these two facts are:

1. The West should not have any illusions about the positive effects of the arms control process over Soviet strategic behavior. One should quote here one of the former U.S. Defense Secretaries, Harold Brown: "When we build, they build. When we do not build, they build." I am not arguing that arms control agreements are useless. They are on the contrary a useful part of the East-West relationship. But arms control agreements should not prevent the West—and primarily the U.S.—from maintaining the military balance. The right policy does not imply a drastic choice: arms control agreement *or* large military spending. The right policy should be a combination of arms control *and* a continuous military effort in order to maintain the military balance. It should be borne in mind that the Soviet Union always understands international situations in terms of a *correlation of forces*, and all its efforts are aimed at shifting the correlation of forces in its direction. Arms control negotiations are for Moscow part of a policy of getting and maintaining a strategic superiority over the West. The record of the Soviet strategic efforts in the seventies points to such an interpretation of *parity*.

2. Another dilemma has to do with the need to preserve and even develop the Western alliance system. Its cohesiveness weakens the Soviet position and it is not surprising that Moscow continuously tries to stir up defiance and arguments among the NATO members. When it adopts diverging stances in response to Soviet aggression and when it argues too loudly about relations with the USSR (as in the Siberian

natural gas case), the West paves the way for more Soviet initiatives. The Western alliance can only deter Moscow from trying to enlarge its area of control or activity by presenting a common front on certain major problems, all of them related to the security of the Western world. The decision to deploy the Euro-missiles, which was a major blow to Moscow, left the Soviet leadership without any effective reaction, because of the level of solidarity in the West.

For these two reasons—the need to maintain a permanent military effort, and the need to maintain a strong alliance—the West needs a healthy economy. Recession induces the policy-makers to make cuts in defense spending. Recession also increases the opposition and competition among the alliance partners.

3. The West should keep in mind that the Soviet leadership is used to acting in a cautious way. Aggression and caution are not to be separated. Each time that Moscow acts aggressively, it knows that the risks are quite low, or even non-existent (Afghanistan is a clear case). When the West asserts its determination to resist, that suffices to deter Soviet aggressiveness. In 1973 in the Middle East, and 10 years later in Grenada, the U.S. experienced the positive effects of a clear and determined attitude towards Moscow.

As regards foreign trade, the West tends to raise the issue in the wrong terms. The choice is not between embarking on uncontrolled and unconditional trade with the USSR or suppressing all commercial ties. Our object should be rather to avoid sustaining exaggerated hopes and illusions about the positive effects of trade on the Soviet political system. Even though getting grain and credits from the West may be comforting to Moscow, the Soviet system can afford to do without them. The Soviet Union is not dependent on the foreign imports and can manage never to depend on them. The Soviet regime cannot be blackmailed on these terms.

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## DISCUSSION

*This section begins with summaries of the remarks of a German and of an American participant who, together with the authors of the German working paper and the French background paper, constituted the panel for this discussion.*

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In assessing the significance of the recent change of leadership in the Soviet Union, the German panelist argued that it was more important for the West to consider what it should do than to wonder what Gorbachev might do. The Soviet Union was in a period of transition and, hence, not one of strength. It was therefore a favorable time for the West to take the initiative and act, instead of react. The West should capitalize on its own strengths and exploit the Soviets' weaknesses. Our goals should be: (1) to increase the stability in the power relationship between East and West in order to continue to prevent war or the use of force and to contain Soviet expansionism; (2) to reduce the level of arms on both sides; (3) to increase international cooperation, including the widening of contacts and exchanges.

In order to accomplish these objectives, there were two prerequisites for the West. The first was to maintain its military strength. There could be no substantial arms control agreement or any reasonable political settlement if the Soviet Union was allowed to believe it could capitalize on its military strength to achieve political ends.

The Russians had achieved parity with the West in strategic weapons and superiority in intermediate- and short-range weapons and in conventional forces. The West's aim should not be to regain superiority; but inferiority was unacceptable. The West needed enough military strength to preclude the use of force by the Soviet Union. This meant strengthening our conventional forces. It also meant that we could not renounce nuclear weapons or their first use, which were the core of our policy of deterrence. We could not afford to discredit our strategy of flexible response, which we would need for at least one more decade. In arms control negotiations, we had to maintain Alliance cohesion in the face of Soviet attempts to divide us. Our approach at the Geneva talks should be characterized by "firmness in principle, patience in timing, and flexibility in method," with the aim of substantial mutual reductions in strategic and intermediate weapons.

The second prerequisite was to induce the Soviets to be more cooperative. In this effort we should use our areas of strength: our economic and technical superiority and the freedom and creativity of our societies. The Russians knew and feared the capabilities of the West in these areas, as evidenced by their reaction to the Strategic Defense Initiative (SDI). They viewed reaching strategic parity with the U.S. as their main achievement, and we should not give the impression that we would deprive them of it. We should let them know that we preferred cooperation to confrontation, that their choice was to continue the military power struggle or to cooperate in a way that would impose political restraint and limit military competition. The former option would absorb all the resources needed for domestic purposes; the latter would allow economic and technological cooperation with the West.

There was no quick fix to the current situation in East-West relations; we were in for a long struggle of wills. An intellectual and moral challenge faced the West—to fight the fear, pessimism, and resignation creeping into our societies. These presented the main danger to the free world's future. If we wanted to preserve our freedom, we would have to make sacrifices. We had to strive for peace, but remain ready to defend our freedom. If we stuck to those principles, the speaker concluded, there was reason for optimism.

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The American panelist viewed the current state of East-West relations in the context of four aspects: personal, geopolitical, strategic, and regional.

Regarding the ascension of Gorbachev, it was true that he brought "new dimensions of energy and intelligence" to the Soviet leadership. But there was a tendency in the West to overemphasize the importance of personal changes for the Russian side of the East-West relationship. We should not exaggerate the significance of Gorbachev, nor should we idealize him, as some Western observers had done. It was important to understand the nature of the change. Every new Russian leader in recent history had had less power than his predecessor. The Soviet system had become increasingly bureaucratized and the role of the leader less decisive. Gorbachev was the first Russian leader to have been chosen by his predecessors, who saw in him a rejuvenator and modernizer of the Soviet system, not the reformer and accommodator some in the West wanted to see in him. In this sense, he would have less room than his predecessors to make decisive changes.

From the geopolitical point of view, the first indications from Gorbachev were not encouraging. Soon after taking office, he had issued a stern warning to Pakistan not to support the Afghan resistance and had deployed Soviet forces closer to the Pakistan border. He had presided with a heavy hand over his first Warsaw Pact meeting,

allowing no free discussion or any internal dissent. So the hope for new initiatives in East-West relations was not great. Still, the West had to undertake a "comprehensive, serious, and enduring political dialogue" with the Russians. The U.S. was at fault to some degree for not having tried to initiate such a dialogue on the fundamental divergence of perceptions on key geopolitical issues. Until these perceptions were narrowed, we could not expect much progress toward the moderation of relations.

In the strategic context, the arms race was a symptom and not the cause of the current state of U.S.-Soviet relations. Until the geopolitical dimension was contained, not even a successful arms control agreement would alter the essentially hostile relationship between the two sides. For arms control to succeed, it was necessary that the U.S. be able to negotiate with public support for a long period of time. SALT I had taken four years to negotiate, SALT II had taken seven years. If we wished to make progress in arms control, we had to come to grips with the central issue in strategic stability in the 1980's and 1990's—the transformation of the equation from one of the mutual vulnerability of the two societies to one of the growing potential vulnerability of one another's strategic systems to a disarming, preemptive first-strike. This was a particularly acute danger because the U.S. was not deploying effective first strike systems in sufficient numbers to pose a credible threat to the Russians, who were deploying enough such systems to make the power relationship more precarious. Future arms control negotiations would have to deal with these systems. We needed the capacity for a trade-off, and here lay the significance of SDI—in its capability to disrupt a first strike. If we demonstrated to the Soviets our determination to proceed with SDI, we would have the chance to strike a bargain which would engage them in the kinds of reductions that would be stabilizing.

Finally, with respect to the regional aspect of East-West relations, Europe remained the central arena of competition between the two spheres. It was a long-term competition, and, if the military and strategic relations could be stabilized, was primarily political. It behooved the West to undertake that competition. If a "more organically European" Europe was to emerge, there would have to be changes in the relationship between Western Europe and the U.S. and between Eastern Europe and the Soviet Union. Some movement in this direction was underway already, and should be encouraged. But there were two problems on the horizon. One was a growing gap between the European and American perceptions of the nature of the East-West problem. If it were allowed to become much wider, it would paralyze any effort to have a common policy. The other problem was the oscillations in U.S. public opinion from excessive optimism to excessive pessimism about relations with the Soviet Union. These swings—from excessive fascination with détente to excessive preoccupation with the cold war—were extremely harmful to the U.S. capacity to manage its relations in a stable fashion. What was needed was a return in the U.S. to a genuinely bipartisan foreign policy.

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There was general agreement that significant changes in Soviet policy and behavior could not be expected merely because of new leadership. In terms of ability to bring about change, said a Finnish speaker, one should not equate the General Secretary of the Soviet Communist Party with the President of the U.S. There were vested interests in leaving the Soviet system as it was. Any major economic change would mean reallocation of political power internally. It was far easier for Soviet leadership to resist change than to initiate it. True, the Russians were preoccupied with their

economic problems. The difficulty they faced was how to restructure their economy, how to build in incentives, without introducing the market mechanism.

An American agreed that it was difficult to expect much in the way of bold initiatives from Gorbachev, who had accomplished little when he had been in charge of Soviet agriculture. It was surely embarrassing for Moscow to see China exporting food as the result of adopting a more market-oriented system. Indeed, in this regard, perhaps we focused too much on issues between the Soviet Union and the West, to the exclusion of China, where developments surely were causing the Russians concern. Conceivably, China's modernization could be a catalyst for reform in the Soviet Union.

Another American warned that the Chinese leg of the U.S.-Soviet-Chinese triangle should not be neglected. We could expect some movement in Sino-Soviet relations in the coming years. Both sides had incentives to reduce tensions. The Russians were faced with the "restlessness" of the European satellites and problems along both sides of their southern border. The Chinese wished to devote their resources to economic modernization. There had already been some eased rhetoric toward China by Gorbachev, and some increase in trade and other exchanges. But, from the Chinese point of view, Soviet activity in Indochina and Afghanistan remained an obstacle. The West should not show anxiety, but remain confident that, in the long run, the Chinese would lean to the West because of built-in antagonisms to the Russians.

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Several speakers commented on the economic liberalization and foreign policy autonomy that now existed in certain Eastern European countries. An American noted that Hungary and East Germany had recently had serious differences with the Soviet Union, especially with respect to policy toward West Germany. It could be expected that such dissent would continue to occur from time to time as the result of Russian policy and not any actions by the West. Other participants spoke of an emerging sense on the part of both Western and Eastern European countries that they "belonged together." But, a German warned, we should not see in these signs a "fundamental challenge to the existing order, or that the division of Europe has been overcome." The East-West division and its ideological antagonisms were here to stay.

A French participant wondered if the autonomous trends at work in Eastern Europe signified that the Soviet Bloc was disintegrating and if the Soviet Union were losing control over its satellites. Answering her own question, the speaker pointed out that three patterns were at work in the Soviet Bloc. The first pattern was economic and was illustrated by Hungary. The Soviet Union accepted Hungary's economic modernization because the political system had been kept intact and the classical economic system could be reverted to immediately. In the Romanian pattern, a certain amount of foreign policy autonomy was tolerated by the Russians because of the Stalinist style of the political leadership and because the Soviet Union could sometimes use Romania's independent positions to its benefit, as when Romania became the first East Bloc country to establish relations with West Germany. Finally, in the political pattern exemplified by Czechoslovakia and Poland, the Soviet Union was easily able to re-establish its grip. The disintegration of the Soviet Bloc had been stopped or compensated for by the development of integrative processes. The Warsaw Pact itself was an element of political integration in that it provided the means of educating and training political and military elites.

A German speaker sought to provide a perspective on his country's special position in East-West relations. Germany was a divided country and even those who believed

reunification was its destiny knew it was at best a distant objective, and more likely, an illusive dream. So the task for West Germans was to focus on the reality of division and to make it less brutal, to facilitate contacts. It was first necessary to be firmly anchored in the West—which the Federal Republic was—and to be realistic, to recognize that "it was better to have a full grip on half of Germany than half a grip on the whole of Germany." The Germans had to help create an international climate in which confrontation was reduced and cooperation enhanced. In this regard, the speaker continued, most Germans were more comfortable with the Nixon-Kissinger approach than that of the current U.S. administration. The German desire was to keep channels of communication open and not to use trade as a weapon. Arms control must be given a chance, and Western arms programs had to take into account Russian concerns. SDI would ruin the Geneva negotiations because it evoked for the Soviet Union first-strike scenarios, thus prompting the Russians to deploy even more offensive weapons. It was in the German national interest not to be part of a new cold war, nor to participate in an ideological crusade, nor a trade war.

Taking exception with the views of his countryman, another German intervened to say that, in his view, most Germans were happy with the American administration, which had created the atmosphere and reality of strong leadership and had restored credibility and strength as prerequisites of negotiation with the Russians. It should be our own interests, not those of the Soviet Union, that should dictate our policies. We needed to differentiate between real and so-called Soviet concerns. For example, the Russians had falsely created the impression that they feared a first strike from the INF deployment. As for SDI, without it, the Soviets would not have returned so quickly to the bargaining table. If handled the right way, SDI could foster agreements on the political level, if not the arms control level.

A third German speaker felt that a particular problem in his country was that public opinion focused on arms control as an end in itself and not on the underlying political issues. It was critical that German leaders explain, especially to youth, the political substance of the arms control debate. The Russian goal with respect to Germany was to require "preemptive good behavior." The German question had to be seen not as a separate issue, but as part of the East-West situation. No solution was possible that involved collusion with the Soviet Union at the expense of the West. It was Germany's task to convince the Russians that it was in their own interest to completely reappraise their policies toward the Soviet Union's European neighbors.

In an American speaker's opinion, we were in for a period of extended negotiation. Regardless of the incentives, the Russians did not want to add major foreign policy decisions to the others they already had to make. Foreign policy negotiations would be of a stalling nature and not substantive. This would be reinforced by the "Western obsession with arms control as the only subject worth discussing." The West had no new ideas about arms control that improved the current situation, and the Russians now tended to use arms control negotiations to veto the most advanced Western weapons systems. Weapons had become symbolic rather than substantive.

The Russians had three options before them. One was to use their objections to a weapons system as an obstacle to negotiations and thereby split the alliance. The second was an "ameliorated status quo." The third was fundamental change, and this they were reluctant to undertake, as was the West. It was unlikely to be undertaken without some discussion of the political issues dividing the world—which the West resisted in the name of decrying linkage and of settling first the alleged dangers of the arms race. The most important thing we could convey to the Russians was a sense of our perception about the evolution of international affairs over the next 15 years, and



to attempt to see if we and they could come to some understanding about where we would want to be at the end of that time. From there, we should work backwards to specific issues. There were at present no channels in which to do this, and the outlook for progress in negotiations was not hopeful. With respect to SDI, we had not presented it or thought it through very well. But it was crucial not to give it up just because it might become an obstacle to an agreement. Without it, we would have no concept of arms control, nor, in the long run, any strategic concept.

In the opinion of the American panelist, linkage was fundamental to the conduct of Soviet-American relations. Whether we formally linked issues or not, the reality of the political interaction between issues in terms of American politics created a situation which was, in fact, linkage. Thus it was important to deal with the underlying political issues on a continuing basis, and it was necessary to make a more deliberate effort to return to some form of bipartisanship, because only in that context could we handle the question of linkage. In the absence of bipartisanship, linkage became polarization and exploitation of political differences in the area of foreign policy. In recent years, the trend in the U.S. had been toward differences rather than consensus, toward an "artificial fanning of differences on the East-West front."

In this regard, another American intervention offered some hope. In a recent, not well-publicized speech on the subject of the long-term management of U.S.-Soviet affairs, reported the speaker, Secretary of State Shultz had stated that the U.S. needed to have a stable and continuing relationship with the Russians. Americans had to avoid the destabilizing swings of policy that disrupted that relationship, and both sides had to find a method of discussing their differences.

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### III. THE STRATEGIC DEFENSE INITIATIVE

*A briefing by a member of the Reagan Administration provided the basis for the discussion of SDI. This section begins with an account of those remarks.*

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The American research program into strategic defenses had to be seen in the historical context of the 1972 ABM Treaty and the Interim Agreement limiting offensive weapons. It was hoped that, as the result of these agreements, the Russians would stop short of threatening the American deterrent—especially its land-based forces—and that this would obviate the need for the U.S. to build the ABM system that it was then technically capable of constructing. It was expected that a period of stability would follow.

In fact, neither the Interim Agreement nor the SALT II agreement in 1979 had restrained the Soviet offensive build-up to the extent that the U.S. could be confident its strategic retaliatory capability was secure from attack. The ABM Treaty was not an agreement between the U.S. and Russia that it was desirable to be vulnerable. Everything the Russians had done since 1972—building up offensive forces, developing hardened underground facilities, deploying air defenses, and pursuing their own ABM and strategic defense programs—suggested they were far from content to remain vulnerable. Clearly they did not accept the proposition that mutual assured destruction was a basis for long-term stability. By building up offensive weapons that would degrade the American ability to respond, and defensive weapons that could cope with what response the U.S. might be able to make, the Russians were determined to strengthen their position and deprive the U.S. of its ability to deter through the threat of retaliation.

What precisely were the Russians doing? There was considerable evidence that they might be verging on a violation of the ABM Treaty by deploying elements of the same sort of ballistic missile defense that the Americans had planned to construct. This defense was based on a combination of large and small phased-array radars and short- and long-range interceptor missiles. The Soviets had deployed twice the number of large phased-array radars that the U.S. planned to build prior to 1972, and they had developed a highly effective radar that, if mobile, would be banned under the terms of the ABM Treaty. (It was considered to be transportable, rather than mobile.) They had also developed both long- and short-range missiles comparable to what the U.S. had anticipated building. And they were deploying a new generation of air defense systems effective against most warheads in the Western arsenal. They had, in the testing phase, yet another missile, with even more impressive ABM capability.

Before the ABM Treaty, the Russians had deployed the type of large, phased-array radar systems needed by a missile defense in all but one area of their national territory. They now had under construction a radar that would fill out coverage of the Soviet Union and would support a missile-defense system. A key part of the ABM Treaty was a limitation on such radars, because, while other components of an ABM system could be surreptitiously built and stored and rapidly deployed, construction of large radars took five to seven years and would provide an early warning of a breakout from the treaty. The treaty stipulated that large radars were only to be constructed on the periphery of national territory, facing outward. Inland radars that covered national territory could be used to track missiles above it, while peripheral radars could not technically be used in a missile defense. The Russians contended that their new radar

was for space tracking; yet it was oriented not toward space, but toward the horizon. Hence, the new radar was a clear violation of the ABM Treaty.

In addition, the Soviet Union had been and was now at work on developing its own strategic defense technology based on, in the language of the ABM Treaty, "other physical principles." In particular, they were researching high energy lasers and particle beams as part of a program far larger than what the Reagan Administration was seeking.

As to the U.S. program, it was, first of all, a research program and nothing more. No decisions had been made about deployment of a strategic defense, nor could they be made until the research results were in, and determinations could be made about cost, effectiveness, and sensitivity to countermeasures. Since the signing of the ABM Treaty, the U.S. had invested nothing in missile defense. Its capability to pursue such a program now derived mainly from developments in civil technologies, which put it in a position to explore whether these advances could be applied to defense. The evolution of technologies, particularly in data processing and in pointing and tracking, promised the possibility that a missile defense might be developed.

The Soviet program was justification enough for the American research effort. In the absence of a comparable U.S. program, we ran the risk of the Russians emerging in sole possession of an advanced and sophisticated strategic defense capability. In addition, we had no way of knowing whether our efforts to negotiate limits on offensive weapons would succeed. The Soviets had been unreceptive to significant reductions that would impair their ability for a first strike; it was likely they would further add to their offensive arsenal. Should that happen, SDI could restore the integrity of the U.S. retaliatory capability without a parallel build-up of its offensive forces. A strategic defense in the face of growing Soviet offensive capability would restore the credibility of the U.S. deterrent. The moral argument against SDI was a false one; there was no other means to protect the Alliance and deter conflict.

There was a close historical analogy between the SDI debate and the debate that had taken place in 1946 between Robert Oppenheimer and Edward Teller over whether or not to develop the atom bomb. History had shown that, if President Truman had sided with Oppenheimer and not proceeded with development, the Russians would have wound up in sole possession of nuclear weapons. Conceivably, the same thing could happen with strategic defense, should the West abandon its research program.

Finally, with respect to European objections to SDI, the question had to be asked: how much longer would American public opinion accept the proposition that the U.S. was justified in assuming risks in defending its allies while those allies insisted that the U.S. not take steps to defend itself?

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A major part of the discussion of SDI took the form of questions, principally from European participants, about specific aspects of the program. The questions generally fell into three categories: political, industrial, and strategic, including arms control aspects.

With respect to the political dimension, several participants wanted to know what effect uncertainties in the American political process might have on SDI. How likely was it, in the words of a Frenchman, that SDI would survive the ups and downs of American political life and become part of a bipartisan defense and foreign policy for the years to come? A German worried that the political process would have trouble sustaining SDI over the long period of time that was required to carry out the research.

Might not SDI become a "technological MLF that the U.S. would foist on the Europeans and then sink before they had a chance to jump ship?"

Questions about the industrial aspect focused on what role the U.S. wanted Europe to play in SDI. Was European participation to occur at the individual, the company, or the state level? (A French speaker disapproved of American overtures to specific European companies.) Was it technically feasible to cut out a package within SDI and hand it over to the Europeans for development? A Belgian wondered how it would be possible to organize cooperation in carrying out research into such a complex issue when there existed no framework in which to do it. And the sensitive issue of technology transfer was bound to be an obstacle.

In the area of strategic considerations, a Briton remarked that it sounded to him as though "the U.S. wants to build itself a bomb shelter and is inviting the Europeans to help." But would there be room in the shelter for Europe? In a similar vein, a Dutch speaker felt SDI would "isolate Europe from the defense of the U.S." unless it could provide protection against battlefield nuclear weapons.

By far the greatest area of concern was the effect that SDI might have on the Geneva arms control negotiations. In this regard, a Frenchman wondered if SDI was negotiable and whether Europe would have any say in setting the conditions for its negotiability. If the Russians came up with a "dramatic proposal," would that not cause a serious breach in the Alliance?

An American felt SDI had "catastrophic implications." First, it was not well understood, even by Americans, because it had been "deceptively packaged." President Reagan had said it would free the West from nuclear deterrence, which he had called amoral, and render nuclear weapons obsolete. Meanwhile, the Defense Department had been saying SDI's purpose was to defend weapons rather than populations, and that it would enhance deterrence. How were the Russians to respond to this? If they had returned to the bargaining table because of SDI, they surely were not about to negotiate away their offensive build-up. Either they would build a defense of their own, or concentrate on countermeasures with existing technology, or undertake an enormous increase in offensive weapons in order to overwhelm our defense. In short, nothing useful would be accomplished at Geneva as long as SDI remained non-negotiable. Indeed, it was likely the talks would fall apart within three months.

A Dutch participant asked why the U.S. had backed away from its offer to share research on strategic defenses with the Russians. If it would take at least 10 years before a defensive system could be deployed, how could limiting offensive weapons be made attractive in the interim? Without a sharing of research, there would be uncertainties that would "ruin" the Geneva negotiations.

It was an International speaker's view that the case for the research phase of SDI was a good one. What had caused problems for the Alliance had been the pace and scale of the program, the manner in which it had been launched in 1983, and the fear that it might cause an impasse, if it had not already, in Geneva. We could expect the debate on SDI to go on for a long time. No definitive answers about the desirability of strategic defense were possible yet. The major worries were: (1) how to reconcile the maintenance of the credibility of flexible response in a world in which strategic defenses were deployed; (2) how to make deterrence by denial as credible as punitive deterrence had been for over a generation; and (3) how to insure that whatever strategic defense system was introduced enhanced rather than degraded stability.

Regarding deterrence, an American argued that what had worked for the past 40 years would not work for the next 40. We needed to reconsider our concept of deterrence, taking into account the impact on it of multiplying retaliatory forces on both

sides. The situation today was much different from that of the 1950's and 1960's. As for SDI, the speaker felt the Administration's emphasis on research was "too clever by half" and very dangerous. We could not segment the program into a research phase, followed by a phase of negotiation with the Allies, then a phase of negotiation with the Russians. Such a process would surely kill the program. We needed to have the courage to declare our commitment to an effective defense and our readiness to negotiate it along with offensive limitations. To separate the defensive and offensive negotiations would produce "the nightmare" of endless negotiations with the Europeans and then the Russians.

Another American agreed that the U.S. should be more forthright, first in stating that SDI was a counter-first-strike system, then in making clear its intention to acquire such a system, and its capability to have one by the 1990's. That posture would give the U.S. more credibility to persuade the Russians to engage in genuine weapons reductions. If there was no progress in arms control, the U.S. would have to deploy a counter-first-strike defense system within the next decade. Continued Soviet development and deployment of defensive systems and of offensive systems capable of a first strike was likely, by the 1990's, to put the West in a precarious situation in which its missiles would be vulnerable to a Soviet first strike and the effectiveness of its surviving missiles (mostly submarine-launched) would be compromised by Soviet defensive systems. At current rates of development, the Soviet Union would have 8,000 first-strike-capable warheads by 1990; even deploying at the maximum rate, the U.S. would have only 2,000. The only alternative to a defensive system would be for the U.S. to deploy more offensive weapons; SDI would be preferable and more stable.

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Another official of the U.S. administration sought to respond to concerns about the program's effect on arms control negotiations. It was important to realize that, while the U.S. was moving toward a system that emphasized defense, the Russians were not advocating the doctrine of mutual assured destruction as preferable. They, too, were concentrating on defense; they had the only operational ABM and anti-satellite systems, as well as their own strategic defense research program. What they saw at Geneva was an opportunity to abort the U.S. strategic defense program at the outset.

As to the negotiability of SDI, it was unlikely that the Russians would put on the table any dramatic offer constituting deep reductions in offensive nuclear capability. They were happy with the present strategic balance. Nor were they willing to abandon their own strategic defense program. The U.S. position was that it "envisions a cooperative transition with the Soviets toward a more defense-oriented posture." It was willing to negotiate, but not in the sense of preemptive concessions.

The American spokesman addressed some of the specific questions about SDI raised by participants in the discussion. Regarding the political dimension, there was broad support for the research phase for the next few years. It was difficult to predict what might be the case in the development phase, which would in any case be undertaken by a future administration. He expressed confidence that, as more became known about the Soviet program and the ambitions of the U.S. program, it would get support up to the development phase.

With respect to the industrial issue, it was possible there were some elements which could be better done in Europe than in the U.S. But the program was diffuse even in the U.S., and was not really a single project. Domestic political considerations would effect the level of European participation, but every effort would be made to let contracts to low bidders. There would have to be special arrangements covering

technology transfer, and these, in addition to other security issues, would have to be worked out on a government-to-government basis.

As for the capabilities of the system, 80 percent effectiveness would reduce to 20 percent the number of warheads the Soviet Union could deliver against the U.S. retaliatory arsenal—equivalent to the status quo in 1972. And the research was aiming at a layered defense with reliability greater than 80 percent. As to the concern of some Europeans that SDI would not defend Europe, the speaker pointed out that some of the most promising approaches in interception involved the boost phase, meaning that all missiles could be intercepted, not just ICBM's. Other systems and technologies aimed at defense against tactical weapons were in fact less complex than those dealing with strategic weapons, so that defense against short- and intermediate-range weapons might emerge first.

Addressing the arms control dimension, the speaker said that the research phase of SDI was not negotiable, that the Russians understood this and planned to continue their own research, and that research was not constrained by the ABM Treaty. It was the Administration's intent to abide by the treaty and consult with the Soviets before deploying a system based on "other physical principles." To follow the suggestion that the U.S. ought to declare its intention to deploy a counter-first-strike defensive system would require the U.S. to withdraw from the ABM Treaty, which would have political costs and well as benefits. It would also mean relinquishing the treaty without the certain knowledge that the defensive system was workable.

To the concern that the Russians might deploy more offensive weapons to overwhelm the U.S. defense, the speaker replied that the U.S. would not deploy a system that was vulnerable. At present, the leverage in terms of cost was on the side of defensive systems, but if this ceased to be the case, the U.S. would not deploy a non-cost-effective system. As to countermeasures, extensive research was being done, and it was unlikely that the Soviets had measures effective against the sort of defensive system the U.S. would deploy.

Finally, the speaker agreed that it was possible to emphasize research to the extent that it was separated from deployment by a line that was impossible to cross. But the U.S. was faced with a dilemma. It did not know enough about the possible success of SDI to run the political risks of declaring now that it planned to deploy it. It was hard to effectively negotiate a system that did not yet exist and to anticipate all the freedoms that would be needed under the ABM treaty to proceed. And it was true that the emphasis on research was partly in response to the political problem of getting a majority in Congress to support deployment.

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#### IV. HOW SHOULD THE WEST DEAL WITH DEVELOPING COUNTRIES

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##### "The Debt Problem"

*Working Paper Prepared by The Rt. Hon. Lord Lever of Manchester,  
Former Cabinet Minister and Financial Secretary, Former Member of Parliament*

Current accounts deficits are a normal and productive feature in the evolution of developing countries. Past experience indicates that a sound system for financing these deficits include:

1. *A greater Governmental role than has been previously accepted.* Private banks and finance cannot adjudge the broad aggregates of funds to be provided, nor their apportionment between the countries concerned; nor can they insist upon adequate responses by the debtor countries.

2. *A role for the private lenders and investors including the banking systems of the West.* The budgetary mechanisms of Government are inadequate to provide the amounts required, and it is desirable to involve the private banks and financial concerns of both the borrowing and the lending countries to secure an improved allocation of resources within the borrowing countries themselves and that the private sector receives an adequate share of the resources made available.

3. *Arrangements to achieve reasonable continuity in the flow of funds not liable to suffer abrupt changes from feast to famine.* Such changes create crises and make solvency dependent on the exaction of premature trading surpluses from the debtor countries before their development is sufficiently advanced. They prejudice growth and employment in the debtor countries and impose unrealistic burdens of adjustment on the Western countries themselves to accommodate the export surpluses required.

In early stages of development it is unrealistic and indeed undesirable that the debtors attempt to service the debt in real terms, i.e., by trade surpluses. There must, therefore, be reliable provisions made for the re-finance of debt during that period. Past lending was based on the false assumption that such re-finance would be available without an appropriate supporting and supervisory role of the public authorities.

The present dangers are:

1. Great uncertainty of service of past debt. This leaves the key banks of the West involved with a chronic balance sheet fragility.

2. Stability is dependent on a premature and unsustainable trading surplus from the debtors.

3. The role of public authorities is inadequately systematised and is geared to promoting the anomalous trading surplus of the debtors.

4. The present arrangements do not contribute sufficiently to the improvement of the economies and internal finances of the debtors. In some respects they contribute to a dislocating inflation and injury to the private sectors of those countries.

##### AN OUTLINE FOR ACTION

*Past debt—an equitable and efficient sharing of responsibility.*

If we are to preserve the full and healthy functioning of the private banking system, the banks must not be exposed to the danger of an abrupt increase in "non-performing" debt. Reliable interest service will require a flow of new finance to the debtors. For some years ahead this can only be achieved if supportive guarantees by public authorities are made available to the debtors.

A necessary part of these arrangements would be that the banks themselves made substantial provisions out of profits over a lengthy period against these debts. As these debts would be continuously written down the volume of guaranteed finance required to service the interest payments on them would be continuously diminishing.

The debtors' contribution to the resolution of past debt must be the development of more austere policies directed to the strengthening of their economies. The responses required are not the indiscriminate cutting of imports nor the attempts to develop a sufficient trading surplus. And the mandate of the IMF and other public authorities should be adjusted accordingly. This would also make clear that the central long-term purposes of the Western authorities are identical with the legitimate interests of the debtors countries.

The costs to the public authorities of these guarantees will depend on the longer term prospects and evolution of the debtor countries. Whatever these costs may be, if they are not borne by the public authorities they would otherwise fall most disruptively on the private banking system and hence on the economies of the Western countries.

At present we are relying for debt service partly on the trading surpluses of the debtors, partly on the funds of the IMF and partly on involuntary re-lending by the banks. For future flows of funds we are relying on unrealistic assumptions of an early and sufficient flow of voluntary lending.

#### FUTURE FUNDS

Outline decisions will be required on:

1. The amount of such funds.
2. How they should be apportioned.
3. The responses required from the borrowers.
4. The mechanics to achieve such transfers.

The best means for ensuring sound and sustainable arrangements in respect of past debt and future lending is by the extension of the role of the export credit guarantee agencies. It is not coherent on the one hand to guarantee trade debts and on the other to make no provision for ensuring that the countries concerned will have available the necessary foreign currency. The action of these agencies should be made dependent upon advice from the IMF who in turn would need to be satisfied that the lending was justified.

In the past, the West's recognition of the important global interests involved in these issues has been vague and generalized. As a result, these interests have been supported mainly by a small and vulnerable section of the West's resources, namely, the private banking system. The proven inadequacy of pre-crisis arrangements cannot be remedied by purely ad hoc emergency arrangements. Of course there has to be case-by-case differentiation between the needs of the different countries and a willingness to act in emergency. But an outline strategy is required to give coherence and sustainability to these actions.

#### QUESTIONS FOR CONSIDERATION

1. How vulnerable are the present arrangements to new shocks, e.g., correction of the U.S. trade deficit or temporary recession in world trade?
2. Will voluntary lending be resumed on a sufficient scale and within a reasonable time without some form of insurance?
3. Are present arrangements conducive to the healthy economic, financial and political development of the debtor countries?

4. Do present arrangements leave the leading banks of the West in a safe and satisfactory situation conducive to their full and healthy functioning?

#### "Comments on the 'Debt Problem'"

*Working Paper Prepared by Edwin H. Yeo III,  
Managing Director, Morgan, Stanley & Co.; Former Undersecretary of the Treasury*

The phrase the "debt problem" has come to conceal more than it reveals. It is in such common use that an effort to define it almost seems condescending. In this country viewers of television are treated to learned descriptions of the money the "third world" owes, to whom it is owed, and why it is highly improbable that it will be paid back. "Solutions" have also become worn with usage. They fall into three general categories. One involves efforts to adjust debtor economies and stretch out—fund—debt service schedules. Characterized as the case-by-case approach, these programs are designed to increase external earning capacity, set the stage for renewed growth, and ameliorate debt service burdens.

Another general approach envisages large transfers of resources from creditor countries or, in its broader iteration, "rich countries." Such transfers can be effected by legislated means or by more elliptical measures including SDR allocations, expansion of soft loan schemes, and in its most subtle, and some would say most disingenuous, cloak, capitalization of interest.

This introduces us to the third general approach to the debt problem—forgiveness, abrogation, evaporation—the disappearance of the debts. In some proposals just a little disappearance is called for—in others total absolution. In some approaches the authors imagine a debtor cartel approaching the creditors on a sovereign nation to sovereign nation basis and announcing that as a group they will not pay some portion or all of their obligations. Other variations involve creditor banks grouping together and concluding that after all the heavily indebted countries can't pay; the banks then execute a unilateral partial write-down. One is prompted to suggest the site for such a meeting—heaven, but before dismissing such a scheme as preposterous one must consider if the massive Mexican rescheduling in which \$67.8 billion of commercial bank loans to public and private borrowers were funded out for a decade was not a partial forgiveness in an economic sense whilst maintaining financial probity.

This brief catalogue of general approaches is incomplete and does not do justice to the considerable work that has been done. But it does seem sufficient to make the point—that we missed the point.

The year 1975 is a good place to start. Economic recovery was well underway in America and starting in Europe and Asia. Oil was at \$11.50 a barrel; Saudi Arabia was producing 7 million barrels per day. Put another way, that country's pro forma oil cashflow on an annual basis was \$28 billion. Of that amount, Saudi Arabia spent \$4 billion on goods and services purchased from the rest of the world. The difference of \$24 billion was added to Saudi Arabian monetary reserves.

The Saudi Arabia case is one of the more extreme, but there were others in approximately the same position. The increase in oil prices represented a redistribution of income in favor of oil producing countries. At that time, many of these countries had low absorption rates, and therefore became the proxy savers for the world.

Oil importing developed countries could have accepted the transfers of income. In the event, however, they tried to avoid it with varying degrees of success. Internally, this meant a standard menu of what were thought to be stimulative policies; in many cases it meant increasing external indebtedness to cover current account deficits.

Some nondeveloped countries, including Eastern bloc nations, followed this course and at the same time embarked on a course of borrowing to finance investment and additional consumption. This process was punctuated briefly in late 1976 by the Mexican financial crisis but by mid-1977 was back in full swing. In 1979 OPEC executed another price increase which among other things, served to insure the continuance of the proxy saving role assumed by many members of that group. These savings were largely recycled by intermediaries—the banks. The vehicle was the dollar, with some interruption caused by mistrust of the economic policies pursued by the U.S. for part of this period. There were a variety of flaws:

- The banks and related financial markets were not equipped to handle the prodigious amounts involved;
- To the degree funds were borrowed to finance consumption, funds available for world capital formation were reduced, and all else equal, economic growth suffered;
- Funds borrowed to finance consumption meant that the borrowing countries faced increased debt service requirements with no attendant augmentation of their external earning capacity—*financial problems were implicit in the process.*
- Funds were borrowed to finance the removal of internal capital. In some cases the use of proceeds didn't involve consumption or investment but simply served to liquify holders of domestic capital and thereby permit its removal; and
- The system of sovereign credits lacked checks and balances that insured extension of credit for activities that had a high probability of generating cash flow sufficient to meet debt services. *Put another way, sovereign credit lending tends to facilitate or, at the very least, mask the misallocation of capital* because there is no measure of profit or loss on which to base the extension of credit.

The enormous savings accumulated by the proxy savers were, in the event, handled in a manner that resulted in the misallocation of a portion of world savings and thereby insured that financial problems would result. The timing and severity of these problems hinged on the prospects for inflation. In a general sense, accelerating rates of inflation tended to obfuscate financial strains, and of course, it could be argued, ultimately caused them to be more severe.

Certainly by mid-1979 expectations of accelerating inflation in all but a few countries was the norm. The recycling process had continued apace. For example, Saudi Arabia's external financial assets increased well over \$100 billion from the end of 1974 to mid-1979. Other proxy savers had in varying degrees similar experiences, although in some cases absorption rates increased more rapidly than had been thought possible. As the world entered the decade of the 1980s, it was clear that in some cases continuance in the role of proxy savers was contingent on another significant increase in the price of oil, but then that was almost a certainty.

It was equally clear that capital importing nations in South America, Eastern Europe and Asia had developed debt service ratios reminiscent of the 1920s. In many cases the high debt service to external earnings capacity ratios were matched by a high ratio of short-term, unfunded debt to owned reserves and access to incremental, unconditional short-term credit.

Less clear, but of pivotal importance, was a change in attitude in the U.S. and elsewhere about the acceptability of accelerating rates of inflation. People, particularly the middle class in the U.S., perceived themselves as losers in the inflationary process and this formed a broad base of support for a change in U.S. policy—monetary policy was redirected and restoration of price equilibrium became the objective. However, due to the legacy of a trail of broken promises by U.S. politicians, expectations were locked on the prospects for continued inflation. The result was high interest rates.

By 1981–82 the combination of high debt service levels—a function of the level of debt and high interest rates—and a recession-induced weakening of external earning capacity served to unveil what was soon to be known as the debt problem. Mexico was first, others followed. Most would say Mexican “debt problems” became visible with the near financial collapse in the late summer of 1982. But many Mexican residents were more prescient. Capital outflows—movement of funds out of the country by Mexican nationals—accelerated in 1980 and 1981.

This performance was matched by residents in many other countries. The proxy saving role of OPEC withered as a result of its inability to raise prices, a cyclical slowdown in energy consumption, and increased internal absorption capacity. The resulting diminution of the flow of funds into the dollar from these proxy savers was offset by an accelerated flow of funds out of heavily indebted countries into the “haven” currencies, particularly the dollar.

Increased flows of funds into the dollar from developed countries in Europe and Japan occurred roughly in the same period. The reasons for this phenomenon are the subject of heated discussion. They fall into four groups:

- evidence of vigorous economic recovery in the U.S.;
- high U.S. interest rates occasioned by, among other things, a large fiscal deficit;
- social, political, and economic problems in other countries; and
- an insistence on the part of some countries of their need to operate with large structural current account surpluses which makes them capital exporters.

While there is great debate as to the causes of capital inflows, there is no debate as to their existence. It is equally clear that the U.S. has been unable to recycle, in the manner of the 1970s, that portion of the inflows not used. The appreciation of the dollar and the resultant economic merchandise trade deficits have become monuments to the inability to recycle.

Initially things were not so clear. A cyclical swing in the U.S. merchandise trade account was to be expected, in fact hoped for. It was the mechanism by which cyclical recovery originating in the U.S. was transmitted to other economies. Without such a swing, these heavily indebted economies, that had taken steps to curb domestic consumption by individuals and government and release resources for export, had no hope of increasing their external earning capacity and thereby stepping back from the brink of financial collapse. They desperately needed the income effects of an expanding world economy to create the basis for export-led recoveries in their economies. This in turn could be expected to dampen, if not end, the tendency of capital to move out, thereby easing one source of capital inflow into the dollar and enabling countries to retain capital which could be used to add an investment dimension to their export-led recoveries.

The U.S., it was expected, would be joined by other developed countries in providing the economic expansion that the heavily indebted countries needed to underpin

their efforts to augment their external earning capacity. It was reasonable to expect the U.S. to contribute to this process by a reduction in budget expenditures thereby releasing resources for investment type activity and contributing to a lessening of financial tensions both internal and external. The result it was hoped would be a quickening of economic expansion in other countries, and an induced slower rate of growth in the U.S., oriented more towards investment and less dependent on consumption.

It is clear that in the past three years there have been successes and failures. The successes include:

- the vigorous recovery of the U.S. economy;
- determined steps on the part of many heavily indebted countries to adjust their economies and a resultant gain in external earning capacity;
- a series of mini-refinancings, and one maxi-refinancing (Mexico) which served to reduce financial tensions; and
- containment of financial strains associated with an unanticipated slowdown in rates of inflation in key economies.

Failures would include:

- an inability thus far of the U.S. to reduce Federal expenditures and thereby contribute to the second phase of adjustment;
- disappointing rates of growth in other developed countries;
- an inability to curb the tendency on the part of some developed countries to run large current account surpluses, which not only tends to thwart the efforts of the heavily indebted countries to increase their external earning capacity, but results in large capital exports by the surplus countries which go into the dollar, thereby exacerbating the recycling problem;
- the inability to restore the capacity for capital recycling; and time.

It is the last shortcoming which is the most threatening. Prompt results in each of the areas mentioned above cannot be expected, but the need for action has existed for some time, and in that sense we are in the process of consuming time in which action is possible and relevant.

Continued heavy capital inflows into the dollar coupled with an inability to recycle results in:

- a strong dollar;
- large U.S. merchandise trade deficit;
- growth of U.S. domestic demand exceeding the growth in income;
- unusually large creation of U.S. domestic debt to finance the difference between growth in demand for goods and services and growth in incomes;
- diminution of income growth centered in businesses that compete in international markets;
- attendant creation of financial strains;

- recession;
- or
- inflation, then severe recession; and
  - protectionism.

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## DISCUSSION

In his opening remarks, the British author placed heavy emphasis on two points he had made in his paper: that it was a misguided policy for developing countries to service their debt through trade surpluses, and that refinancing of current debt and provision of new credit could not adequately be accomplished without "supportive government intervention."

Running continuous trade surpluses in order to repay debt was harmful to the long-term growth of developing countries, which required a "positive transfer of resources" from developed countries for an extended period of time. These trade surpluses at the same time required developed countries to run corresponding trade deficits which in turn necessitated difficult structural adjustments on their parts. Further, it was not economically or politically sustainable to expect developing countries to devote their resources to the service of past debt; repudiation of debt was a more likely outcome.

Government involvement in international lending was necessary for the banks' own protection. Private banks could not support the time scale required in the lending, nor could they deal alone with the results of such inevitable occurrences as recessions, changes in interest rates, and exchange rate fluctuations. They were not equipped to provide the surveillance necessary to optimize the use of the credit being extended, nor to require the appropriate policy responses from debtor nations. Governments of the developed countries had virtually coerced private banks to lend up until 1981, and it was now necessary for them to play a part in solving the debt problem. An "act of innovative generosity" akin to the Marshall Plan was in order. Failure of governments to act would leave the economic and political stability of the West "balanced on a knife edge."

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Introducing his working paper, the American author argued that the debt problem had to be seen in terms of the "disequilibria in the pattern of world trading and economic activity." At the core of these disequilibria was the inability of the U.S. to recycle capital inflows in a financial sense. These inflows were being recycled through the U.S.'s current account, which had caused a dramatic appreciation of the dollar's value in relation to other currencies.

It could be argued, continued the speaker, that the developing countries were doing a better job than the developed countries in adjusting to the disequilibria. The de-

veloped countries seemed unable to deal with current account surpluses, and the U.S. had failed in the past eighteen months to correct its current account deficit. Indeed, the U.S. was headed on a potentially dangerous course. The current expansion was characterized by the highest ratio of increments in debt to increments in real economic activity of any recorded expansion. Exchange rates were putting great pressure on prices, and profit margins, especially in the manufacturing sector, were being squeezed. This was a course that ultimately could lead to recession.

What was required of the U.S. now was to take steps to reduce its current account deficit and to get other developed countries to act to curb their structural surpluses, thereby alleviating capital inflows into the U.S. and taking pressure off the dollar.

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An International participant agreed with the American author that the debt problem was "just one of a number of interrelated economic issues" where action by the developed countries was required. And he supported the observation of the British author that one cause of the current debt problem was that there had been too much borrowing for non-productive purposes. Indeed, in many of the debtor nations, the growth in external debt had exceeded the growth in foreign exchange earnings. The key to solving the economic problems of the developing countries was an adjustment of their economic policies. Progress had been made in this direction; the developed countries, the banks, and the multilateral agencies had moved away from "momentary crisis management" to dealing with the problems on a deliberate case-by-case basis.

Both working papers, the speaker continued, were overly pessimistic about the voluntary resumption of private bank lending. There was a "reasonable prospect" that debt service ratios would be reduced, creditworthiness restored, and more rapid growth resumed if three prerequisites were met. First, the developing countries had to continue policy reforms aimed at increasing efficient allocation of resources and augmenting productive capacity. Second, there had to be sustained non-inflationary growth in the developed countries. Third, the developing countries had to be assured access to markets in the developed countries. Under these conditions, the banks would start rolling over debt on a voluntary basis.

An American participant largely concurred with this analysis. He recalled that, at a Bilderberg Meeting two years before, he had said that the debt problem could be handled by a combination of IMF-monitored economic reform measures undertaken by the major debtor countries, continuation of the U.S. economic recovery, and extension of debt maturities and provision of new front-end money by the banks. All of these things had taken place, and, in addition, a large U.S. trade deficit had developed, interest rates had held steady, and capital outflows from the LDC's had declined somewhat. The debt picture was, then, considerably brighter. But it remained for the developing countries, the official agencies, and the commercial banks to work together to re-establish growth.

The speaker went on to prognosticate that voluntary lending to major developing countries would resume, official agencies would provide funds at a steady rate of about \$25 billion per year, and the export earnings of the LDC's would continue to rise and fall in correlation with growth rates of the OECD countries, especially the U.S. Banks would continue to work with the adjusting LDC's and the official agencies, but they would, at the same time, continue to build up reserves and equity capital to meet the losses that could be expected from some of the smaller developing countries. There was also some hope that the LDC's would open their borders to attract outside investors as partners and not just creditors. Finally, the speaker foresaw no debt repudiation. The system, he said, would "hold and work together."

A German was similarly optimistic that progress was being made in alleviating the debt crisis. The key, he argued, was in restoring the creditworthiness of the debtor nations. The role of the banks in this process had three phases. First, the banks had to provide new money to enable the debtors to pay interest and, in some cases, principal. In doing so, the banks were financing the debt service itself, a necessity to avoid writing off the loans. Second, the banks had to stretch out loan maturities, and, where possible, lower interest rates. The third phase would be the restored creditworthiness of the LDC's, and hence their renewed access to the international financial markets. Contrary to the popular misconception, this did not mean that debtor countries had first to repay their debts in order to be granted new credit. What it did mean was restoring a sound relation between the financial burden of the developing countries and their economic possibilities, which would put them in a position to go to the credit markets once again.

The restoration of the LDC's creditworthiness required the cooperation of the IMF, the World Bank, the respective governments, and the private banks. The IMF role was to elaborate programs for economic recovery and, along with the World Bank, to provide the necessary funds to implement reform measures. The governments of the creditor countries had to be ready to provide export credit guarantees and development aid. The debtor countries had to put their houses in order; this meant, in particular, stopping the outflow of capital. And the private banks had to negotiate the re-scheduling of old debt and the provision of new credit to those countries successfully working their way back onto their feet.

A Dutch speaker pointed out that at the recent meeting of the Interim Committee of the IMF, there had been an "encouraging degree of consensus" among the members present on a program of coordinated action by both the developed and the debtor countries. The LDC's had to undertake adjustment of their policies with IMF help, reduce military expenditure, and curb capital outflows. The developed countries had to adopt policies that would lead to less protectionism, lower interest rates, and more growth in order to allow LDC's to increase exports. The banks had to implement multi-year rescheduling, provided the LDC's undertook proper adjustment policies. The Interim Committee also called for increased surveillance by the IMF and World Bank of the economic policies of all member countries, and for stronger coordination between the IMF and World Bank. The speaker concluded that he too was optimistic that voluntary bank lending would resume based on this program.

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While there was general agreement that the LDC's had to take steps to put their economic houses in order, a number of speakers expressed concern that austerity measures could lead to domestic political problems for the leaders of developing countries. An American cited the example of former Sudanese President Nimeiri, in whose downfall economic factors had played an important part. A Turkish participant worried that pressure on LDC's to reform economies would lead to recession and unemployment, and thence to violence and destabilization. This was, agreed another American, the "Achilles' heel" of the problem: what was right economically could become intolerable politically.

But other speakers took a brighter view of trends in the developing world. A Canadian reported finding, in his travels to developing countries, a more positive attitude toward their business communities and a new desire to attract foreign investment. This was reflected in the dismantling of many restrictions, liberalization of imports, and privatization of some state enterprises. The time was ripe, the speaker continued,



for direct investment in the LDC's by multinational companies and the transfer of technology and of management skills. Another Canadian agreed that there was a new openness. With the passing of the "independence generation of leaders," there were new opportunities in the developing countries.

An International participant pointed out that many of the countries that had gotten into trouble in the early eighties, when the economic climate had become noninflationary and growth had slowed, had market economies but did not allow them to function. Some of these countries appeared to have learned their lesson. Interventionism was going out of fashion; instead there was a new flexibility—something the developed countries, on the other hand, had not showed much of. Rather, they had increased trade restrictions, especially against successful economies. Such restrictions had to be eliminated, in order to "make credible the West's general concept of economic policy".

Indeed, the issue of protectionism concerned many speakers. An Italian saw it as "rampant," and feared it would be difficult to overcome, given the wide disparity in labor costs between the developed and developing countries. A Canadian warned that continuing protectionism was a "guarantee of financial disaster." It was a time of opportunity for the West to gain new markets, but that opportunity would be squandered if we followed the Soviet example of offering limited markets and forcing developing countries into barter, counter trade, and sub-optimal regional trading arrangements.

As important as acting against protectionism, argued a Greek speaker, was the need for the West to follow policies that would lead to a lowering of the international interest rate structure. This required, in particular, "energetic action" on the part of the U.S. to correct its budget deficit.

An American acknowledged the failures of his country that had adversely affected the developing countries—"slow economic growth over the past two decades, a poor savings rate, inconsistencies in the tax laws, and a dismal budget performance." But, he continued, the U.S. was not alone. U.S. Government debt as a share of GNP was less than that of the other major OECD countries, and the American contribution to "free world welfare," in the form of military and aid spending, was far higher.

On the subject of official government assistance, an Irish speaker felt it was regrettable that the level of aid as a share of GNP in developed countries had "gotten stuck" since the last recession. It was important, he added, to recognize the differences between debtor nations in terms of GNP per capita and their ability to help themselves and to achieve growth. Speakers from Switzerland and the Netherlands agreed, pointing particularly to the countries of sub-Saharan Africa as special problems where aid was vital. The Irish and Swiss speakers felt that aid to these countries needed to be directed to basic infrastructure and agriculture, and that it had not, in the past, been very efficiently applied. In certain African countries, added the Irish participant, the debt levels were very high, but the absolute sums were relatively small. There, the cost to the developed countries of cancelling debt or replacing it with government aid would be minimal.

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The session concluded with brief remarks by the two authors. The British author acknowledged that, although the lending to developing countries that had given rise to the current debt crisis was "clumsily done," it was better to have done it than not to have. But now it was important that the debtor countries not be left the victims of events beyond their control. Merely restoring their creditworthiness was not enough;

government support of and intervention in future lending was crucial to avoid misdirection of funds and to assure the right policy responses from the debtors.

The American author acknowledged that economic austerity could be a very bitter pill. Bolivia, where the GNP had declined almost ten percent in each of the past two years, was a good example. But Mexico, on the other hand, had grown faster in the previous year than in the heyday of the late 1970s and early 1980s. It was wrong to assume that opening up economies, privatizing industries and balancing budgets were mutually exclusive with growth; rather, they were the very foundation of growth.

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## V. CURRENT EVENTS

*The topic discussed in the Current Events session was: The Current Status of the Budget in Congress and the European Perspective on that Situation. The subject was introduced by two American legislators, who reported on developments in the U.S. Congress, and by a Dutch minister, who commented on the situation from the European point of view. Also discussed in this session was the issue of tax reform in the U.S. A report by another U.S. legislator on this issue was given earlier in the Conference, but is reported in this section. Also included in this section, because of their relevance to the topic under discussion, are remarks about the U.S. defense budget made in the first session of the conference.*

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Addressing the issue of tax reform, an American legislator reported that there were four tax reform proposals before Congress: a Democratic plan, a Republican plan, and two Administration plans. Each plan embodied the same general goal: to cut tax rates dramatically and to eliminate many of the "tax expenditures" in the code.

The first rationale for tax reform was economic. It was based upon the realization that the U.S. could attain full employment only if it competed effectively in a growing world economy. This required, on the international front, a stable trading and financial system, and, domestically, an efficient allocation of resources. The economic basis of tax reform was that the market was the most efficient allocator of resources, and it was necessary to remove the tax code as a barrier between the investor and ultimate investment, so that capital would flow to those areas of the market that had real value and would create jobs and wealth and enhance the international competitive position of the U.S. With current effective tax rates ranging from minus five percent to plus 44 percent, capital was not being rationally allocated. Tax reform was widely supported by American business because it would lead to a more stable economy. By making saving more attractive than borrowing, the price of credit could be attacked from both the supply and the demand side, resulting in lower interest rates.

There was also a cultural rationale behind tax reform. In 1984, there had been 263,000 tax returns in some stage of audit or litigation by the IRS. Ten years earlier, the number had been only 15,000. In addition, eight million Americans required professional assistance in preparing their tax returns last year; tax strategizing and tax return preparation had become a big industry. And the value of all tax expenditures had grown from \$37 billion in 1967 to \$370 billion today. So preoccupied were Americans with avoiding taxation that there was a real danger that a whole generation was growing up to feel it had no responsibility to support the legitimate functions of government—a serious development in view of the system of voluntary compliance upon which tax collection was based. The underground economy in the U.S. was estimated to be the seventh largest economy in the world. In short, the cultural rationale for tax reform was that millions of Americans correctly perceived that equal incomes did not, under the current system, pay equal taxes.

Finally, there was a historical rationale which was based on how a legislator interpreted his function as laid out by the Constitution. Was it to balance the narrow interests and try to keep as many people happy as possible? Or was it to perceive the general interest and formulate policy that served it? It should correctly be the latter.

As to the prospects for tax reform in 1985, it was certainly in the interest of both political parties, though many legislators did not yet realize that. Their constituents suffered from "loophole illusion," the belief that they were better off with loopholes

than with lower tax rates. Tax reform was viewed by many legislators as a defensive political issue because of the need to explain to various interest groups why their loopholes were being taken away. But tax reform was, in fact, an offensive issue, and legislators could win by arguing for lower rates and a fairer system. It presented an opportunity for genuine bipartisan cooperation. Tax reform would not increase the budget deficit or the tax burden on lower and middle income people. It would give the lowest possible tax rates to the greatest number of people, produce greater incentive for work, savings, and investment, and it would tax profits at the lowest possible rate.

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While tax reform dealt with the method of taxation, fundamental to the budget debate was the amount of taxation, said the American legislator who introduced that issue. How much the government should tax had always been a matter of controversy. Theoretically, it should collect enough to provide for the common defense and the general welfare, but what was enough was a matter of subjective judgment. There was, however, one objective test of the adequacy of revenue—the occurrence of a deficit.

The U.S. budget was at present in the red more than \$200 billion annually. The national debt had doubled in the last four years to almost \$2 trillion, and the interest burden had grown by 89 percent, making it the largest and fastest growing government spending program. This year interest would be approximately \$135 billion. Since 1981, revenues from the individual income tax had risen only four percent, while the corporate tax had decreased by \$4 billion. Spending cuts of \$90 billion in discretionary funding and \$77 billion in entitlements, as well as reductions in numerous social programs, had been made. Yet there was still a growing deficit.

The question, then, was not should taxes go up, but would they? President Reagan's opposition to a tax increase had prevailed in the recent Senate debate. But some of his advisors privately admitted that, if the Senate version of the budget were adopted, it would reveal a need for more revenue and that would have to be dealt with. Yet there was considerable public and Congressional opposition to higher taxes. To implement a tax increase would take more than the "grudging assent" of the President. His vigorous leadership and advocacy would be needed to persuade the Congress and the country. It was highly unlikely that these would be forthcoming from the President, or that Congress would shoulder the burden. In the Senate, there were not now enough votes to pass a tax bill, and, if there were, the President would veto it.

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According to another the Member of Congress, no tax increase measure would be passed in the House this year either. But there was a good possibility that meaningful budget cuts would be approved, in spite of two factors that might inhibit action. These were the very high degree of partisanship in the House, which was an obstacle to building a coalition, and the absence of strong leadership arising from the announced retirement of the Speaker and the probable retirement of the Minority Leader.

But other factors favored action on the budget. One was that liberal Congressmen were serious about deficit reduction because they knew that unchecked growth in the deficit would play into the hands of those in the Administration who wanted to shrink government's role still further. So the liberals were willing to allow some cutbacks and eliminations in order to save other social programs. Congressmen were also concerned about their political survival. They realized that when today's high school graduates entered the work force in four years, they would be paying more than half their federal income taxes to service the national debt, and not for any programs from

which they would directly benefit. And finally, there was the private fear that, if nothing were done, the economy would fall apart and Congress would pay the price at the polls in 1986.

That a consensus on the budget based on public opinion was gradually building was indicated by the declarations of interest groups that they would go along with cuts if they were all treated alike. This argued for an across-the-board freeze, which would yield a \$40 billion reduction. The goal in the House was a deficit reduction next year of \$50 billion through spending cuts alone. Defense spending would be frozen at this year's level; the big question was whether there would be a freeze in Social Security cost of living adjustments. Some programs would be eliminated and others reduced. The ultimate goal was to get the deficit to less than two percent of GNP by 1988. In order to do that, revenues would have to be raised, but that would not happen this year. It was possible a second phase would include a tax increase in the form of an energy tax, plus an excise tax and perhaps some form of minimum tax, not for new programs but strictly for deficit reduction. Yet much depended on whether the President chose to get involved. If there was a genuine spending reduction and the revenue component was not a genuine tax increase, such a second phase might get his support and, hence, that of the Senate leadership.

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In viewing the U.S. budget deficit from the European perspective, said the Dutch panelist, one had to acknowledge that, as a percentage of GNP, it was less than the average of European countries' deficits, and it was still financeable. But its rapid growth, both in absolute terms and as a percentage of GNP, posed a real danger if no action was taken to stop it.

The rapidly rising burden of the government's interest payments adversely affected every American citizen. The deficit absorbed a high percentage of available domestic savings, which, in the U.S., were already low, compared to Europe. Direct private investment also placed a demand on savings, so the result was either a crowding out of the private sector or the attracting of a large amount of imported capital. Either way, real interest rates were high.

As far as the rest of the world was concerned, the absorption of large amounts of foreign capital was undesirable if allowed to continue. A highly developed, mature economy should be a capital exporter, particularly to countries in need. Flows from developed countries should not be going to the U.S., but to the LDCs; nor should capital flow to the U.S. from the LDCs themselves. The high dollar resulting from these capital inflows had some benefits for Europe, but was bad in the long run if the result was protectionism. There was also the risk of a "hard landing" for the dollar if steps were not taken to reduce its level gradually. And the high dollar led to high repayment obligations for debtor nations whose loans were denominated in dollars.

High U.S. interest rates were largely a result of the deficit, and only to a small extent due to monetary policy. They had a major adverse impact on rates in many other countries, especially Europe, where they were an obstacle to recovery. Even more worrying was the impact on the LDCs, especially the highly indebted middle income ones. There was no way to solve the debt problem for many of these countries as long as the dollar remained high.

The U.S. had to pay more attention to the external, international effects of its domestic financial and economic policies, because the dollar remained the principal currency of the international monetary system.

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In the minds of most of those who participated in the discussion about the U.S. budget and tax reform issues, the two were closely linked. Several Europeans queried why the U.S. did not enact certain tax measures to help reduce the budget deficit. A Briton pointed out that a gasoline tax at the level imposed in most European countries, if phased in over five years, would yield between \$130 and \$150 billion in additional revenue. And, because of the falling price of oil, it would not increase prices at the pump. Both American panelists responded that a gasoline tax was extremely unpopular politically and therefore unlikely to be imposed, although, according to one, an import fee on imported crude oil and petroleum products of \$5 to \$10 a barrel was possible. Responding to a Frenchman's suggestion of a value-added tax, both legislators agreed that it, too, was not feasible. One explained that the state governments feared it would compete with their sales and excise taxes.

An Italian observed that one reason, beyond the federal deficit, that interest rates remained high in the U.S. was that the tax system subsidized borrowing by allowing interest to be deducted. This was, agreed an American, one of those incentives that had become abused and caused distortions. It was, however, unlikely to be changed for political reasons, though its impact would be reduced if the top tax bracket was lowered. Both American legislators felt that the deductibility of interest payments would be curtailed, though not eliminated.

A Canadian warned that experience in his country had shown that "tax simplification was not that simple." Incentives had been built into the system for a reason—to help achieve broad social and economic purposes. The consensus for tax simplification would evaporate when special interest groups realized that the incentives which benefited them faced elimination. Furthermore, if the philosophy of using tax incentives to achieve certain objectives was being abandoned in favor of direct government action to achieve those objectives, the role of government would thus be enlarged. Government would be injected even more into the economy, with more government spending to replace the eliminated tax expenditures.

This view was shared by one of the American legislators. Many social programs—low-income housing, for example—had already been phased out, and, theoretically, the private sector would take up the slack. But if the tax incentives for the private sector were removed, the economic incentive would disappear. Thus, in budget cutting and tax reform, there was the potential for a "mixing of motives." The likely result was that tax reform would be used to raise some revenues, and that simplification would not be all that simple.

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Regarding the dangers of the deficit to the U.S. itself, a German feared that the day might come when the U.S. would find itself in the same position as Brazil or Argentina today—unable to continue paying its debt. This notion was not too far-fetched for one American participant, who warned that, with the deficit at five percent of GNP and national debt heading toward \$2 trillion, the U.S. was "living on borrowed money and borrowed time." The deficit had given rise to a number of serious domestic problems. The mix between monetary and fiscal policy had been destabilized, and monetary policy was prevented from playing a more stimulative role in the economy. This would be a particular danger in another recession. In addition, there was great pressure on credit markets. And the trade deficit brought about by the high dollar was having a "devastating effect" on American industry, which was already competitively weak in terms of wage rates. Finally, debt creation in the U.S. was growing faster than economic activity. This had been manageable in the inflationary 1970's, but, in a defla-

tionary world, it became a "crushing burden." Debt service problems in the U.S. were serious, especially in certain sectors, like agriculture.

The hour, concluded the speaker, was late. The combination of problems could cause another recession in the U.S., with "disastrous consequences" for the rest of the world. Already the U.S. economy was showing signs of slowing up. A new recession would put great strain on the world debt structure and financial system. The margin for error had been reduced and the maneuvering room curtailed; it was becoming increasingly difficult to execute a "soft landing."

Another American was particularly concerned about the deficit's effect on trade policy, and the rise of protectionist sentiment in the U.S. In 1984, the merchandise trade deficit had reached \$123 billion. Without significant changes, it would grow to \$200 billion by 1990. The unprecedented level of imports had led to the loss of two million jobs; four million might be lost by the end of the decade. The effects of trade deficits extended beyond the traditional smokestack industries to the high technology sphere, where surpluses were declining. The result was that businessmen and legislators were talking seriously about protectionist measures.

Both American legislators acknowledged that political pressure for protectionism was mounting, in particular for specific textile protection and for an across-the-board import surcharge. But, in the view of one of them, as long as the President adhered to a free-trade policy, his veto of protectionist legislation could be sustained.

A number of speakers expressed support for a new round of trade negotiations. According to a Swede, Third World resistance to a new round was diminishing as it became clear that it was needed to stem protectionism, increase the discipline and predictability of the trading system, and provide some liberalization. Failure to move ahead with new negotiations risked increased bilateralism and protectionism.

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Addressing one particular effect of the U.S. deficit on Europe, an Austrian argued that one of Europe's main problems was that it was no longer competitive in many traditional industries, which were being kept alive only to save jobs. Exports had been thriving due only to the strong dollar, which was covering up problems and weaknesses in European industry. Europe needed to pursue a policy of economic growth, concentrating on new technologies and gradually getting out of industries in which it was not competitive. This required investment on a large scale—an approach that was impeded by the U.S. deficit, because high interest rates increased the cost of investment or channelled it away from plant and equipment into financial assets. In addition, the volatility of international financial markets caused uncertainty in domestic capital markets. Domestic private savings were flowing into U.S. havens. Thus the U.S. deficit directly and indirectly added to the costs of the necessary restructuring and adjustments in European industry.

But a German warned against blaming the U.S. for all of Europe's problems. Weren't Europeans expecting the U.S. to do things that they were incapable of doing or unwilling to do themselves? Responding to this, a Dutch speaker agreed that Europe deserved much of the blame for its own problems and needed to take certain actions. But the truth was that deficits in European countries did not have the worldwide impact of the U.S. deficit. Europeans were justified in criticizing certain aspects of the U.S. economy—like the budget—but it was true they had to take measures to correct their own wrongdoings.

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An American offered an assessment of the impact on the defense budget of the recent spending reduction proposals, including the freeze recently approved by the Senate. Defense, in the speaker's view, was not "just another social program to take its share of cuts." In the ten years up to 1983, real defense spending had increased by six percent, while spending on social programs had gone up 160 percent. In the 1950s and 1960s defense spending had been about 10 percent of GNP and half the budget. By those standards, it was not today taking an excessive portion of national income. There were two places to make cuts in the defense budget. One was in readiness, which meant steaming time, flying time, training, ammunition and the like; cuts here would show up in immediate dollars. The other area was in the investment portion, which was already underfunded, in the speaker's opinion. Cuts here traditionally came about by agreement between Congress and the Defense Department to stretch out programs rather than eliminate them. The usual result was less efficiency and no real saving. The speaker worried that the message we were sending to the Soviet Union about our determination to be strong was not convincing. The President wanted six percent real growth in defense spending, but apparently not if we had to raise revenue to pay for it. And what were the European allies to make of the spending freeze? Would they feel they were off the hook on burden sharing?

Also concerned about trading-off defense spending and social spending, another American argued that defense spending had to follow its own criteria—"either you have enough or you don't." It was necessary to have a strategic concept that defined the adequacy of defense and to know what were the gains and the risks of making cuts. "A mindless mechanical reduction" was not the "antidote to a mindless mechanical increase."

But several speakers felt there was tremendous waste in U.S. defense spending. A Briton suggested that there would be less waste if the defense budget was open to international competition. It was a Canadian's view that there was excessive duplication in many programs, largely resulting from political considerations. Choices had to be made.

One of the Americans on the panel argued that military strength was impossible without economic security, which in turn depended on deficit reduction. Military spending was 30 percent of the budget, entitlements 42 percent. Debt service took up 14 percent, leaving only another 14 percent in other programs. Clearly, the cuts would have to come in the two big items. Public opinion demanded that they both be cut, or neither. One of the problems facing the U.S. was that the support of public opinion was needed to sustain a foreign policy and a defense policy. Public opinion in the U.S. was unclear about what the foreign policy was, except to be strong. What was needed was a redefinition of U.S. foreign policy and of how it was to be defended. One approach was to reduce the U.S. deficit by cutting defense spending, with Europe and Japan picking up the slack.

Another American interjected that, even with a freeze in the U.S. defense budget, Europe should not consider itself off the hook on burden sharing. The rapid increase in defense expenditures in the first years of the Reagan Administration would, even with the freeze, produce an increase of considerably more than three percent compounded.

In a final intervention on the defense question, a Dutch speaker saw a direct connection between reduction of the U.S. deficit and Europe's sharing of the defense burden.

The defense build-up of the Reagan Administration had contributed toward the budget deficit, which, in turn, had reduced Europe's capacity to take a greater share of defense. By cutting military spending and reducing the deficit, the U.S. would allow Europe to shoulder more of the burden of its own defense.

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A Canadian wondered if the passage of spending reduction measures and some form of revenue enhancement yielding a \$75 billion deficit reduction would start the U.S. "on a benign cycle of deficit reduction, including balancing the budget, encouraging interest rate reduction, normalizing currency levels, and repatriating jobs." This was not necessarily the case, responded one of the U.S. legislators. There was no strong leadership from either party that called for a balanced budget within a certain period of time.

Another Canadian asked what were the values and goals behind tax reform and budget cutting. The answer from the other American panelist was that, with regard to tax reform, the basic goal was a reduction in taxes for individuals, to be paid for by business, with no change in overall revenues. With regard to budget cuts, it appeared that the Administration's view was that government should pay for defense and retirement security and very little else. The value system in Congress was somewhat "hazier" because political circumstances prevented the setting of priorities. An across-the-board freeze had the greatest public support, exempting programs for the truly needy and education and job training. The response of the European panelist was that parliaments and cabinets were unable to agree on expenditure cuts. It was hard to come up with criteria from the economic point of view, and very subjective from the political point of view. Said one of the American panelists, there was no overall philosophical plan or blueprint—just "general considerations of equity." Decisions would be made largely on a case-by-case basis.

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## VI. OPERATING THE ALLIANCE

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*Working Paper Prepared by Etienne Davignon,  
Former Member, Commission of the European Communities*

A lot has been written, more even has been said, in relation to the endemic state of "malaise" prevailing at some time or other in the Atlantic Alliance. Fidelity to NATO, reaffirmation of its indispensable nature, but concern over its health seems to be a near-permanent theme.

The analysis usually shows that the cause of today's difficulties are to be found in yesterday's mistakes attributed mainly—depending on the nationality of the author—either to the American or European partner.

Without in any sense questioning the validity of this approach, I would like to suggest that priority should be given to anticipating the coming tensions and suggest the means to overcome them. It might well be, that the efficiency and trustworthiness of NATO will depend tomorrow, to an increasing extent, on the capacity of the Europeans to put their act together, and so become less dependent on the necessary leadership of the U.S.

This might also bring an answer to the disconsolate remark one of my American friends once made: "If we take a resolute lead, we are told off for being bullies; if we sit back and wait, our complacency and unreliability are immediately stigmatized".

In this context, four elements are worth looking at:

1. *Enlargement of the Community*. On the 1st of January 1986 the Community will welcome Spain and Portugal. The facts and figures being known, I would like to point out the following:

- Spanish and Portuguese motivations were essentially *political* and not economic and so give the second enlargement, in comparison with the first, a quite different character.
- Management and decision-making inside the Community, which have been unsatisfactory with nine and then ten member states, will become grotesque if no improvements are sought and agreed.
- Eleven out of the sixteen NATO countries will be members of the EEC, increasing the pressure, but also improving the conditions, for the coming of age of a more balanced alliance.
- The center of gravity of the Community will be moving South, modifying the traditional equilibrium inside the Community and improving the probability of far-reaching reshaping of the common agricultural policy.

2. *Economic problems* are the major political headaches for the European governments. It is no longer possible to make a distinction between the so-called "technical" problems and the "political" issues. Political leaders are being judged, more than anything else, on their performance in relation to unemployment and success toward economic recovery. Ten thousand jobs have to be created daily just to keep the number of unemployed from increasing. This fact and its political implications explain why the following consequences can be drawn:

- Seeking short-term quick-fix measures takes precedence over strategic thinking.

- The political leaders, because of this, have little time available for any other preoccupation. This is particularly true for the smaller European states, which have thus become less involved and active in European and international affairs than 15 years ago. Reticence to be involved has become a characteristic of public opinion in the Netherlands, Norway, Denmark and Belgium.

These two elements increase the regional character of present European thinking.

3. *Innovation and "high technology."* In the wake of U.S. successes, innovation and "high technology" have become a priority for thought—or at least speech-making—in Europe. Public opinion, although worried over the possible "job-killing" effects, would presently like to believe that innovation and technology are a vehicle for "catching up" with Japan and the U.S. and a motor for increasing economic growth.

This psychological trend on the one hand, and the objective requirements (increase of R&D, an economic environment more friendly to business, elimination of the compartmentalisation which obstructs the emergence of a Community home market) on the other hand, may turn this topic into a major factor of European integration.

Taken in conjunction with comparative U.S. superiority in this area, this issue could become a very delicate topic of U.S.-European relations.

4. *Trust and self-confidence.* President Reagan, the "great communicator," has demonstrated the importance of creating trust and self-confidence. "Eurosclerosis" is presently an imaginary threat, but "Europessimism" is still, unfortunately, a real mood. To be overcome, it requires a reinforcement of the European identity. A step-by-step approach will not be successful if it is not linked to a more clearly defined political concept.

The European leaders can no longer avoid a debate over the real ambitions of the Community, the issues can no longer be ignored. If the U.S. takes this quest towards reinforced unity seriously, it will grant it credibility and momentum even before the practical results are attained.

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Progress towards an increased European identity demands, in my view, *specific, qualitative improvements* translatable into *measurable practical steps* in the following areas:

A. *Defense.* The political cohesion of the Community has been increasingly lost as the budgetary rows endlessly dominated the available time in the meetings of Heads of Government and Foreign Ministers. The much-talked-of strengthening of the European pillar of the Alliance has not merely not happened; such strength as the pillar has already achieved is being eroded.

Atlanticists who were cool on Europe might argue that this did not matter if it coincided with a prospect of Washington's resuming its old effortless captaincy and this being again freely accepted throughout the West. "Effortless" in some senses the leadership of the White House may currently be, but it certainly creates at least as much conflict and suspicion in most of the other fifteen members of NATO as at any other time.

The dangerous dichotomy in European feeling vis-à-vis the U.S. remains. We are torn between a fear that they will desert us and an apprehension that they want us as, for them, a relatively safe nuclear battleground.

Henry Kissinger has rightly pointed out that, if only for reasons related to the passage of time, with the passage of every year, the acceptance of dissuasion, mainly based on the possible death of tens of million of people, becomes more fragile.

Against this background, the debate over SDI has started. It is presently marked by great confusion: American objectives and tactics remain unclear; Europeans faced with a clear presidential commitment, but an unprecise proposal, find it difficult to reconcile their contradictions and produce a coordinated response.

Common sense should suggest that we should favour a concept which aims to reduce the vulnerability of the U.S. and its allies, thus increasing the credibility of nuclear deterrents, but other questions relating to:

- the arms control talks,
- the ABM treaty,
- intermediate ballistic missiles,
- technological feasibility,
- the attitude of Congress

remain unanswered.

Beyond these preoccupations, a fundamental uncertainty remains: Taking into account the dimension of the problem, is the U.S. ready for a real debate in the framework of NATO, accepting consequently to share with its partners the final decisions over substance and tactics?

Does the U.S. administration accept that to defeat the neutralists and the pacifists—be they sincere or not—it will be necessary for Europe to stop being a "follower" and so assume more responsibilities?

The challenge for the Europeans to coordinate their position is a difficult one to pick up; it becomes a utopian task, if the U.S. considers the attempt with suspicion!

SDI brings an element of novelty into the strategic debate: the advantage will outweigh the risk if the opportunity is seized to develop—and the auspices are not good—the transatlantic dialogue; if not, the tensions will increase and with them the attempt by the USSR to decouple the U.S. from Europe.

B. *The technological challenge.* We are entering an era of accelerated change brought about by technological breakthroughs in the way information is developed, stored, processed and transferred. The way in which states cope with this new challenge will affect the international environment.

The necessity for Europe to perform well is all the greater because the U.S. is leading the way and moreover is comfortable with change; Japan is close behind and committed to succeed.

The Community has to put its house in order. Building Europe and picking up the technological challenge are related matters. Scientifically, the Community is not behind, but in developing technology and manufacturing a gap has emerged. Without an improved Community, a large home market will not exist and a concerted approach to technological development will be unmanageable.

The size of the market is essential, and I must say the *Economist* summed up well in November the message I was, for years, trying to get across to governments:

"Young, innovative European firms labour under crippling burdens that their American and Japanese counterparts do not have. One—the uncommon market—is well known, though the extent of the damage it does, is not. Testing and certification requirements, differing standards, border delays and restraints on trade in services all take their toll on trade between EEC countries. These obstacles add as much as 20 per cent to the cost of goods in intracommunity trade. And the effects of Europe's market fragmentation are getting worse all the time: as development costs rise it becomes harder to recoup investment in a single national market."

The necessity to reward and stimulate innovation is the second requirement. During the fifties and sixties, we believed we could promote simultaneously security and innovation. The reality is different: the legislation introduced, but to a varying extent, in every Western European country, made industry and thus society less able to adjust to changing times and market demands. The economic crisis and the accelerated technological change have increased the penalty we are paying for having persisted too long with this dream. The trend is now being reversed, but whether it is being implemented fast enough remains to be seen.

Beyond these basic goals, the development of technology must also be stimulated, so that two factors are taken into account:

- The need to master the technologies which will strategically shape the future.
- The necessity to match the advantages American enterprises enjoy through the military and space programs, and the Japanese through MITI led programs.

In this relation another look at SDI and the question of technological transfer is useful. SDI implies an acceleration in technological research and the rapid implementation of new techniques. From a European point of view, this raises at least three questions:

- a) Will it be a unilateral program?
- b) How will it effect technological transfer?
- c) What could be a European response?

a) A research program is very difficult to share, unless duplication, with a full exchange of data, or a division of tasks, is organized in the framework of a joint program. In the present state of affairs, the information available points towards some subcontracting arrangements in relation to an American program. Maybe more is not possible because of the unique character of the program and its military and legal constraints (ABM provisions and classification of data.)

b) To reach any sort of meaningful partnership, the technological transfer questions have to be addressed. This has to be achieved against a background of uncertainty:

- Conflicting opinions inside the U.S. administrations as to how to deal with sensitive, dual-purpose (military and civil) technology,
- Limitations set by the provisions of the ABM treaty,
- Absence of a legally binding framework.

c) The European choir has been even more out of tune than usual. Because of the present situation in the Community, without a European community initiative the improved environment for technological change will not be brought about. How can then an individual European state believe it could become, all by itself, a real partner for the U.S. in an enterprise of this magnitude?

The lessons of past attempts in arms procurement on the so-called "two-way street" have shown that there is no real partnership or sharing if there is not a relative balance between the parties involved.

*C. Economic and monetary questions.* It is not my purpose here to analyze how the Community should pursue the building of Europe in these essential fields. Helmut Schmidt has last week, in a powerful article, summed up his present thinking and made a number of specific suggestions.

I would like to single out two questions where an increased Community contribution could help because vital interests of the Atlantic partners are involved.

During the past year or so, there has been a strong recovery in the U.S. and the countries of the Pacific Basin have retained their very good relative performance. But in Europe any recovery has been at best very hesitant, making no impact on unemployment levels which are higher than for a generation past. And the developing countries have suffered heavily from low commodity prices and high interest rates, which in combination have made debt service consume a cripplingly high proportion of their export earnings.

A substantial slowdown in the U.S. economy could well kill the hesitant European recovery almost before it had started, certainly before it has made any real impact on employment levels. We could be plunged into a new period of recession with unemployment going to still higher levels than those which prevail today, and with many countries in the Third World being pushed over the edge of bankruptcy. I believe that in order to avoid this dangerous but possible scenario we need concerted action in Europe.

An important distinction must be drawn between the U.S. deficit and the budgetary deficits of the other industrialized countries. The OECD Economic Outlook issued at the end of 1983 demonstrated that for the major 7 industrialized nations excluding the U.S., inflation was eroding the stock of public debt more quickly than current borrowing was adding to it. There is no purely financial constraint on more dynamic policies in some states of Europe.

More than half the growth in world trade last year took the form of increased exports to the U.S. It can immediately be seen how quickly and how widely a slowdown in the U.S. will be communicated around the world with further deleterious effects on growth and unemployment.

This makes it vital that all the industrialized countries should not embark on further generalised deflation, but that those in a financial position to do so should adopt a more expansionary stance to offset the effects of an almost inevitably falling American growth. Since it is difficult for individual countries to expand alone without running into balance of payments, exchange rate, and hence inflationary difficulties, these are the strongest reasons for coordinated action to expand the European economies together at the rate necessary at least to maintain the present unspectacular growth performance of the world economy taken as a whole. Action of this kind could be concerted at the European level.

This would be a major contribution to a real dialogue with the U.S. and Japan. The recent summit should not discourage us. When the homework has not been done, no decisions can be taken.

Next and last monetary stability. Let me here bring my support to the ideas that Roy Jenkins and J. Delors have been voicing. These are met with a degree of skepticism, but no alternatives have been offered, except in terms of procedures. We have no ideas, so let's have conferences.

Concerted action will not succeed unless exchange rates are given a reasonable stability. If they are allowed to fluctuate wildly and often irrationally, they become the enemy of world trade and of international investment. They also stimulate protectionist forces in those countries whose currencies are forced too high. But we should not be utopian. The economic performance of countries inevitably varies in terms of growth in productivity and comparative inflation. We cannot therefore just proclaim a new regime of fixed exchange rates and expect it to stick. The simple re-establishment of the Bretton Woods system of fixed rates, great though were the benefits which flowed from that system, is not a practical option today.



Yet there is mounting disillusion with free-floating currencies. Experience of these has not been that they adjust gradually and smoothly, keeping payments in balance. On the contrary, exchange rates have lurched wildly from one extreme to another—in the U.S./British case from a pound/dollar rate of \$1.60 to \$2.40 and back down to below \$1.20 over the past eight years. And not only have they been unstable, but they have shown a capacity to stay well out of line—in terms of relative inflation, competitiveness, and balance of payments—for long periods.

The markets themselves cannot and do not ensure that currencies adjust to reality so as to keep foreign payments in balance and employment reasonably full. What is required is a system of exchange rates which broadly maintains the competitive position of one economy against another and avoids the short-term fluctuations which are damaging to trade and devastating to investment decisions.

I believe that substantial progress could be made on a trilateral basis between the U.S., Japan and the members of the European Monetary System, which should evermore obviously include Britain. This is certainly in the British interest. It is probably in the general European interest too, not so much because of the importance of sterling—the DM is now more important—but because of the predominance of London as a financial centre. Each bloc would define a “target zone” for its currency within which the value would be free to vary. This should, in present circumstances, be wider than the old Bretton Woods margins. Perhaps the six per cent margins which the Italian lira has within the EMS would be reasonable. From time to time the central rates would be shifted upwards and downwards according to medium-term changes in relative competitiveness which would embrace inflation differentials. Monetary policy would be used to keep the rates within the zones. They should not be permitted to go outside in response to speculative movements or short-term factors. Adequate swap agreements, which are not difficult to secure, can iron out disruptive short-term waves, although they cannot—nor should they—obviate the need for responding to a long-term swell of the ocean.

The new tripod would form the basis of a new, stable, but not rigid international monetary system. It would be possible and desirable for other countries strongly dependent on one or another of the blocs to tie their currencies to the dollar, yen or European ECU. To take European examples, the Austrian schilling and the Swedish krona would obviously move in general step with the ECU.

Achieving results in the three fields I have just dealt with will require time, imagination and perseverance. In a world where short-term considerations are paramount, where scoring debating points prevails over dealing with substance, where essential elements of foreign policy are no longer supported by a near consensus of the main political parties, is such a goal beyond our grasp? Is our ambition out of step with our possibilities?

The U.S. holds the key to the answer. By calling for a policy, it sets the objectives; by trusting its partners and encouraging their integration, it gives them an increased importance; by favoring multilateral procedures over bilateral arrangements, it ensures a balanced approach.

The Community has unfortunately not yet reached the stage where it can propose with credibility; it can still respond to the challenge of an ally calling for more partnership. Let us deal with substance and not procedures, and here, I believe the banking and entrepreneurial sectors must make their voices heard.

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*Working Paper Prepared by Brent Scowcroft,  
Vice Chairman, Kissinger Associates,*

*Former Member of President's General Advisory Committee on Arms Control*

Despite such tactical successes as the INF deployment, the alliance is not operating well. While the miracle may be the fact that it is operating at all, that is small comfort if the performance is inadequate to the challenge.

It can be argued that NATO has never been adequate to the challenge. The alliance has always relied on a decreasingly credible threat of nuclear escalation to compensate for its failure to deploy military forces adequate in themselves to cope with a Warsaw Pact assault.

What is new is growing divergence over fundamental issues: the nature of the Soviet threat and how to deal with it. It is true that the Soviets do not at present appear poised to undertake the military conquest of Western Europe. European and American perceptions of the ultimate threat, however, seem farther apart than ever before, with some few voices in Europe equating the two superpowers as threats to the peace. Appraisals in Europe and the U.S. over the significance and the appropriate western response to developments such as Afghanistan and Poland have reflected this divergence.

In the U.S., under the burden of huge budget deficits and consequent pressure on the defense budget, there have been increasing calls for greater burden-sharing and charges that the U.S. seems more concerned about European defense than do the Europeans.

The list of irritants is a long one, some perennial, some more recent, and the economic pressures stemming from the process of economic transformation of the advanced industrial societies exacerbates the issues and narrows the vision of the leaderships. Yet all is not negative. NATO has managed successfully a very difficult deployment of INF. While the price of that deployment within the Alliance may have been high, it has succeeded in forcing a major change in strategy by the Soviet Union. Failing to stop INF deployment by terminating arms control negotiations in 1983 and by its subsequent blustering and belligerent diplomacy, the Soviet Union has been compelled to return to the bargaining table and assume a less threatening posture.

The Soviet Union does not wish us well, however, and growing economic difficulties at home and continuing and perhaps increasing instabilities in Eastern Europe could make the future more rather than less dangerous. In addition, a new and more vigorous leadership gives initial indications of being able to exploit the tensions within NATO with much greater skill and subtlety than its predecessors.

What is to be done? Unfortunately, there is no single simple solution which will sweep away the problems encumbering the Alliance. Proposals currently springing up for radical shifts in the current structure and relationships risk unleashing forces which are little understood and whose consequences are unpredictable. However vexing the current situation, modest changes within the current general framework are to be preferred to bold departures which would discard the general structure which has worked, not well but adequately, for over 35 years.

Whatever the current disparity of views, most can agree that strength does not invite aggression. The Alliance has always sought to prevent, not to fight, war. The only secure prevention, however, is the ability to fight successfully. While that goal is likely to remain an impossible dream, even those who deprecate the threat are likely to agree that some approximation of a military balance is likely to prove an element of stability in the face of possible political volatility, especially in Eastern Europe. Those

outside even such a modest consensus probably cannot be placated within the framework of a North Atlantic Alliance, but the Alliance should attempt to operate in such a way as not significantly to increase the numbers of fundamental detractors.

One of the frequently cited causes of problems within the Alliance is the dominance of the U.S. It is argued that the consequence of this is abdication of responsibility by the European members and simultaneously European chafing at an American leadership in whom confidence is frequently less than optimal. Several leadership and structural modifications could be helpful in themselves and could also be useful in alleviating this problem to the extent it exists.

One of the developments to be encouraged in this regard is the growth of a European collective approach, as, for example, in the revitalization of the WEU. European unity in military procurement, R&D and even strategic concepts could do much to provide an effective counterbalance to the U.S. and to remove any current sense of impotence or inferiority. It would greatly reduce current problems of standardization and interoperability, for example, with respect to which the U.S. is a heavy offender. If extended to include the development of a European Nuclear Force, it would be possible even to contemplate a European SACEUR. A move of that magnitude, while significantly shifting responsibility at the heart of the Alliance, would, of course, necessitate the prior resolution of other problems and could only be considered in a U.S.-European environment where it could in no way be construed as U.S. withdrawal or abandonment.

On the political side, a new, dynamic Secretary-General opens the possibility for upgrading the status of the Permreps. Were the Permreps to be at the policy-making level of their respective foreign ministries, dialogue and consultation could assume a character which would considerably enhance the cohesion of the Alliance. The Council is the one place the Alliance members are in constant contact, and that should be utilized to the fullest to enhance cooperation and reduce suspicion or misunderstanding. Since extra-NATO developments can vitally affect the Alliance, rules should be changed to facilitate as well discussion of extra-NATO events and to permit planning and action on them by "coalitions of the willing."

Dealing with extra-NATO problems leads broadly into the area of burden-sharing. The U.S., in general, is best able to respond to threats to the Alliance in areas outside Alliance boundaries (e.g., Gulf oil). However, U.S. forces available for such contingencies are, for the most part, committed to NATO. The European members should improve their manpower mobilization capability in order to reduce the ground force reinforcement burden now carried by the U.S. There are several reasons for this aside from pure burden-sharing considerations. It would reduce Soviet incentives to take advantage in Europe of U.S. involvement elsewhere, or to feint in order to tie down U.S. forces in other areas in the event it did contemplate military pressure or aggression against Western Europe.

But, perhaps most important, modifying reinforcement responsibilities would reduce an enormous burden on port and airfield facilities at a time of maximum peril and confusion for the Alliance. If one makes the reasonable assumption that a Soviet calculated, deliberate assault on western Europe is a least likely contingency, any European conflict would more probably arise from some unexpected event or crisis. Under such circumstances, time for a deliberate force buildup may not exist, and attempting to reinforce while under Soviet attack on ports and airfields would be a formidable task indeed.

Further, enhanced European ground mobilization capability would add considerably to the overall strength of the Alliance in view of the fact that U.S. forces now

earmarked could, in perhaps most circumstances, also be available. It is true that manpower is an increasingly scarce commodity, but pools of trained manpower do exist and could, with adequate preparation, be augmented and mobilized. The U.S. could presumably assist in defraying the costs of additional unit sets of equipment.

Lastly, a modification of this type would do a great deal toward resolving the burden-sharing issue. Without some move, this being one which would enhance NATO military capability, some unfortunate Congressional action cannot be ruled out.

Emerging technology (ET) is increasingly referred to as the means by which NATO can offset Warsaw Pact conventional military advantages. That it will not do. However, technology, coupled with innovative tactics, may in some cases be able to offset some Soviet strengths which NATO will never otherwise match (e.g., tanks), or to deal with Soviet advances in weapons, strategy or tactics. A random few examples will illustrate.

ET is often cited as a means of intercepting and disrupting Warsaw Pact second echelon forces, preventing their reinforcement of the battlefield. That may or may not be an advantageous use of military resources. It certainly is not if NATO forces are not already able to contain an attack by Soviet first echelon forces. I am not aware of any general presumption that that is the case. Even if it were, substantial additional analysis would be required to demonstrate that second echelon interdiction was the optimal use of additional resources.

Technology may be of more obvious benefit in coping with the Soviet development of the Operational Maneuver Group (OMG). The fluid character of the battlefield which results from this organization and tactics would put a premium on C<sup>3</sup>I. Future ability to know precise location of friendly units, enemy units (under some circumstances) and flexible distributed systems for communication have the potential to provide significant differential advantage to NATO units.

Another potentially valuable technology is SDI related. Soviet missile developments (SS-20, 21, 22) seem designed to implement a strategy of attack on, among other targets, NATO tactical airfields. The tactic appears to be to initiate hostilities with attacks designed to crater airfield runways, preventing aircraft takeoff. This would provide several hours time during which those aircraft would be very vulnerable to destruction on the ground by Warsaw Pact aircraft.

One of the few, and perhaps the only, means of coping with such an attack would be through the development of an ATBM capability. Such a development could take place as an adjunct of SDI, a development which has a further advantage of not being prohibited by the ABM treaty (the Soviets may, in fact, be in the process of developing such a capability themselves). One of the most vital fruits of SDI research could be the development of an effective capability to intercept tactical ballistic missiles. That, in itself, would be reason enough for European support of SDI research.

SDI itself, other than ATBM capability, is perhaps less likely to have a clearly defined impact on the Alliance. The mutual deployment of SDI by East and West could mark the virtual end of extended deterrence, mandating the improvement of NATO conventional capability (assuming it had not already taken place). There is no reason to believe, however, that achievement of SDI capability by the U.S. would increase its reluctance to come to the defense of Western Europe. Quite the contrary result is a more likely consequence. While funding of SDI R&D and development could compete with funds for the improvement of NATO defenses, competition on the frontiers of technology—should the Soviets eschew a cooperative approach to SDI development—is likely in the abstract to differentially be to the advantage of the West.

Given apparent political attitudes within the Alliance on SDI, however, the potential of the Soviet Union to exploit it to the detriment of the Alliance can become a painful reality far in advance of any military returns to the West. In the near term, political controversy over SDI and burden-sharing are likely to pose the greatest peril to the cohesiveness of the Alliance.

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## DISCUSSION

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*The topic was introduced by a panel consisting of the authors of the working papers and a French participant, whose remarks begin this section.*

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The Alliance was, in the opinion of the French panelist, "doing quite well," and perhaps one way to keep it that way was to leave it alone. In any event, the attitude of "doom and desolation" that so often prevailed in discussions about the state of the Alliance was very much exaggerated.

Relations between Europe and the U.S. were in a period of exceptional harmony. Public opinion polls on both sides of the Atlantic indicated a high degree of support for the Alliance. The deployment of intermediate-range missiles on European soil—one of the Alliance's most important and difficult decisions—was being carried out with very little opposition. In areas outside the Alliance, there were few conflicts. American and European policies concerning Southeast Asia, Africa, Afghanistan, and even the Middle East were essentially the same. (In the Middle East we seemed to have no policy, but at least we were in agreement.) Central America, in the speaker's view, was really a domestic U.S. issue, about which most Europeans "couldn't care less."

While the traditional problems in the Alliance had not disappeared, neither had they gotten worse. There were differences between American and European attitudes toward the Soviet Union, but these tended to be practical rather than philosophical. Being geographically so close to the East Bloc, Europeans, West Germans in particular, were "allergic" to East-West crises. Europeans were reluctant to link out-of-area conflicts with the Russians to East-West relations in Europe; they tended to believe that cooperation in trade and other areas was more useful in influencing Soviet behavior than pressure and compulsion. Most Americans had the opposite view. The problem of American unilateralism—the lack of appropriate consultation—was also still there, but it had always been overcome in the past with good will. Perhaps the only problem that had gotten somewhat worse was the issue of burden sharing.

New problems had arisen, but they had so far not proven destructive to the Alliance. Nevertheless, they were serious and deserved our attention. One was the strategic problem. Nuclear parity between the U.S. and the Soviet Union had weakened the credibility of the American nuclear protection of Europe. This increased the importance of developing a strong conventional defense, but here there was uncertainty about what new technologies could achieve and who would pay for them. The strategic problem had also brought forth a new wave of anti-nuclear feeling and pacificism. It was important to note that this was by no means confined to Europe, but existed among certain groups in the U.S. as well. Indeed, most Europeans accepted that nuclear weapons would be essential for their defense for a long time to come.

The other new problem was economic. The depressed state of the European economy and the widening gap between it and the U.S. economy could become one of the Alliance's most serious long-range problems. Unless checked, unemployment would eventually erode the social and political consensus in Europe. And economic problems would lead to changes in Europe's share of world trade. There was a danger that we were heading to a situation in the pattern of U.S.–European trade in which "the geography of security no longer coincided with the geography of economic development." This was potentially a very divisive issue.

The problems facing the Alliance did not call for sudden, dramatic changes, but rather for thoughtful, long-range action. On the issue of security, we did not need experiments, but rather meaningful proposals for the adjustments necessary to meet the increased Russian threat. We needed, in particular, a common concept concerning our long-range objectives in East–West relations. Detente had been one such concept. It had failed, and had never been replaced. The absence of such a shared, long-range view could lead to differences. And finally, we needed increased European participation, without which there would be no answers to the nagging questions of burden sharing and a greater European influence in Alliance decision making.

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The American author, while agreeing that there was much in the Alliance to be heartened about, was concerned about new dangers on the horizon which might threaten the Alliance far more than the "family squabbles" of the past.

One danger was the growing divergence between the U.S. and Europe about the nature of the Soviet threat. It had been unanimity about the basic character of that threat that had led to the creation of the Alliance and kept it going. If Europe either perceived U.S. paranoia as an equal threat to its security, or lost confidence in the will and ability of the U.S. to defend the Alliance, then we had a fundamental problem.

What should we do about the Soviet threat? We were operating on the basis of a strategic concept formulated more than 30 years before—to defend Europe "on the cheap" by using nuclear weapons rather than conventional forces. Time, circumstances, and weapons developments were making it increasingly difficult to have confidence in that concept. Regarding arms control, the U.S. had lost considerable faith in it as a vehicle for restoring a strategic balance. Europe, on the other hand, still believed that arms control had a contribution to make.

It was true that crises outside of the NATO area had not occurred recently. But here, too, was a source for dissension between the U.S. and Europe. The U.S. considered itself to be "manning the fronts of the free world against threats wherever they might be." European criticism of this role was a problem. It was the American view that NATO could more easily be defeated in the Straits of Hormuz than on the North German plain. Recognizing that and dealing with the burden it implied was as important as the defense of the NATO territory itself.

All of these issues were coming to the fore at a time when attitudes within the Alliance were evolving. It had been observed that Europe was more concerned about economic issues than political ones and that a new sense of "Europeanism" had emerged. In the U.S., the generation of Atlanticists whose primary focus was on Europe, was passing. A generation of more Pacific-oriented policy makers, many from the Western U.S., was gaining prominence, and with them, the notion that U.S. strategy should be less tied to defending the European continent.

The principal problems facing the Alliance were, in the view of the Belgian author, economic ones. It was ironic because the Alliance had been created for political and military reasons. Tensions over economic issues were effecting the other areas of the Alliance. It was essential that the trend toward a stronger economy in Europe not be jeopardized by actions of the U.S. or by problems in the U.S.-European relationship. Were we doing enough to put our economies on a path toward growth? Without growth, we would have to share a diminishing cake, and we were having enough trouble sharing the cake we had now. Protectionism, even more than defense, could become a divisive issue.

Technology was seen in Europe as the one thing that would help restore growth and make Europe once again competitive with the U.S. and Japan. This was a strong integrating political factor in Europe. Real cooperation between American and European firms was crucial. We needed a new framework to deal with future questions of sensitive technology. The mechanisms we had today would not be sufficient to deal with the rapid pace of technological development in the future. Unless we dealt with this problem, we could not have meaningful cooperation and European participation. If, for example, SDI was seen as improving and advancing the technological expertise of American companies through a program not available in Europe because of technology transfer questions, the effect would be very divisive. The issues were too complex for governments to deal with alone. American and European firms needed to join together to assist governments in working out ways to deal with questions of sensitive technology.

Currently, the smaller European countries were becoming increasingly content to remain under the NATO umbrella but not to participate. This was bad for the integration process within Europe and bad for the balance between Europe and the U.S. Without economic growth and a greater European role in NATO, we could expect this trend to continue. It was vital for the U.S. to maintain a balanced, interested relationship with Europe and not to look skeptically at European attitudes toward defense. Finally, there had to be in our defense strategy an element of negotiation, as we had in the two-track decision, defining what our objective in dealing with the Soviet Union was. We should bear in mind that Soviet prestige was at an all-time low in Europe.

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As an Italian participant put it, we could not expect to deal effectively with the Russians as long as we had problems within the Alliance, especially between the U.S. and Europe. We had to develop greater cohesion and a shared strategic concept. A revitalization of Europe's military, political, and economic role was basic to establishing a sound partnership with the U.S. The European Allies needed to take steps to strengthen their union, consolidate their economies, and develop a public consensus on defense issues. They had to assume increasing responsibility for the defense of Europe in order to support the U.S. capability to face threats elsewhere. It was crucial to convey to the Russians that they could not rely on divisions within the West.

An American agreed that the stresses and strains within NATO had to be dealt with, because Gorbachev could be expected to focus on these long-term vulnerabilities. Gorbachev posed a real threat; he was young, smart, tough, and patient, and he was likely to be around longer than any current Western leader.

In this context, one particular concern voiced by several speakers was that the political aspect of the Alliance was insufficiently emphasized. If NATO lacked political strength, said a Canadian, it could not be strong militarily. We needed to discuss at

summits the objectives and general purposes of the Alliance. This was particularly true with respect to European youth, pointed out a Norwegian. There was a growing indifference on the part of young people in Europe toward the Alliance, a tendency to take it for granted, which could lead ultimately to a loss of support. That the Alliance had an important political dimension had been obscured by the emphasis on the military aspect of the public debate on INF. Western leaders had to project more consistently and clearly that the Alliance was primarily political and was the most promising vehicle to achieve a resumption of a constructive East-West dialogue.

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Another sensitive issue was the tendency, observed by a Canadian speaker, for there to be two classes of countries in NATO, or, more specifically, an "underclass" of less powerful, sometimes less developed, members of the Alliance. A Portuguese participant characterized his country as having no particular problems with respect to East-West relations. Although it had a large communist party, there was little anti-NATO or anti-American feeling. There was, however, a desire to play a greater role within the Alliance and for the country's strategic importance to be recognized. Indeed, with its experience and relationships in Southern Africa and Latin America, Portugal had special expertise that should be utilized by the Alliance. And it was geographically close to potential trouble spots in North Africa.

A Spaniard, too, warned against taking smaller NATO countries for granted. Spanish membership in the Alliance would be put to a referendum next year, and recent polls indicated that a significant majority of Spaniards supported withdrawal. This would be a serious crisis for NATO. But another Spanish speaker, while agreeing that current opinion was running against the Alliance, felt that this was due in large part to events in Latin America and President Reagan's recent visit to Spain. It was to be hoped that the favorable conclusion of the Common Market negotiations as well as a renegotiation of the bilateral agreement with the U.S. would shift public sentiment in favor of staying in the Alliance.

Turkey was another NATO member that felt neglected, according to two participants from that country. One warned that Turkey's role as a staunch ally should not be taken for granted. It was assumed Turkey had nowhere else to go, but this might not always be the case. The other speaker pointed to his country's sensitive geographical location, next to two members of the Warsaw Pact and to two of the most unstable countries in the volatile Middle East. This flank of NATO needed strengthening.

It was an Italian participant's view that the Alliance would have to become more concerned with its southern flank, the Mediterranean region. It was this area that was becoming the most important in terms of potential conflict. A Briton observed that this might be particularly true for NATO if Greece were to become destabilized, as it showed some indication of doing. But a Greek responded that there was little chance of this happening, and that the strong anti-NATO sentiments in Greece arose from Western backing of the now-defunct military dictatorship and handling of the Cyprus situation.

With respect to conflicts outside of NATO territory, an International participant felt that these arose from economic and political developments as well as from Soviet influence. The Russian position in many parts of the world was not strong, but that would not always be the case, so it behooved the Alliance to pay some attention. By supporting various regional organizations and initiatives, we could increase stability and reduce Soviet incentives to induce Allied, and especially American, overextension of commitments. We needed to give advice, intelligence, political support, access

to technology, and training of experts, as well as back up our support with a convincing rapid-deployment capability for handling major threats.

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From the military point of view, the Alliance had made encouraging progress in the last year, reported an International speaker. The continued deployment of Cruise and Pershing missiles on schedule was providing the Russians with an incentive to negotiate seriously and was sending them the signal that they did not have a veto over our security arrangements. Other heartening developments included provision of increased funding to construct new facilities, approval of new planning guidelines regarding attack of follow-on forces, harmonization of rapid deployment plans, and completion of an airborne early warning system. Studies would soon be completed on reduction of theater nuclear weapons without decreasing deterrence, and on the direction of conventional forces for the coming decade.

NATO's mission in Europe was to deter overt aggression, and, more important, to deter intimidation and coercion by Soviet military might. The strategy of moving to 572 intermediate weapons if there were no breakthrough in Europe was correct, as was achieving a conventional capacity sufficient to frustrate a conventional attack without early use of nuclear weapons. It was essential to have enough conventional forces so that the political leaders could make a deliberate decision regarding the use of nuclear weapons. Certain new weapons systems were needed to achieve this conventional capacity. One of the problems of SDI was that it diverted too much attention from the enhancement of non-strategic nuclear weapons and of conventional forces. If we were to be alive to enjoy the fruits of SDI, we had to take other steps in the meantime.

The need to bolster Europe's conventional defense was particularly compelling to a speaker from Lichtenstein. It was his view that SDI offered the U.S. a possibility of protection from the only kind of attack to which it was vulnerable. But Europe was also vulnerable to a conventional war, which was a more realistic threat. It was unlikely a Soviet leader would launch a nuclear attack against Europe in view of the U.S. retaliatory capacity and the prospect of nuclear winter. The latter had reduced the possibility that nuclear weapons would be used and, at the same time, diminished the credibility of nuclear deterrence in the strategic defense of Europe. Far more important than doing SDI research, Europe should concentrate its efforts on making conventional war impossible.

A German agreed that there had been too much attention paid to SDI when other things needed doing. Conflicting statements about SDI had created a great deal of confusion, especially in Germany. We needed doctrinal clarity in defining the importance of SDI in the public debate. Conflicts over SDI could lead to American impatience and, hence, unilateralism. SDI was basically an American-Soviet issue over which Europe had little leverage. An American agreed that SDI presented a difficult problem for the Alliance because the U.S. did not require bases for it in Europe, as with INF. Yet Europe wanted some technological spin-off from SDI research. There would have to be a great deal of consultation on the issue, and the U.S. had to avoid giving the impression either that was unwilling to compromise at all, or that it would make a deal with the Russians over the heads of the Europeans, or not in the European interest.

Regarding the arms control aspect of SDI, the American speaker continued, the Russians could be expected to exert great efforts to block SDI, and, therefore, there would be little progress in Geneva in the next year or two. A Dutch participant who

viewed the two-track decision as a failed strategy because the result had, in his view, not made Europe more stable, felt that SDI would fail as a strategy, too, because it raised the level of Soviet fear. NATO's objective, he argued, should be to reduce the level of Soviet fear, and this meant gradual abandonment of the strategy of deterrence. One possibility that worried another American was that the Russians could exploit SDI at the negotiations. If they offered to make meaningful cuts in offensive weapons in exchange for abandonment by the U.S. of SDI, then the Alliance would have a serious crisis on its hands.

But that possibility seemed remote to the French author, who viewed SDI as an opportunity for a major cooperative effort in scientific development between the U.S. and Europe. If not seized, it would substantially damage U.S.-European cooperation.

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#### CLOSING REMARKS

At the conclusion of the final session, Mr. Giovanni Agnelli thanked all those who had contributed to the success of this thirty-third Bilderberg Meeting. In particular, he mentioned the American members of the Steering Committee and the Advisory Group; Mr. Charles Muller, who organized the conference; the Bilderberg staff, especially Mrs. Anne Hoogendoorn, who was retiring this year after ten years of service; the management of Arrowwood and its owner, Citicorp, here represented by Mr. Hans Angermueller; the authors, panelists and moderators; and the interpreters.

Mr. Agnelli observed that relations among the countries of the Atlantic Alliance were generally healthy, and that the Bilderberg Meetings had played a part in making them so.