

A casual reading of contemporary news reports suggests that during the past decade economic issues have taken on growing importance in the relations of non-Communist developed countries. The disputes between the United States and Japan over textiles, between the United States and the European Community over agricultural trade, and between France and Germany over currency alignments come readily to mind. It is perhaps symbolic of the enormous success of early postwar foreign policy that issues no graver than these play such a prominent part in relations among countries that, earlier in the century, were sporadically at each other's throats. But I contend that economic issues are becoming, and will continue to become, more problematic in relations among advanced non-Communist countries, and that their relative prominence today is not merely due to the fact that other, more fundamental issues have been resolved. Indeed, the trend toward greater economic interdependence among countries will require substantial changes in their approach to foreign policy in the next decade or so.

To clarify this proposition, we first need some delineation of the terms "trends," "economic interdependence," and "foreign policy." By "trends," I mean developments that can be confidently projected into the future on the basis of information now available, but not, of course, projected with certainty, since future developments are also influenced by future policies. Indeed, a principal reason for ascertaining trends is to suggest what policies will be required in order to change those that are disagreeable. Moreover, trends represent a projection of observable forces, not a description of present reality.

"Economic interdependence" normally refers to the dollar value of economic transactions among regions or countries, either in absolute terms or relative to their total transactions. I shall use it in a more restricted sense: to refer to the *sensitivity* of economic transactions between two or more nations to economic developments within those nations. This approach

means that two countries with much mutual trade would still experience a low degree of interdependence if the value of that trade were not sensitive to price and income developments in the two countries; on the other hand, two countries would be highly interdependence if their transactions were greatly sensitive to economic developments, even if their mutual trade were initially at a low level.¹ *Interdependence* implies two-way sensitivity; one-way sensitivity leads to a dependent economy. The reason for this focus on sensitivity rather than on level will become clearer as the argument proceeds; for the moment I will simply observe that the economy of the United States is becoming highly interdependent with that of Europe and Japan, even though total U.S. exports to those areas account for only about 3 percent of total output and (so far as we can tell) international financial transactions are a similarly small proportion of the total financial transactions in the United States.

"Foreign policy" is the most difficult term to define. It may be interpreted to mean all points of contact between the residents of one country and those of another, but surely that—although important—would be too broad. The term "policy" would seem, at a minimum, to reduce the term to mean all points of contact between national governments. But even this is broader than is usually understood in the press and in casual discussion; it probably refers to points of contact between governments concerning the territorial integrity of the nation-state and the security of its citizens (and possibly their well-being, but that broadens the meaning considerably)—in short, what has come to be called national security, broadly defined. A third notion of foreign policy is a grand conception of world economic and political order that provides a consistent framework for, and guidance to, the month-to-month decisions that nations must take in their relations with other nations.

There is, of course, a continuous gradation between grand conceptions and day-to-day operating decisions, with many proximate objectives advanced for guidance in specific instances, on the (sometimes incorrect) assumption that those proximate objectives will serve to advance the grander and inevitably more general conceptions of what is desirable. Despite this continuous gradation, I believe it is useful to distinguish between the grand conceptions of desirable relations among the peoples of the world and the usually all-absorbing concerns for day-to-day decisions that typically govern foreign ministries.

Growing economic interdependence has important implications for the first and third of these concepts of foreign policy—for the number and the character of contacts between governments and, more importantly, for the conception of a world economic and political order that is both desirable and

attainable. In particular, it bears on the viability of the nation-state as the principal unit of decision-making. The implications for the second concept of foreign policy—national security—are less immediately compelling and are largely derived from the other two.

In the observations that follow I take up, in turn, the fact of growing economic interdependence, the challenge this poses for domestic economic policies and balance-of-payments adjustment, the actual and potential national responses to this challenge, and the implications of the resulting tensions and pressures for foreign policy in the 1970s.

Growing Economic Interdependence

The extraordinary and unprecedented growth in international trade has frequently been mentioned. The increase in international travel has been even faster, and is equally unprecedented. It is not clear whether international trade has grown in relation to total economic output (GNP); the relative growth of “services” would argue against this. But, in any case, that is less important than the sensitivity of international transactions to domestic economic developments such as taxation, inflation, and interest rates. There is no question that this sensitivity has increased in certain dimensions. Although merchandise imports account for only 4 percent of total U.S. expenditure, for example, imports account for a much larger share of the increment during periods of rapidly rising expenditure (17 percent in 1968, in real terms). When demand runs ahead of output, the rest of the world fills the gap. This process has long been more operative in other countries than in the United States, but even there the response has become more rapid and more complete.

It is less clear whether the *price* sensitivity of international demand has increased. Improved transportation and communications, wider acceptability of foreign styling, and narrowed cost and quality differences among nations suggest that it has; but growing product differentiation, with each major firm trying to establish its secure niche in the market, cuts the other way. So does the growing importance of the multinational firm wherever market-sharing conventions prevail among its various components. But these firms have also contributed to the convergence of cost and design and to the wider acceptability of “foreign” products. On balance, price sensitivity for international trade has probably increased as well.

This increased sensitivity has extended even to labor, an area in which the integrative forces of policy and technology are undoubtedly weaker than in any other. In 1967, when Germany slumped into its first postwar recession,

one-third of the unemployed workers who lost jobs were foreigners on short-term contracts. On returning to their homelands they raised unemployment there and reduced it in Germany, literally representing an exportation of unemployment. The reverse occurred once Germany expanded again. When reductions in federal funding, the stock market slump, and rising prices combined to bring about a sharp reduction in new hiring of university teachers in the United States, graduate students in Britain—whose higher educational establishment continues to grow at a rapid pace—nonetheless also felt the pinch: Britons and Commonwealth students studying in the United States started to look for jobs in Britain to replace those they could not find in the United States.

The greatest growth in interdependence has undoubtedly been in investment, both real and financial. The great growth in direct foreign business investment in the 1960s testifies to the new search for earning opportunities everywhere, not merely in the national market. Barriers of language and law have gradually been broken down or surmounted by large and even not-so-large American firms, who have flocked to Europe to exploit new or newly perceived market opportunities and tax advantages. Financial capital has also become much more sensitive to yield differentials among major financial markets, and an increasing number of both borrowers and lenders scan a world horizon for sources of funds and investment opportunities; in doing so, they tie national markets more closely together. German firms can borrow from Arabian sheiks and Iowa farmers in London's Eurodollar market. Even national stock markets, although they are subject to diverse influences, have shown increasing parallelism of movement during the past decade.² As in other areas of economics, it is the marginal transaction that counts in linking markets together.

This growing interdependence may be confidently projected into the future, in the absence of strong government action to retard the process, because it is based on the technological advances in transportation and communication which increase both the speed and the reliability of moving goods, funds, persons, information, and ideas across national boundaries—in short, the same forces that are producing the much-touted shrinking world, in terms of both economic and psychological distance.

Although this process is worldwide, it is much further advanced among the industrial countries of the non-Communist world—Western Europe, North America, and, increasingly, Japan—countries that, in the last few decades, have converged remarkably in their objectives of social and economic policy and in their political processes for reconciling differences and for executing policies. Although these countries will continue to be

concerned about the Second and the Third World, their concerns will derive largely from considerations other than growing economic interdependence. (Economic interdependence must, in this context, be distinguished from the growing psychological interdependence brought about by increasing direct exposure through television and other media.) The remarks that follow will largely concern relations among the Western industrial countries.

A second kind of growing economic interdependence, institutional rather than structural, can be discerned among industrial nations. This institutional interdependence occurs when these countries must, by prior agreement, confer, and even reach joint decisions, on matters of economic policy. The two outstanding examples of this, neither of them present a decade ago, are the periodic decisions leading to the creation of Special Drawing Rights (paper gold) at the International Monetary Fund, and the decisions concerning the formation of commercial and agricultural policies within the European Economic Community. Both involve truly supranational decision-making, although of course only after prior negotiations among nations. Less dramatic instances are the attempts by donors to coordinate foreign aid to particular countries in "consortia" under the general direction of the World Bank, and the attempts, so far largely unsuccessful, to coordinate trade policies of the developed countries with respect to the products of the less-developed countries. This kind of institutional interdependence is in some measure a response to the growing structural interdependence, but it often also has a quite different, more strictly political origin, and thus is a separately identifiable factor in the economic area.³ It will therefore be ignored in my argument, as will British accession to the EEC.

The Challenge of Growing Interdependence to National Economic Policies

Domestic Policies

Most national economic policies rely for their effectiveness on the separation of markets. This is true of monetary policy, of income taxation, of regulatory policies, and of redistributive policies (whether the last be through differential taxation or through direct transfers). Increased economic interdependence, by joining national markets, erodes the effectiveness of these policies and hence threatens national autonomy in the determination and pursuit of economic objectives. The term "threaten" is used nonpejoratively; there are also economic advantages to the joining of markets, and in some—but not all—cases these outweigh the resultant loss of economic autonomy; indeed,

that is what creates the predicament. It is aggravated by the fact that during the past few decades the peoples of all industrial countries have substantially raised their expectations of governmental activity in managing the economy with respect to employment, inflation, growth, income distribution, and a host of other objectives, leading to the emergence of what is sometimes called the welfare state.

The loss of autonomy has been most prominently discussed in the area of monetary policy.⁴ As national money and capital markets are joined by international flows of funds, interest rates in various markets are drawn together. Subsequently, if an individual country wishes to pursue a contractionary monetary policy in order to discourage a domestic boom, it will find, in the course of trying to tighten monetary conditions, that it is merely drawing funds from abroad; the more its central bank tightens, the more its would-be domestic borrowers will satisfy their needs by borrowing abroad rather than at home. Under these circumstances, monetary policy becomes an effective tool for influencing the short-term balance-of-payments position of a country, since it can attract or repel short-term funds; but it has become an ineffective tool for its customary objective of influencing the course of domestic economic activity.

The international mobility of firms and funds also erodes the tax policies of nations. It is no secret that the nascent international bond market has thrived on funds that engage in tax evasion. Host countries such as Luxembourg have a disincentive to police carefully the taxation of interest earnings on foreign funds: they thereby attract financial business. Without the full cooperation of countries where the earnings take place, the difficulty of enforcing tax laws on residents holding funds abroad will enable the wealthy and astute residents of all nations maintain a tax-free source of interest income; as more people become aware of the possibilities open to them, this will, in turn, increasingly erode both the revenue and the redistributive objectives of many countries.

For operating business firms it is more difficult to avoid an accurate declaration of earnings. But by adjusting the prices at which transactions take place among branches in different countries, they may sharply reduce their total tax liabilities and thereby thwart the fiscal objectives of countries with high tax rates.

In both of these cases—tax evasion and transfer pricing for tax avoidance—national authorities are not without countervailing courses of action. But, as will be made clear, in some respects these courses of action either infringe on the sovereignty of other nations or place their own international firms in a difficult competitive position. So a dilemma remains.

The same is true of regulatory policies of business, such as antitrust regulations, capitalization requirements, disclosure requirements, trading regulations, and the like. In each case the international mobility of funds and firms erodes the national capacity to impose and enforce limitations on business behavior. A Swiss corporation, faced with local requirements to give initial rights to new equity to existing stockholders, found it convenient to establish a subsidiary in Curaçao instead, and to raise its new equity from that base, drawing on international (including Swiss) sources of funds. If it were not for laws extending the jurisdiction of the United States to its citizens everywhere—a powerful irritant to some countries—American firms could escape U.S. proscriptions on trade with Cuba simply by locating in countries more sympathetic to such trade.

Although labor is still far less mobile than capital, the mobility of certain groups of people is sufficiently high to limit policies designed toward redistribution, whether through taxation or, as in the case of the British Health Service, through imposed conditions of work. This force can be seen most clearly within the United States, where states and municipalities with generous welfare programs have been swamped by immigrants from elsewhere in the country; in the end this requires a fiscal bailout by the federal government.

Mobility unites previously fragmented markets, and in so doing threatens policies that, for their feasibility, depended on the fragmentation of markets. As nations become increasingly interdependent, as capital and skilled labor become less exclusively national in their orientations, countries desiring to pursue tax or regulatory policies that deviate widely from those policies in other countries will find themselves stimulating large inflows or outflows of funds, firms, or persons; these induced movements will in turn weaken the intended effects of the policies, or make them more costly. Economic policies that have hitherto been regarded as exclusively domestic will come under increasing influence from the international environment.

Balance-of-Payments Policy

In addition to affecting domestic economic policies, increased interdependence will also, and more importantly in the immediate future, affect our methods for dealing with imbalances in international payments. Under the present rules of the game, laid down in the Bretton Woods Agreement in 1944, countries are required to fix their exchange rates and to finance out of reserves, or by borrowing at the International Monetary Fund, any temporary imbalances in payments. "Fundamental" imbalances are to be corrected

by moving a country's fixed exchange rate parity to a new level. This system requires a governmental judgment concerning when a given imbalance is fundamental rather than merely temporary; while this judgment is being made, the public at large can speculate on whether or not the value of the currency is going to be changed. In the event of a change, this speculation results in both a redistribution (from government to successful domestic speculators) and a loss (from government to successful foreign speculators) of national wealth.

This system presupposes fragmentation of the markets for financial assets. Such fragmentation was implicit in the Bretton Woods Agreement, to be achieved, if necessary, by the imposition of controls on movements of capital. [Article VIII, Sec. 2(b) requires all members of the IMF to help police the capital controls of any member.] For various reasons, restrictions on capital movements have seemed both less desirable and less feasible than they appeared 25 years ago; therefore, as the barriers of ignorance and cost in undertaking international transactions have fallen, the potential speculative movement of funds has increased enormously. Just as the reduction in barriers has increased the sensitivity of funds to transnational interest-rate differentials, and thereby eroded the effectiveness of national policy, it has increased the sensitivity of funds to prospects for speculative gain, and thereby rendered more difficult (because more costly) the use of changes in the exchange rate to correct imbalances in payments. A crude quantitative indicator of these developments is provided by contrasting the maximum daily speculation of under \$100 million against the pound sterling, in the "massive run" of August 1947, with the maximum daily speculation of over \$1.5 billion in favor of the German mark in May 1969, and the movement of over \$1 billion into Germany in less than an hour in May 1971. Moreover, as the barriers of ignorance fall further, there is no reason why \$1.5 billion should not rise to \$15 billion, or even to \$50 billion, in a day. A 10 percent gain over the weekend is a tidy rate of return; if the speculator guesses wrong, he has lost, under the Bretton Woods arrangements, only the relatively modest transactions costs. Such huge speculative movements impose proportionate losses on countries that do change their exchange parities.

Reluctance to make an adjustment in the exchange rate will induce a search for alternative devices for correcting payments positions, and these, in turn, will impinge—as, indeed, they already have—on both domestic politics and foreign policy. One can make a plausible case in conjectural history that the governments of France, Germany, and Britain were turned out in 1969–70, as was that of Canada in 1963, on grounds that fundamen-

tally reflect this growing economic interdependence among nations and the resulting influence on the ability of countries to cope satisfactorily with balance-of-payments difficulties. The exchange rate figured explicitly in the German election. De Gaulle was ostensibly rejected on the basis of his proposals for regional government in France, but one may argue that the more fundamental reason for his rejection can be found in the economic factors that led to the disruptions of May–June 1968, namely France's restrictive economic policy after 1965. This policy represented an attempt to halt the deterioration in France's balance-of-payments position, and, *inter alia*, it involved sharp cuts in the planned educational budget and produced the highest level of unemployment in France since the 1930s. Harold Wilson's promise that the devaluation of the pound in 1967 would not devalue the pound in the pocket of the average Briton, which was followed by the most rapid price increases in two decades—linked in turn to the devaluation and to Britain's dependence on the world market, where prices were also rising—despite growing unemployment, played a key role in his electoral defeat in 1970.

Responses to the Challenge to National Autonomy in Economic Policy

Domestic Policies

The intrusions of growing interdependence into domestic economic policy, which are already visible but are likely to become much more intense in the next decade, have elicited five quite different but not mutually exclusive types of response by national governments: passive, exploitative, defensive, aggressive, and constructive. These designations are meant to be descriptive, not normative.

A *passive* response involves acceptance of the loss of domestic economic autonomy and virtual abandonment of any attempt to pursue courses independent of those determined by the countries to which the passive country is closely linked with ties of trade and finance. It is largely a resort of small countries who have become aware of their dependence on others and for whom the costs of independent action (i.e., of forgoing the benefits of linked markets) are likely to be high.

Some of these countries also pursue an *exploitative* course, which attempts to take advantage of the growing interdependence in ways which are successful if pursued by only a few countries, but which cannot be generalized for the world economy. Thus, we observe countries offering flags of

convenience on ocean shipping, light registration and disclosure requirements for securities, nominal taxation on certain forms of business activity (tax havens), and generous subsidies to foreign investment.⁵ So long as only a few countries create especially favorable conditions for certain forms of economic activity, they will succeed in attracting that kind of activity from elsewhere; if many countries begin to compete for the same activities in similar ways, international location will be little influenced, and net benefits will accrue to the favored activities at the general expense of governments, consumers, or labor. This kind of policy competition is already noticeable in the tax concessions, and even direct subsidies, given by many less-developed countries to foreign investors; as the practice spreads, revenue bases will be eroded while the effect in attracting investment will diminish. Competition can also be observed in the export credit terms given by the industrialized countries, in subsidies to hotel building and other aspects of tourism in Europe, and in the use by municipalities *within* the United States of tax-free industrial development bonds to attract industry. (This development has recently been restrained by congressional action.) Success in exploiting the new mobility is therefore limited to those countries that *begin* the process, and continues only so long as other countries do not follow or retaliate.

A *defensive* response involves attempts to reduce economic interdependence by preserving or restoring the fragmentation of markets in order to retain some economic autonomy. An early example was the imposition of restrictions on immigration into the United States. This was done, among other reasons, in order to protect the distribution of income then prevailing and to reduce the flow of new immigrants to a level which might reasonably be assimilated. More recently, Britain, Denmark, and Switzerland have all imposed limits on the number of foreign workers. The reasons are both political (on the assumption that certain minimum requirements of homogeneity in the population must be met in a functioning democracy) and economic (concerning in particular the distribution of income between relatively unskilled labor and other factors of production). The United States has long maintained an escape clause on its commitments to lower tariffs that can be invoked if foreign competition creates insuperable adjustment problems for domestic firms and labor. Some countries have for years imposed impediments to the movement of financial capital across their boundaries. Others have started to do so more recently. The United States has its interest-equalization tax on purchases of foreign stocks and bonds, and its mandatory restrictions on foreign lending by U.S. firms and banks. Britain and France have even more stringent controls. These restrictions are often

imposed under the heading of balance-of-payments measures, but they are more correctly viewed, I think, as devices to insulate national capital and money markets from one another in order to preserve some degree of national monetary control. This view is supported by the fact that countries such as Germany and Switzerland, with strong or neutral payments positions, have also resorted to such measures.

Some countries have engaged in *aggressive* as well as defensive actions to preserve national autonomy. Rather than reduce mobility, these actions attempt to extend national control to the mobile factors wherever they be. Thus, the United States (which because of its size and relative importance is in the best position to engage in extraterritorial extension of its laws and regulations) has from time to time extended its antitrust laws to the foreign subsidiaries of U.S. firms and even to the foreign parents of foreign subsidiaries operating in the United States. For example, it has demanded the disclosure of financial information by foreign firms whose securities are traded informally in the United States, prevented foreign subsidiaries of U.S. corporations from selling to certain Communist countries, imposed minimum limits on repatriation of earnings by American firms operating abroad, and attempted (unsuccessfully) to compel submission of certain business information by foreign sea and air carriers. These various actions invariably provoke cries of outrage from other countries,⁶ for they attempt to extend U.S. regulatory jurisdiction to economic agents that are the legal entities of other countries and hence under their jurisdiction, despite their American ownership. On the other hand, failure to subject these foreign entities to U.S. regulations or their equivalent invites circumvention of the regulatory intent through movement abroad. If the records of American-owned firms outside the United States are not subject to subpoena, for example, firms which are prevented by law from conspiring to fix prices or share markets within the United States may do so abroad, with impunity. Or, if American firms operating from foreign bases are not affected by the U.S. proscription on exports to Cuba, the restrictive policy can be vitiated simply by locating abroad. (This observation is not meant to imply approval of this proscription—only that a national policy can be undercut by international mobility of its firms.) In other words, while the response of the United States in these cases has been aggressive, it has not been capricious; it is addressed to a real problem in which the decisionmaking domain of businesses covers a wider geographic area than the jurisdiction of government.⁷

A fifth type of response involves the *constructive* attempt by governments to frame their policies jointly, so that mobility among the cooperating countries ceases to offer an escape from governmental jurisdiction. Examples

of true coordination of policies are rare, although in the area of monetary management there have been several faint signs of coordinated action, notably in the general lowering of interest rates in 1967. There have also been attempts, partially successful, to limit export-credit concessions by government-sponsored export-credit institutions. Bilateral tax treaties have, of course, been used for years to reconcile the conflicting claims of tax jurisdiction over business income. But this approach through coordination could go much further, and encompass a wide range of policies concerning taxation, the regulation of business structure and activity, the framing of monetary policy, and other "domestic" policies. It is an approach that requires considerable patience, however, for joint regulation can proceed only as rapidly as the most laggard participant; since some potential participants have successfully exploited the new mobility, they will be reluctant to give up their gains.

Balance of Payments Policies

The same five types of response can occur in the area of balance-of-payments adjustment. The passive response, which represents a return to the feature of the nineteenth-century gold standard that required domestic economies to be keyed to balance-of-payments conditions, has proved acceptable to few countries. There is a wider danger, already observable, that, in their attempt to avoid exchange-rate adjustment, some countries will engage in exploitative responses. By altering the domestic tax system to take advantage of a feature of the international trading rules (embodied in the General Agreement on Tariffs and Trade) that permits certain types of border tax adjustments but not others, these countries will attempt to improve their trade positions; by subsidizing the tourist industry, they will try to increase foreign exchange receipts.

A defensive response involves imposing restrictions on various payments to foreigners in order to improve the balance of payments—restrictions that could in the past be observed with respect to virtually all international transactions: trade, tourist expenditures, foreign aid, private capital movements. Canada in 1970, and Germany and the Netherlands in 1971, adopted quite a different defensive response in allowing their exchange rates to float freely, to be determined by market forces. This expedient, long urged by many academic economists but prohibited by the Bretton Woods agreement, insulates those economies from inflows of interest-sensitive and speculative funds.

The United States is in the unique position of being able to adopt an

aggressive response in this area. It has been suggested by some that the United States should cease to pay gold for dollars offered by other central banks, in order to force the world onto a dollar standard or to induce other countries to allow their currencies to float against the dollar—in the expectation that most countries would reject the latter option and prove willing to accept and hold large (unlimited?) numbers of dollars, thereby relieving the United States of concern over its balance-of-payments condition.⁸ Others have claimed that for all practical purposes we have already reached this state. But in terms of foreign policy, there is a vast difference between an explicit arrangement that most governments would find deeply offensive and an implicit arrangement with many of the same features in practice. The former would create considerable public as well as official resentment, which might lead to actions on grounds of national pride that are neither in the economic interests of the countries undertaking them nor in the interests of the world economy; the latter would have enough ambiguity to permit both the United States and other like-minded governments to maintain with semi-truth that nothing has changed and that each country retains its freedom of action while still enjoying the benefits of international intercourse.

Finally, it is possible to imagine truly cooperative forms of payments adjustment, in which rules or conventions are established to determine which countries should make what adjustments, with derogations subject to international consultation. The rules of Bretton Woods made an attempt in this direction, but the possibilities for private speculative gain surrounding discrete alterations in exchange rates that are the system's keystone have in practice rendered the IMF consultative procedure a dead letter. Nevertheless, in recent years tense and sometimes acrimonious consultation on exchange-rate changes has taken place outside the IMF among the major countries.

Economic Interdependence: Implications for Foreign Policy

The foregoing excursion into the challenge that increased interdependence constitutes to domestic economic policies and the possible national responses sets the stage for an examination of the implications for foreign policy.

Obviously, the impact on domestic politics is one route whereby economic interdependence can influence a nation's foreign policy; hence the problems facing the foreign policy of the United States. The shift from De Gaulle to Pompidou and from Labour to Tory may not basically alter the shape of world affairs, but it can affect them in important details. For

example, France's willingness to consider Britain's entry into the European Economic Community blunted Britain's general foreign-policy role as long as negotiations were in process and will divert British and European official attention and energy from other matters for some time. Another example is the restoration of Britain's military commitment east of Suez before the withdrawal had proceeded so far as to become irreversible. The important influence of domestic politics on foreign policy is also demonstrated by election of a communist as president of Chile. It has been alleged that the very rapid growth of foreign ownership in Chilean manufacturing in the late 1960s, much of it in the form of takeovers, played a significant role in the public appeal of Sr. Allende, who during his campaign raised the specter of foreign domination of Chile's infant manufacturing sector.

The impact on political leadership may possibly lead to the most important effect of interdependence on foreign policy, but it is too subtle and too uncertain in direction to be analyzed with any confidence. More direct and clearly identifiable effects arise from the challenges to national autonomy in the realms of economic policy. These challenges take foreign policy right into the thicket of domestic politics. On the whole, foreign policy, in the narrower sense of national security and military-strategic considerations, has in all countries been elitist—the interest and province of a relatively small group of persons. Strategic considerations do become political issues, but generally in a rather abstract fashion, as broad issues and postures. Even the foreign-policy budget—largely military—has until recently been relatively immune from domestic political considerations. (This is equally true of foreign aid, where one small group is pitted against another, and the public remains passive and uninterested.)

With the advent of increased economic interdependence, however, foreign developments will intrude on a whole range of policies that are traditionally domestic, and these bread-and-butter domestic political issues will in turn influence and greatly complicate the management of foreign policy.⁹ It follows that foreign policy in the sense of all official relations between countries will become more intricate both in the range of issues and in the frequency with which they arise. National reaction in the 1970s will undoubtedly blend all five types of response. Many of these responses will create frictions between countries, and diplomats will be kept busy at their traditional task of smoothing ruffled feathers. If foreign policy is to be regarded as successful, it will have the additional task of channeling and controlling the reactions to greater interdependence in order to prevent the dominance of those exploitative, defensive, and aggressive responses that, if generalized, are detrimental to international order and hence to all partici-

pants. This means, in particular, confining the exploitative responses to *de minimus* cases and introducing some kind of order into the defensive and aggressive responses so that they will not provoke retaliation that is damaging to all parties.

To say this, however, is to say little more than that in times of tension and conflicting objectives it is in the interest of all to avoid outcomes that are detrimental to all. It is far more difficult to define the maximal task for foreign policy (even in an area limited to economics), for that depends, among other things, on our basic objectives and in particular on the value we attach to the preservation of *national* autonomy as such. We must sooner or later face in a global context the issue of centralization or decentralization that is so prominent within the United States. In thinking about these issues, I find it helpful to consider three extreme cases—Weberian “ideal types.” None of them will be realized during the next 10 years, but each may serve as a model, or general guideline, toward which we might move; all of them accept as given the fact of extensive government influence on the operation of market forces.

The first is a regime of nation-states, each successfully pursuing its own objectives that have been determined in its own way, democratically or otherwise. As noted above, successful pursuit of economic objectives at the national level requires markets that are fragmented at least to the national level, and this in turn implies that each nation is sufficiently insulated from other nations to pursue its independent course (although groupings of like-minded nations need not be excluded). This does not rule out trade and capital movements, but it does presuppose some instrument of policy (tariffs, quotas, taxes on international transactions, flexible exchange rates, or other defensive measures) that will permit a country to prevent emaciation of its domestic policies by international transactions that are highly sensitive to them. It is the sensitivity of international transactions that must be reduced, and that objective does not require autarky.

The second regime involves a supranational state that will take over many of the functions that are now performed by the nation—an extreme form of “constructive” response. In the area of economic policy this would mean economic stabilization, taxation of mobile factors, regulatory policies concerning businesses and unions, and even, up to a point, redistributive policies. In other words, the span of government control would be brought into correspondence with the decisionmaking domain of mobile businesses and individuals. Such a superstate need not be global in scope. Businesses, funds, and labor are not free to move globally, and they will not be for some time. The Communist countries and many less-developed countries are effectively insulated from the main economic centers of the industrial world,

either by policy or by the uncertainty inherent in the absence of policy under politically unsettled circumstances.

There is a natural historical analogy here. It is the gradual passage of responsibility for increasing areas of economic management from the American states to the federal government. As American business became truly national rather than regional or local in character, the states found it increasingly difficult, in a country within which free trade prevailed and contracts made in one state had to be honored in others, to regulate business activity effectively. Businesses simply left the states that imposed onerous restrictions on their activities, or at least the head offices migrated. Consequently, the federal government gradually took over regulatory responsibilities.

The third regime involves American hegemony, an extreme form of "aggressive" response. Rather than turn responsibility over to a superstate, the United States would gradually extend its regulations to cover U.S. citizens abroad and foreigners residing in, or dealing with, the United States. By a combination of persuasion and (nonmilitary) threat, it would either bring other countries into line or drive them into the first regime, thereby insulating them from such contact with the United States as they find offensive to their sovereignty. The world would be on a dollar standard, and many nations would adopt systems of regulation and taxation similar to those of the United States in order to avert punitive reactions from it and to avoid internal embarrassments arising from differential treatment favoring American over domestic enterprises. This state of affairs could not be brought about, of course, without the overcoming of a certain amount of domestic American opposition, concerning, for instance, the taxation of income from foreign sources even when it is not repatriated.

None of these regimes is immediately foreseeable, for none is politically feasible. But the model regime which we implicitly use at present—autonomous and purposeful nation-states in harmonious and unrestricted economic intercourse, through the competitive marketplace, at fixed exchange rates, governed by occasional treaties and conventions to ensure good conduct and to iron out modest problems of overlapping jurisdiction, leaving virtually all economic decisions to national governments—is simply not viable in the long run, for the reasons already given. Unless we develop some new conception of world economic order, the search for specific solutions to specific problems will run a substantial risk of slipping into practices that are detrimental to all. We will enjoy neither the full benefits of economic integration on a "global" scale nor the full benefits of national autonomy in the establishment and pursuit of economic and social objec-

tives. In short, it is the third notion of foreign policy, the grand conception of a world economic order, which will be profoundly affected by the impact of increased economic interdependence, for greater interdependence will inevitably compel a basic reexamination of the kind of world we ultimately want.

Various viable compromises among these three regimes are of course possible, and we should no doubt work toward one of them in the near future rather than toward the ideal types. Three come to mind. The first leans toward preservation of national autonomy by reducing the degree of interdependence through action by individual governments; such actions would be governed by international conventions to ensure that they were mutually consistent and that they went no further than necessary to achieve their purposes. Thus, agreement might be reached, and controls instituted, to limit movements of financial capital between countries. The blockage would not have to be complete to preserve some degree of national autonomy in monetary policy, but it would have to cover the major sources of flows. Similarly, taxes could be imposed on the outflow of business capital to prevent modest national differences in taxation and regulation of business from influencing the location of industry. Tariff quotas might be used to inhibit any rapid growth of imports that would greatly disturb domestic industries; the quotas could be allowed to grow automatically so that loss of competitiveness would be reflected in a relative but controlled decline in the domestic industry.

A second, preferable approach accomplishes much the same objective by introducing somewhat greater flexibility in exchange rates, with international rules governing the changes in rates and surveillance of adherence to the rules.¹⁰ This approach would, I believe, help enormously with respect to balance-of-payments adjustment, and considerably with respect to the movement of yield-sensitive funds and price-sensitive goods from country to country, but it would still leave the whole area of business regulation untouched. It might therefore be combined with a third approach, involving intensive efforts to discover areas of potentially overlapping jurisdiction with a view to reaching common tax and regulatory policies among countries—preferably while the process of extensive foreign investment is still at a relatively early stage, so that a reasonably firm framework of expectations regarding corporate practices is available. (Recent inconclusive discussions between the United States and Swiss authorities regarding the prosecution of tax evaders indicate just how difficult agreement will be in some areas, and with some countries.)

The new requirements of the international scene will undoubtedly revive

the debate between those with a *dirigiste* philosophy of economic policy and those who lean toward *laissez faire*. The former have largely carried the day domestically,¹¹ with governments committed to stabilize the economy, ensure growth, and establish an equitable distribution of income. The latter will therefore welcome a chance to reopen the issue in a new context; they will resist attempts to restrict international transactions and to regulate international firms and financial transactions through intergovernmental cooperation. International mobility offers a welcome escape from domestic regulation. The new circumstances will also result in some major realignments on broad issues at home. American labor has generally been internationalist in outlook and position, but it correctly sees the mobility of American firms as a threat to its welfare. Its opposition to "tariff factories" has begun to spread to all foreign investment and even to liberal trade policy, just as, in a somewhat different context, British Socialists regarded a restriction-free international economy as a threat to their plans for domestic social reform in the late 1940s. *Laissez faire* might logically be regarded as a fourth extreme regime, reflecting a universal passive response, but its manifest conflict with accepted domestic objectives warrants its exclusion.

In summary, increased economic interdependence will result in more varied and more frequent official and semi-official contact between nations—far more than foreign ministries can handle in volume, scope, or technical detail. As a result, the relative importance of foreign ministries in relations among the Western industrial countries will decline. Increased economic interdependence will also compel a reassessment of the prevailing model of world economic order.

The impact on foreign policy in the sense of national security is not likely, in the medium run, to be any greater than it was in the 1950s or the 1960s.¹² Such influence as there is will come through two channels: the tone of public attitudes toward foreign nations and the process of adjustment to imbalances in international payments. Public feelings of benevolence or malevolence toward particular foreign nations are easy to underrate because of their intangible quality; although they rarely prove decisive, they can influence the flexibility with which the executive can pursue foreign policy. In the absence of an adequate adjustment mechanism, balance-of-payments pressures can of course have very tangible effects on a nation's flexibility, as Britain and France have both learned during the past 15 years. These limits have been brought home to the United States in a variety of ways that range from the perceived need to tie foreign aid to procurement in the United States (the most important irritant in our relations with some countries) to the persistent pleas for reduction of force levels in Europe and elsewhere on

balance-of-payments grounds. Such pressures erode the confidence of other nations in our ability to carry out our stated commitments and objectives. What is clearly needed is the introduction of some instrument of control that would achieve a balance-of-payments adjustment among major countries but would also further the cause of international cooperation.

It is important to recall that most of the tensions between international transactions and the autonomous pursuit of domestic economic policy arise from the sensitivity of movements of goods, services, funds, firms, and persons to economic developments at home and abroad, and not from the absolute magnitude of the flows. The value of trade to a country, in terms of its contribution to national welfare, may depend neither on the sensitivity nor on the magnitude of the flows, although it is more likely to be related to the magnitude than to the sensitivity. Indeed, value and sensitivity are inversely related in one important respect: High sensitivity results precisely from the capacity of a country to substitute domestic for foreign production or investment, in response to relatively small margins of advantage; yet when such substitution is easily possible at relatively low cost, the value per dollar of trade or investment to the country is correspondingly diminished. (It is of course possible that the total gains from trade remain high even when the gains close to the margin are small, so that sensitivity is high up to a point but not beyond that point.) Where the total gains from trade are high, preservation of trade becomes a matter of high foreign policy, as it is sometimes called, or even of national security. Thus, a high value placed on trade may lead countries to war over it, as it led Japan in 1941 to attack the Philippines and the U.S. fleet at Pearl Harbor to remove threats to its oil trade with the East Indies. Increased interdependence in the sense used here will greatly reduce that risk, but it will also greatly increase the intrusion of international transactions into domestic affairs, thereby augmenting and aggravating a very different range of problems in foreign policy.

Growing economic interdependence thus negates the sharp distinction between internal and external policies that underlies the present political organization of the world—sometimes called the Westphalian System, after the treaty that marked an end to the universalism of the Middle Ages—into sovereign, territorially-based nation-states that are inviolable in their domestic actions and subject to voluntarily agreed rules and conventions in their foreign policies (including war).¹³ The growing interdependence of the world economy creates pressures for common policies, and hence for procedures whereby countries discuss and coordinate actions that hitherto were regarded as being of domestic concern exclusively. These pressures arise because market forces increasingly circumscribe the ability of nation-

states to achieve their desired aims, regardless of their formal retention of sovereignty. Where autonomy implies success in achieving objectives and not merely the freedom to make futile attempts to achieve objectives, some autonomy in policy can actually be restored by yielding sovereignty in certain areas.

The Westphalian System formally treats all nations as equals, and diplomatic forms preserve that fiction. But there are many important asymmetries in the world, so that "interdependence" is not always even-handed in its circumscribing impact. The asymmetries do not, however, always favor the larger countries. It is true that the United States, by virtue of its relative economic size and the international use of its currency (which in turn is partly related to size), retains much more autonomy in the use of monetary policy for domestic purposes than do other countries, for its own actions strongly influence world monetary conditions. Tight money in the United States means tight money in the world (as in 1969), with capital inflows eroding the tight-money position only modestly. Similarly, the importance of American investment abroad means that American corporate-tax practices (and in particular the provisions for crediting foreign taxes against U.S. corporate-tax liabilities) have a strong influence on corporate-tax treatment in other countries, thereby preserving some autonomy for the United States.

On the other hand, small countries are sometimes in a more favorable position to exploit the international rules and the increased mobility of firms and funds than large ones. Like an oligopolistic firm, a large country must be alert to the reactions of others to its own actions; it must concern itself with the viability and stability of the system as a whole. The small country, in contrast, can, within limits, consider the system as being beyond its influence and can therefore act freely in ways that, if generalized, would alter the system, often for the worse. It can act with impunity so long as the resulting movements of funds or firms remain relatively small—that is, so long as they do not threaten the system as a whole. Thus we see the emergence of "flags of convenience" and their analogs in matters of corporate structure, disclosure of information, and taxation.

Throughout this discussion the less-developed countries have been largely excluded from consideration. This is not because their problems are unimportant, but because economic interdependence among the developed countries is moving so rapidly that it creates a common range of problems among countries with broadly similar objectives and institutional setups and therefore calls for common and often collectively agreed solutions. The European Economic Community as a center for economic decisionmaking is rapidly becoming obsolete in the face of growing economic interdependence; the United Nations, on the other hand, is much too large and

reflects much too diverse a range of economic concerns among its members to be a useful instrument for international collective action in this area. An unhappy by-product of relying on a small group of largely industrial nations, a rich man's club, is the accentuation of the perceived differences between the rich and the poor. As time goes on, problems facing the initial group will undoubtedly spread; therefore the club should have a flexible approach to membership, as required by the problems at hand. A much broader group will be appropriate for some issues, for example in defining the relationship between foreign-controlled firms, host governments, and home governments. But even here the concerns and anxieties of less-developed countries, still groping for national identity, may have quite a different character from those of more mature and more self-confident countries, and this in turn will require different solutions.

Notes

1. This definition of interdependence contrasts with that implicitly used by Kenneth Waltz, who emphasizes the importance of foreign trade to the welfare and security of the countries under consideration. See his "The Myth of Interdependence" in C. P. Kindleberger, ed., *The International Corporation* (Cambridge, Mass., 1970). As will be made clear below, trade may become less valuable to countries at the same time that it is becoming more sensitive to price, income, and other economic variables, and indeed for the same reasons.
2. For a more systematic review of the evidence of increased interdependence, see Cooper, *The Economics of Interdependence* (New York, 1968), chaps. 3–5; Cooper, "Towards an International Capital Market?" in C. P. Kindleberger and A. Shonfield, eds., *North American and Western European Economic Policies* (New York, 1971).
3. This second form of integration corresponds to what Karl Kaiser has called "intergovernmental regional subsystems," to be distinguished from "transnational society subsystems," of which economic integration through joined markets would represent one possible example. But joined markets also create pressures for intergovernmental action. See his "The Interaction of Regional Subsystems," *World Politics* 21 (October 1968): 84–107.
4. The term "autonomy" is preferred here to the more usual "economic sovereignty." In fact, nations retain actual as well as legal control over their instruments of policy (sovereignty); the problem arises because these instruments of policy lose their effectiveness, so that countries find themselves able to pursue their objectives but unable to achieve them.
5. For a general discussion of these issues as they affect foreign investment, see Charles P. Kindleberger, *American Business Abroad* (New Haven, Conn., 1969).
6. Or worse. In 1963 Britain threatened to seize Pan American and TWA planes if the CAB did not back down from its insistence on regulating transatlantic fares.

7. The actions by Britain, Denmark, and the Netherlands to halt "pirate" radio stations operating off their coasts in international waters also represent extraterritorial claims to jurisdiction, as does the unilateral extension by Ecuador, Peru, Chile, and Iceland of territorial claims far into international waters in order to control rich fishing grounds.

8. C. Fred Bergsten ["Taking the Monetary Initiative," *Foreign Affairs* 46 (July 1968): 713–732] discussed the proposal but rejected it. It was, however, put into force by President Nixon while this essay was going to press.

9. This has long been true of trade policy, of course, and this fact has set trade policy apart from other aspects of foreign policy—a much wider range of political interests and persons had to be brought into the picture. Indeed, in the early 1930s, tariffs were considered exclusively a matter of domestic concern. Such success as trade policy has had as foreign policy has hinged on the brilliant idea of reciprocity, which in effect pits one set of domestic economic interests against another and thereby restores to the executive some of the freedom of action that he has in other areas of foreign policy. On the general relationship between domestic politics and foreign policy in Britain and the United States, see Kenneth N. Waltz, *Foreign Policy and Democratic Politics* (Boston, 1967). Curiously, Waltz does not discuss trade policy at all; if he had, he might have qualified his judgment that the American executive has more scope for pursuing foreign policy than does the British prime minister.

10. A proposal along these lines can be found in Cooper, "Sliding Parities: A Proposal for Presumptive Rules," in George N. Halm, ed., *Approaches to Greater Flexibility of Exchange Rates* (Princeton, N.J., 1970). This volume contains extensive discussion of a number of similar proposals.

11. Some years ago Gunnar Myrdal identified and lamented the tension between the national pursuit of domestic objectives that are desirable in themselves and the preservation of an integrated international economy. He argued that the growth of the welfare state had led to disintegration of the world economy. I believe that this judgment unduly idealizes the "integration" of the world economy before the rise of the welfare state and that, in any case, it is premature; however, the tension between national pursuit of national economic aims and the attainment of harmonious and unrestricted international transactions is certainly present, and indeed will become more acute. See Myrdal, *Beyond the Welfare State* (London, 1960), especially chap. 10.

12. This statement did not anticipate the extraordinarily aggressive response of the United States in President Nixon's New Economic Policy of August 1971. The imposition of the 10 percent surcharge on imports and the declaration that the dollar would no longer be convertible into gold, without any prior consultation even with our closest allies, are bound to induce others to reexamine their dependence on and their trust in the United States in matters of national security, and may even accelerate the proliferation of nuclear weapons.

13. See Richard A. Falk, "The Interplay of Westphalia and Charter Conceptions of International Legal Order," in Richard A. Falk and Cyril E. Black, eds., *The Future of the International Legal Order*, vol. 1, *Trends and Patterns* (Princeton, N.J., 1969).