

**BILDERBERG
MEETINGS**

**VILLA D'ESTE
CONFERENCE**

24-26 April 1987

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NOT FOR QUOTATION

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FOREWORD

This report is an account of the proceedings of the 1987 Bilderberg Meeting at Villa d'Este, Cernobbio, Italy. Working papers and panelists' opening remarks are presented in their entirety, with minor editing. Discussion sections, which incorporate panelists' closing remarks, are organized according to subject matter. Thus, individual remarks and interventions are not necessarily reported in the order in which they were made.

Grant F. Winthrop
Rapporteur

INTRODUCTION

The thirty-fifth Bilderberg Meeting was held at the Grand Hotel Villa d'Este, in Cernobbio, Italy on April 24, 25, and 26, 1987. There were 106 participants from 19 European countries, the United States, and Canada. They represented government, diplomacy, politics, business, law, labor, 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 governments or organizations to which they belonged. As is usual at Bilderberg Meetings, in order to permit frank and open discussion, no reporting of the conference proceedings took place.

In opening the conference, Lord Roll of Ipsden, the Chairman of the Bilderberg Meetings, welcomed the participants. He then reviewed the conference program and procedures. Finally, he took note of the death of Jack Heinz, a founding member of Bilderberg and one of its most loyal and effective supporters.

I. STRATEGY TOWARD THE U.S.S.R.

Moderator: Andrew Knight
Panelists: Egon Bahr
Henry A. Kissinger
Renato Ruggiero

II. POLICY TOWARD TRADE AND PROTECTIONISM

Moderator: Alfred Herrhausen
Working Paper Author: Helmut H. Haschek
Panelists: Etienne Davignon
Paul A. Volcker
John C. Whitehead

III. THE PUBLIC SECTOR AND ECONOMIC GROWTH

Moderator: David Rockefeller
Panelists: Edouard Balladur
Richard G. Darman
Romano Prodi

IV. CURRENT EVENTS: CHINA

Moderator: Lord Roll of Ipsden
Panelists: Winston Lord
Otto Wolff von Amerongen

V. THE ARMS CONTROL DEBATE

Moderator: Charles McC. Mathias, Jr.
Working Paper Author: John S. Foster, Jr.
Panelists: Christoph Bertram
Maynard W. Glitman

CHAIRMAN:

LORD ROLL OF IPSDEN*
Joint Chairman, S.G. Warburg & Co., Ltd.

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Professor of Money and Banking, University of Limburg

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			LIE	H.S.H. PRINCE	
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			USA	WINSTON LORD	Ambassador to the People's Republic of China
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DEN	UFFE ELLEMANN-JENSEN	Minister for Foreign Affairs	POR	JOSÉ EDUARDO MONIZ	Director of Information, RTP (Portuguese Television)
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IRE	GARRET FITZGERALD	Former Prime Minister	ITA	MARIO MONTI*	Professor of Economics and Director of the Centre for Monetary and Financial Economics, Bocconi University, Milan
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UK	PAUL GIROLAMI	Chairman, Glaxo Holdings PLC	NETH	H.R.H. PRINCE CLAUS OF THE NETHERLANDS	
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FRG	THEO SOMMER*	Publisher, "Die Zeit"
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FRA	HUBERT VÉDRINE	Former Foreign Policy Adviser to the President
USA	PAUL A. VOLCKER	Chairman, Board of Governors of the Federal Reserve System
NETH	JORIS J. C. VOORHOEVE	Parliamentary Leader of the VVD
AUS	FRANZ VRANITZKY	Federal Chancellor
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UK	WILLIAM WALDEGRAVE	Minister for the Environment, Country- side and Planning
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USA	LYNN R. WILLIAMS	International President, United Steel Workers of America
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SPA	JUAN A. YÁÑEZ-BARNUEVO	Director, Department of International Affairs of the Office of the Prime Minister
TUR	ZEKERIYA YILDIRIM	Governor of the Central Bank
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RAPPORTEUR

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IN ATTENDANCE

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USA	CHARLES W. MULLER	President, Murden and Company
ITA	ALESSANDRO VANZETTO	External Relations, Fiat S.p.A.

*Member of the Steering Committee

**Member of the Advisory Committee

LIST OF ABBREVIATIONS

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

Opening Remarks from the Panel

I.

In 1968, the Soviet Union put an end to the Prague Spring by invading Czechoslovakia. At that time, we should have helped to bring about a Prague Spring in Moscow because the Czechs were not likely to invade the Soviet Union.

For two years now, we have been witnessing exciting occurrences in the Soviet Union, with unforeseeable consequences. Before devising a Western strategy, we must try to analyze the true nature of what is happening there. We are witnessing an historic attempt to reform the Soviet system. To be more precise, we are observing an attempt to adjust a country to the fantastic acceleration of scientific and technological progress worldwide, so that it does not fall hopelessly behind in global competition.

Gorbachev has said, of the current situation, that there can be no turning back, but the point of no return has not yet been reached. The system's capacity for reform is to be tested, without actually changing the system's basic structures. How far this is possible in theory is a question that can be left unanswered at the moment. How far it is feasible in practice depends not least on whether the Soviet leaders are supported by enough sufficiently capable functionaries.

This may be in doubt. Most probably, Gorbachev has already suffered his first disappointments and disillusionments. Yet, it is noticeable that his efforts have become more systematic and his language sharper and more direct. He is pressing like someone who has little time.

In two to three years at the most, we shall see how far the limited reforms have succeeded. If the desired results have not yet appeared, the leaders will have to decide whether reforms within the system need to be supplemented by reforms of the system itself.

Moscow's domestic course is accentuating the differences among her European allies. These governments are confronted with domestic difficulties generated by Moscow. The leading power evidently accords higher priority to its own interests than to considerations of its allies. It is not possible for the Soviets to force their allies to conform, because the process underway in the Soviet Union is highly complex and its consequences still unforeseeable.

The Soviet leader is the youngest in the East bloc. Compared with him, others seem like Stalinist fossils, not least for reasons of age, likely to vacate their posts in the next five years. Poland is an exception, once again. The new generation of leaders will probably possess characteristics more managerial than ideological. This is the more likely the firmer Gorbachev is in his aim of carrying out his plans by the Year 2000.

While Moscow's new domestic course is viewed by most of its European allies as more or less narrowing their scope, Gorbachev's foreign policy initiatives, notably in the field of arms control, are greeted enthusiastically, and are perceived by the allies as widening their own room for manoeuvre. They welcome any development that promises a lighter military burden, as well as controlled, guaranteed stability. In this respect, the views of small and medium-sized countries in Eastern and Western Europe do not differ much.

When he came to power, Gorbachev faced a situation that must have been very gloomy. From 1975 to 1978, there had been economic stagnation, and from 1979 to 1984, a one percent decline each year. It became possible to calculate when the Soviet Union would degenerate into a second- or third-rate power. The gap between East and West in modernization and in the rate of economic restructuring was becoming appreciably larger. The only field in which the Soviet Union had achieved its claim to parity with the United States was that of military power. It had attained the state of mutual assured destruction, but not one in which military superiority could produce victory.

The new Soviet leadership could not fail to realize that a continuation of this system of ossification and self-delusion would undermine the system's very historical validity. It has become evident that the Soviet Union cannot escape the objective laws of rapidly evolving science and technology. They are the same laws the West is subject to, but we are clearly better able to cope with them.

Of course, Gorbachev believes in Communism. The reformer Martin Luther was also a

believer. In the long run, Gorbachev, too, can achieve more than a mere reform of his existing church, whose pope he has become. Of course, Gorbachev does not carry out reforms to please the West, but in order to become competitive again. Of course, democratization within his system does not imply democracy along Western lines. And of course, openness and diversity of opinion, even in Soviet publications, do not amount to pluralism of the kind that we enjoy and cherish. But once the flame of this new way of thinking, of individual responsibility and openness has been ignited, who can tell what hitherto dark corners it will light up?

The conclusions which Gorbachev has drawn from this essentially depressing situation for his system are as simple as they are bold; power or security is still the central issue. Since power can no longer be applied by means of weapons at the other's expense without risking one's own destruction—in other words, since there can now only be joint security—any military superiority has become meaningless. It is sufficient to retain a capacity for mutual assured destruction, or, better still, to seek the lowest possible level of mutual security.

To obtain resources of economic relevance, the reduction of conventional weapons is more important than that of nuclear arms. This explains the Soviet Union's readiness to reduce the conventional superiority of the Warsaw Pact forces to obtain stability, which insures a mutual capacity for defense, but not for a major conventional attack. This would also require a change in Soviet strategy, which we in Western Europe consider to be offensive. The Soviet Union is willing to make this change. Considering that neither East nor West has tabled negotiable proposals for conventional stability in Europe, Western concepts would be all the more desirable because only at the negotiating table can we ascertain the true scope of Moscow's theoretical declarations of intent. Of course, this would also have consequences for the Western strategy of flexible response.

What, as a result of this analysis, are the new approaches for Western political strategy? The threat posed by the Soviet Union and its allies does not emanate from either its ideology or its economic appeal. It is attributable solely, or at least predominantly, to Soviet military strength. Neither the social models nor the living standards of the East bloc pose a threat to us, but Soviet tanks and missiles do. Whoever eliminates this military threat simultaneously does away with the Soviet threat. This is especially important because of the possibility that the Soviets may be tempted to engage in military adventures as a way out of the crisis its system may face in a few years' time.

It is not in the Western interest to continue the competition with the East in the only field where the latter is strong, if it is possible to shift the competition to the two fields where the Eastern system is weak—its ideology and its economy. Such a shift in the competition does indeed appear possible in view of the changes of course initiated by Gorbachev.

Holding Gorbachev to his word implies that the West should put forward proposals aimed at achieving military stability. That means the elimination of superiority wherever it exists, the preservation of a defense capacity based on mutual assured destruction, and, hence, the downgrading of the military factor so that political and economic factors predominate.

All of the approaches discussed up to now for attaining balance and stability of strategic weapons do not, incidentally, alter the fact that the West enjoys a geostrategic advantage. If this advantage could be supplemented by conventional stability in Europe, which the Soviet Union claims to be seeking, we could then have achieved a historic breakthrough—security against the Soviet military threat.

We can take advantage of this opportunity in the coming years, regardless of how much progress Gorbachev makes with his reforms. The West must not create the impression that it opposes arms reductions. On the contrary, the West should assist the Soviet quest for reform by depriving the Soviet Union of her trump card, military strength.

In the past, one might have doubted the position of Henry Kissinger, who was disappointed that the treaties aimed at detente, which were concluded in Europe and functioned in Europe, did not lead to Soviet restraint outside of Europe as well. For a Western strategy toward the Soviet Union in the present-day situation, however, a global approach is imperative. In other words, Western proposals should include a charter in which, at a minimum, the two superpowers agree on certain rules governing their global conduct. The documents that Ford and Brezhnev signed at Vladivostok can and should be developed further. The Soviet Union can only obtain relief

from competition in the arms race by appropriate conduct around the world.

By such a strategy, the West could regain the active role, and the full support of the Europeans, and perhaps even the Eastern Europeans. It is thus not denuclearization of the world that appears achievable by the year 2000, but the replacement of military confrontation by peaceful competition between the two systems. All we want is security. Elimination of the danger of military conflict necessary for purely peaceful competition of the systems and ideologies can take placè—as it must, from a historical point of view. There is ample reason to be optimistic about the outcome of such a competition.

Opening Remarks from the Panel II.

It is certainly not the first time that the Western World is facing a dynamic Soviet policy in favor of disarmament, nor is it the first time that we have a new Soviet leader promoting economic reforms coupled with the so-called liberalization of the Communist society.

Each time the West has been faced with this situation, a debate has taken place, with hopes and skepticism confronting each other. On one side were people asserting that we should take almost for granted that a new era was dawning in the Soviet Union and that we should immediately respond favorably in order to help positive movements in Soviet society to develop. For example, in 1960, when Khrushchev was challenging the West in Berlin while at the same time Sino-Soviet relations were deteriorating, some in the West argued that we should help Khrushchev in his policy toward Berlin in order to improve relations between the two Germanies, to avoid a compromise between the Soviets and the Chinese, and to prevent a reversal of his economic reforms and a return to a more conservative, Stalinist style of leadership. These arguments were wrong.

There are also those in the West who believe there is no possibility of positive movement in Soviet society or of improvement in East-West relations, simply because Soviet leaders are Communists. This argument is wrong, too.

Now that we are facing a young, brilliant, and imaginative Soviet leader, the debate in the West is even more intense than in the past. Certainly, Gorbachev is a different sort of leader from his predecessors. For him, the Russian Revolution is no more than an historical event, as the First World War is for many of us. His personal experience of the Stalinist era was limited. He represents a new generation of Soviet citizen and of Soviet apparatchik. His main concern is not to change the Communist regime, but to improve economic performance. He is aware of his country's immense resources. But he is also aware that the Communist regime has failed to modernize agriculture, that industrial development has been characterized by poor performance, low productivity and a waste of resources. He understands that a modern Soviet Union has to come to grips with the technological changes faced by every modern society. He needs more than millions of poorly-skilled and unmotivated workers; he needs the engagement of the intellectual class and of the technicians.

Will he succeed, or will he fail? Will he be in power for a long time, or is he a transitional figure? These are open questions. But what is relevant for the West is how Gorbachev's domestic policies affect his foreign policy, where perhaps his greatest strength is in his public relations ability, in his capacity to use the most effective arguments to capture the attention of Western media and public opinion.

Gorbachev's dynamism is continuously changing, as he changes the linkages in the field of disarmament. This sometimes goes beyond the Alliance's ability to adapt and respond adequately. We have not yet defined a common strategy to deal with Gorbachev. This is, first, because of the differing sentiments in the U.S. and Europe, which he fully exploits.

When Chancellor Schmidt campaigned for the deployment of the Euromissiles, his deep motivation was to improve the coupling of Europe's defense with that of the U.S. in the new situation of nuclear parity between the two superpowers. The deployment was justified on the basis of the new threat posed to Western Europe by the the Soviet deployment of the SS-20. The argument that won over our parliaments and our public opinion was the zero option, an

argument not based on security, but on the need to get approval for own deployment.

Now we face the zero option once again, still in a situation of nuclear parity between the U.S. and the Soviet Union. We cannot go back. We are democratic governments, and the zero option was our proposal. It would be very difficult to explain to our publics why we should retreat from our own proposal, which will bring about the removal of 1300 Soviet and almost 200 U.S. warheads.

But this is not the end of the story. When, after Reykjavik, the zero option for INF became a real prospect, some in Western Europe began to point out the necessity to deal with the imbalance in short-range INF. The Soviets have reacted promptly, proposing to extend the zero option to SRINF with a range between 500 and 1,000 kilometers. Here, too, is an offer not easy to refuse. It means the unilateral elimination of Soviet missiles, because the U.S. has no missiles of this category deployed in Western Europe. We could propose to match Soviet SRINF, perhaps at a lower level. But, then, we would have to explain to our parliaments and publics that, while we are removing some missiles, we are deploying others, instead of accepting unilateral elimination of Soviet missiles.

Why does Western Europe still feel uneasy and insecure at this stage? It is certainly not true that the zero option for INF, including SRINF, will denuclearize Europe. There will still be U.S. nuclear-capable aircraft, like the F-111, as well as short-range weapons, nuclear artillery, and submarine-launched ballistic missiles dedicated to NATO.

But aircraft and submarines are much more mobile than land-based missiles. The strategy of flexible response should be reviewed in the absence of INF, as the U.S. nuclear commitment to defend Western Europe would appear to be weakened—at least its most visible and valuable part. When we accept the zero option for INF, it perhaps will be more difficult to draw the line where we stop the zero option for other weapons. And it is not at all certain that the line we draw will not represent a new imbalance, not in our favor.

Decreasing nuclear weapons in Europe increases the value of conventional forces. And the greater importance of conventional forces will increase the responsibility of Western European governments in terms of financial efforts, common research and development and production, and integration of armed forces. It will also be an important chance to make real progress toward the creation of a European political authority. There is a strong awareness of the challenge we face in Western Europe and the need to move ahead.

The importance of the French and British nuclear deterrents will increase in the eyes of the non-nuclear Western European states, but their modernization will face difficulties in a climate which foresees fewer nuclear weapons in Western Europe. And it will not be easy to clarify what more direct role these deterrents will have in the defense of Western Europe.

A European security effort in conventional forces requires a new understanding with the United States. First, how do we improve the coupling of our defenses in this new situation? Second, how do we decrease the skepticism of the U.S. toward every European effort in the field of defense and security? There must be a change of mood in Washington about the strengthening of the Western European Union. Americans cannot complain if European foreign ministers discuss, in the framework of E.C. political cooperation, questions related to European security, including the question of INF. What is important is that we clearly define what a strengthening of the European pillar of the Alliance will mean, and what will be the responsibilities of both pillars.

Last but not least, Western Europe is confronted in its relations with the U.S. with a certain globalization of our differences in non-military fields: trade agriculture, exchange rates, and growth. From a Western European viewpoint, the credibility of the coupling with the U.S. also involves improving our monetary, macro-economic, trade, and agricultural policies. An American economy whose foreign debt will amount to \$950 billion in 1991—17 percent of its GDP—creates a situation of great concern in Western Europe. The deal, unspoken up to now, is that Western Europe and Japan are financing the U.S. deficit and the U.S. is providing for our defense. But we are now entering a situation where there are perhaps fewer possibilities for Europe and Japan to finance the U.S. deficit, and perhaps, too, less credibility that the U.S. is continuing its defense commitment. There is also the question of the falling dollar, which could bring about worldwide recession without restoring the competitiveness of the American economy. And the recurrent threats of reducing the American military presence, even in the conventional field, in Western Europe to alleviate the U.S. fiscal deficit are certainly not the best arguments to convince Europeans that we can rely on the same American commitment to defend Western Europe that we had in the past.

There should not be two strategies to deal with Gorbachev—an American one and a European one. That would be no strategy. A strategy implies more unity between Europe and the U.S. This, in turn, implies an improvement in the coupling of our defense, in strengthening the European pillar, and a common readiness to exploit all the possibilities of improving our relations with Moscow, while keeping our unity and security.

The alternative will be a gradual disruption of the Alliance and of European unity, with an increase in the appeal for European countries to try to get guarantees from Moscow. This will certainly not guarantee our freedom and security as we have had them up to now.

Opening Remarks from the Panel

III.

The idea that the problem of East-West relations will be solved by conversion is not new; it has been around since the 1940's. Harry Hopkins wrote from Yalta that "there was no doubt we could get along with the Russians," as long as they were led by Stalin, who was "reasonable, sensible, and understanding." In the words of a U.S. Senator from that era, the Soviet Union had been "approaching for years the abandonment of Communism." *Fortune* magazine wrote that Russia, after World War II, would "prefer the peace of Europe to expansionism" and would "focus on the development of her enormous domestic resources." And Averill Harriman said that all Khrushchev wanted was domestic development, and his only obstacle was the Western tendency to force him into an arms race.

Today, we still have this temptation to believe that one morning a Soviet leader will emerge who is dedicated to peace. But then what? The content of peace appears self-evident, but, in the whole literature of containment, there is very little about what happens on the magic day when the situation of strength is conveyed to the Soviets, and they appear in the conference room and say they are ready to negotiate.

What is the Western conception of peace? Does it have an objective reality, or is international conflict a personal quarrel between leaders to be handled by essentially psychiatric methods? President Eisenhower once remarked that "our many post-war conferences have been characterized by too much attention to detail, by an effort to work on specific problems rather than to establish the spirit and attitude in which we shall approach them, and I shall work to remove distrust." President Reagan replicated this quotation before he went to Geneva. This is one of our basic problems—the psychiatrization of foreign policy, the refusal to face either the historic realities of Russian expansionism and of Russian concepts of security or the political realities of the objective causes of tension, which must be removed if any benefit is to be achieved.

Those who say there is an attempt going on in the Soviet Union to change the domestic system are correct. Gorbachev has recognized that, if the Soviet Union pursues its domestic evolution, it will return to the dilemma of Peter the Great, and be, after 400 years of suffering, an underdeveloped country with a huge military machine. What should be considered, however, is the question of what is the foreign policy consequence of that for the West, and in what way, if at all, do we help Gorbachev. (We should not hurt him, but we do not know enough about the internal dynamics of the Soviet system to make helping any Soviet leader an objective of Western policy.) But, assuming this were our objective, Gorbachev's position can be analyzed as follows.

It is doubtful that he can carry out his domestic reforms. It is striking that members of the Politburo, after describing their objectives, can not say how they are going to carry them out. This is unheard of with Soviet leaders, who usually march from truth to truth. But whether Gorbachev can succeed or not, he must be meeting substantial resistance in the planning mechanism from managers on the domestic side. He may have support from the military and the KGB for the reason that, since they are in direct competition with the outside world, they understand the relative position of the Soviet Union better than do the purely domestic apparatchiks. If that is true, one cannot imagine Gorbachev, already in conflict with his domestic apparatus, going to the military and the KGB and proposing concessions to the West that the West hadn't asked for, in order to alleviate the spirit of and ease relationships with a group that believes psychology is the result of objective conditions, and not the other way around.

Therefore, we may not even be doing Gorbachev a favor by permitting him to pick up those Western proposals that he can justify to his apparatus by saying, "The difference between Gromyko and me is that, when (the West) made a silly proposal, Gromyko thought it was a devious one and spent two years analyzing it. Dobrynin has convinced me that what you see in America is what you get, or you get what you see. You can therefore afford to take proposals that seem against (the Western) interest." Our curse is that we have no strategy. We have some vague, general objectives—disarmament, reduction of nuclear weapons, trade—that you cannot disagree with. But we have not figured out a balance of risks and incentives to get us from here to there.

The INF situation is worrisome. It was put forward in the wake of the abandonment of the neutron bomb for one reason—to deal with the problem that the U.S.-based American strategic nuclear deterrent could no longer be credible for the indefinite future, and some political coupling was needed. Since nobody dared to say this on either side of the Atlantic, the INF deployment was rationalized on the basis of countering the SS-20's. This was nonsense. The INF missiles were never going to shoot at SS-20's. It was then put forth that, if there were no SS-20's, there would be no need for the U.S. missiles in Europe, and so the zero option was born, making a military equivalent out of a political necessity and comparing incomparable issues.

The SS-20 is a Soviet military weapon, but the Soviet inhibitions to shoot at Europe with nuclear weapons is no greater or less whether the weapon is launched from Poland or the Soviet Union. The American inhibition to launch from across the ocean may be perceived to be greater, and the principle advantage of the land-based deployment was the establishment of an automatic trigger. That, in turn, created an opposition in the U.S. of the most diverse elements—those who were against all nuclear weapons, those who wanted to get control of the nuclear trigger, and those who didn't like the Europeans anyway.

Thus, a speech had to be made, in 1981, proposing the zero option—as a way to deploy, not to abandon deployment. Then came the short-range weapons, advanced, again, not on the basis of a rational analysis, but as a means of stopping the proposal that had been put forward, but that nobody really wanted. So now we are trapped in a position where the Soviets have accepted our proposals, and, in order to stop the acceptance of our proposals, we have made yet another proposal, which they have also accepted.

From none of this can you deduce that Gorbachev wants peace. The worry is that, with respect to Europe, those people in the U.S. who advocated no first use of nuclear weapons are eloquent in their description of how we can cover any conceivable target from the U.S. and how we have 4600 battlefield weapons left. But that doesn't deal with the political and psychological problems. What they are saying is that they would rather Europe be defeated by conventional weapons than use nuclear weapons. Leaving only battlefield weapons in Europe will have the practical consequence that Germany will become the only nuclear battlefield, and that these weapons will be in the hands of people least easy to control politically, simply because of their dispersal. The combination of these factors must inevitably produce a general trend toward denuclearization which cannot be eased by great statements of reassurance that cannot outlast the 18 months left in the administration, nor the domestic dynamics in which it has now become part of political wisdom that the way you deal with your opponents is to steal their program.

On the Soviet side, Gorbachev is selling these programs to the military and the KGB not as a means to end Soviet superiority, but as an offensive strategy. This, too, is worrisome. He may not have started out that way, and he might want to discuss a serious relaxation of tensions. But, like any political leader, he takes the line of least resistance, and, if we do not ask for things that modify his conduct, why should he do more than accept what we offer? Why should he tell us that we are starting a process in which the coupling of Europe to the U.S. will become progressively more difficult, and where the people who have sustained NATO for 20 years are becoming demoralized?

From what has been observed so far of Gorbachev, this appears to be a Soviet leadership that has the intellectual capacity to understand serious proposals. It may even have the willingness to examine them. It is certainly worth trying. The West should be faulted for not having come up with serious proposals. The West has solved its short-term domestic problems by co-opting its opposition groups wherever possible. One cannot find in what is now being negotiated any ability to describe one benefit to the West other than that we are getting an agreement. One can

describe the potential advantages to the Soviet Union. We have given the Soviets a veto over our nuclear deployments. (It had never occurred to anyone that the deployment of short-range nuclear weapons needed to be discussed with the Soviets at all.)

We are starting unfortunate trends in Germany and in Europe. (This leaves aside the warheads in Asia, whose practical consequence can only be the desire to get American acquiescence in a threat to Japan, Korea, and China in return for an absurd deployment in the continental U.S.) It is absolutely imperative for the Europeans to get serious about developing a strategy, not in opposition to the U.S., but in collaboration with it. America is a country that has gone now for 40 years of world leadership with no historic preparation for the relativities of balances of power, and now it is, itself, in the process of changing the composition of its leadership from the traditional European-oriented groups to those for whom Europe is a distant and emotionally less comprehensible area. It is not possible to have two separate policies, but to have two common policies, Europe must not be a lobbyist in our decision-making processes. Europe must have a view, and it will have a responsible view only if it does more than just critique American proposals.

Abolishing nuclear weapons is not an attainable, desirable, or worthy objective for serious statesmen in this period. Nuclear weapons can be mitigated, and they should be balanced. But we should stop talking nonsense that demoralizes our people by creating wrong impressions. We also need to discuss our economic relationship with the Soviet Union. There may indeed be an historic opportunity. We will not know this until we make proposals we can really believe in.

Gorbachev has asked why some oppose what happened in Reykjavik. The answer is because he and Reagan were discussing numbers that were prepared by technicians and that none of the leaders could have worked on themselves. They were not discussing the future—where we wanted to go as societies—which is what national leaders are most qualified to do. We still can do this, but it requires a totally different style of negotiation than is now being practiced, first within the Alliance, and second between the Alliance and the Soviets.

To quote Metternich, "Policy is like a play in many acts, that unfolds inevitably once the curtain is raised. To discuss the quality of the play is an absurdity. Once the curtain is raised, the play will be completed, either by the actors or by the audience that mounts the stage." The curtain has been raised, and our challenge now is whether the actors are going to complete the play, or the audience that mounts the stage.

Discussion

An American opened the discussion by framing some of the questions that the West faced in formulating a strategy toward the Soviet Union. What was the probable evolution of events in the Soviet Union? How long would Gorbachev be in power? The examples of Khrushchev and Kosygin indicated that failure was possible. Certainly Gorbachev had domestic opposition, notably from the bureaucrats and some of the old guard. Even Gromyko, who had been instrumental in putting Gorbachev in power, now seemed less enthusiastic about him, albeit more on questions of timing than of substance. On his side, Gorbachev appeared to have the KGB, the military, and the intellectuals, as well as support among the general public.

What did Gorbachev mean when he spoke of democratization? Presumably, he was not talking about Western-style democracy? And when he talked about private initiatives, what did he mean? As a dedicated Communist, it was unlikely he would significantly loosen up the central planning of basic industries. What were his chances of economic success? And what would happen if he failed to get the economy moving? Would it be because he had not gone far enough, or because he had simply failed? In shaping its strategy toward the Soviet Union, the West should determine whether there were opportunities for economic cooperation with the Soviet Union that would be in both our interests.

A Norwegian speaker cautioned that the West should be careful in its analysis of the implications of Gorbachev's reforms on the Soviet military threat. Did the reforms change the nature of the threat? Was there a change in long-term Soviet strategy, or merely in the tactics used to achieve the same goals of expansion and domination? *Glasnost* and the reforms, while

they might be the first steps in a process leading to a less expansive Soviet Union, had not yet created a new and less dangerous situation.

In the meantime, if the West was too quick to conclude that the Soviet threat had diminished, we risked providing the Russians with the temptation and opportunity for expansion, thereby increasing the threat we thought was reduced. We could not be sure whether the Russians were ready to abandon an offensive strategy. It was unlikely that the Soviet leadership really believed military superiority had become meaningless or that it was ready to reduce its conventional superiority. The Soviet reformers had not yet changed the character of the threat to the West because they had not yet altered the monopoly of power held by the Communist Party, nor the power of its leader to make decisions. Nor were there safeguards against a return to the methods and policies of previous leaders. Thus, while we should pursue opportunities for breakthroughs in arms control and for economic and cultural cooperation, we would be making a mistake to let down our guard in terms of maintaining a military balance.

Other speakers favored a cautious approach to the Soviet Union. A French speaker worried that the West might be making a mistake to assume that an economically stronger Soviet Union would mean more security. The opposite could be true, he warned. A German agreed that the danger to the West from a Soviet Union made stronger by Gorbachev's reforms could be greater if Soviet political objectives did not change. The West should adopt a cautious strategy, taking into account the causes for antagonism between East and West. These were not just military, but had to do with different ideologies and different understandings of history. They would be with us for a long time.

Another German speaker was rather more heartened by the course of events in Russia. Gorbachev was, in his opinion, serious about changing his country. This was particularly visible in the media, where *glasnost* had created a new kind of openness and enjoyment of controversial debate, through which Gorbachev was trying to foster public opinion in support of his efforts. There appeared to be no organized resistance to Gorbachev, but rather an inchoate opposition, mainly from those who benefited from privilege and sloth under the old system.

The West was faced, in its current dealings with the Soviet Union, with an historic opportunity to break the mold of the postwar world. An important shift had already occurred in Moscow. The current leaders now rejected the notion of the inevitability of war between the imperialists and the Communists. They realized there was one capitalist economic world, and they were ready to join it. In arms control, the Russians were offering real cuts, and we had to try to take them at their word, to probe their intentions. But we should not look at developments in the Soviet Union in the narrow perspective of arms control, for a much larger process was beginning. There seemed to be a kind of mellowing of the nature of Soviet policy going on, which, indeed, had long been an objective of Western policy. The Soviet Union would, at the end of this process, still be a great power, with its own set of interests. But it would be easier to deal with, and in that atmosphere, it would be easier for East and West Europeans to get along.

Another participant from Germany was equally encouraged. He agreed that we were faced with uncertainty about where the Soviet Union would be in three or four years' time; Gorbachev himself didn't know. Western strategy should be to stand together, to maintain our defense and our deterrent, and to probe. But the element of gloom which seemed to surround some Western assessments of developments in Russia was not justified. The kinds of statements Gorbachev had been making—about common security and about military power not being the determining aspect of security—were what Western policy had been seeking for 40 years. What had happened was a success story. We had stood together, looked after our defense, and now here was a Russian leader saying the kinds of things we wanted to hear.

At the heart of the discussion about strategy toward the Soviet Union was the zero-option INF agreement. The preponderance of opinion among speakers was that the West was committed to this approach, however flawed it might be. If we retreated from it, we would be courting disaster in terms of public opinion. Should we fail to reach an agreement on INF, a German warned, our governments would lose the credibility they needed to gain acceptance of arms programs in the

future. The effect on the Alliance would be devastating, added a Dutchman. A Belgian speaker argued that achieving an agreement on INF would give the West greater room to maneuver in the future. If we failed to reach an agreement now, nothing would happen for another two years because of the American political calendar. The result would be a public perception that the Alliance had missed an historic opportunity, a resurgence of pacifism, and, quite possibly, a paralysis of our ability to act.

Yet, a number of participants expressed grave reservations about the zero option. A Dane argued that we had misled our publics when we said our deployment of cruise and Pershing missiles was to counter the SS-20, when, in fact, the real motivation was to strengthen coupling. To argue, now, that sea-based weapons could provide coupling overlooked the psychological factor that land-based weapons were visible and sea-based ones were not. Added an American, the denuclearization of Germany, toward which the zero option seemed to be the first step, would create not just a military imbalance, but a psychological one. A French speaker argued that the zero option would give Gorbachev more security and would split the alliance.

It was true, said an American, that we had gone too far to back away from the zero option, but we should not delude ourselves into thinking we had accomplished a great success. The zero option would not reduce the nuclear or the conventional threat to Europe. And the addition of the short-range INF to the agreement created great psychological problems. All we got in return was the acceptance of our own proposals. Why could we not find a greater justification for an agreement than Soviet acceptance? A sensible strategy at this point would be to propose phased withdrawals of the INF missiles over a period of up to five years and immediately begin conventional negotiations, on whose successful completion the final phase of withdrawal would be dependent. This would give us three and a half years to complete a conventional negotiation. To say we wanted to take care of the conventional threat would not be a betrayal of our promise on INF.

An Irish speaker supported the approach of linking completion of an INF agreement to progress on the conventional front. To do so would restore our moral position. We would no longer be on the defensive, and we would gain the support of public opinion. With the long- and short-range INF removed from Europe, and perhaps battlefield nuclear weapons as well, the West would be faced with a serious conventional imbalance. While there might be problems in precisely defining a conventional balance, we should at least move in the direction of reducing Soviet conventional strength in Europe.

There were, in the opinion of several speakers, positive aspects to the current arms control situation. We had, in the view of an American, achieved an agreement by following through with our deployment. We had decisively shown that we could limit Soviet military power by demonstrating our own capacity to meet Soviet military challenges absent arms control. We had proved the unilateralists in the U.S. and Europe wrong by showing that arms control could only work in concert with a determined effort to maintain our capabilities. Gorbachev, said a German, had performed a very important service to the Western Europeans, who had been talking about doing without deterrence and about how arms control could solve all our problems. Now, Europeans were talking about closer Western European security cooperation—a lesson Gorbachev had unintentionally supplied. There had been a soberization taking place in Western Europe, a realization that perhaps we had been going about arms control the wrong way. This might help us develop a strategy. A Dutchman agreed, saying he found a mixture of fear and hope in Europe. The door was more open than ever for a better defensive organization in Europe. Whether any leaders were ready to walk through it was another question.

A Canadian speaker was encouraged by what he saw as a more sober European evaluation of Gorbachev. The euphoria with which his coming to power had been greeted had been considerably toned down. As to the incoherence between Europe and the U.S. on the arms control situation, it was not as unhelpful as it might seem. We were caught between the expectations of our public opinions and our strategic realities. Europe needed some time for its public opinions to develop. An irony of the current discussion was, in the speaker's view, that many of those most vocal in their concern about the possible use of nuclear weapons were least appreciative of what the introduction of SDI as a non-nuclear defensive system had done to enhance the possibilities of serious management of the nuclear balance. Finally, it was

premature to see a post-Yalta type of outcome to the present negotiations.

It was time to accept that the zero-option INF agreement was going to happen, said a Belgian speaker. But rather than look at an agreement as our objective, we should be focusing on what to do after an agreement was reached. In this, Europe faced particular responsibilities. If an agreement was reached, the post-war basis of the Alliance would end, and a new strategy would become essential.

In formulating such a strategy, Europe faced significant challenges. First, the European Community—the nucleus for European cooperation—had to get back to basics in order to define Europe's common political objectives. To do this, the E.C. would have to deal with more than just economic questions, but political and security ones as well. And it would have to deal with internal problems and differences that could stand in the way of defining the common objectives.

Second, what would be the U.S. reaction to an increase in European cooperation? The U.S. seemed increasingly impatient with multilateral organizations that limited its room to manoeuvre. Could the West return to the type of organization where the U.S. was involved, taking into account the genuine interests of both Europe and the U.S., but having one strategy?

Third, what would be the role of France and Britain in a European move toward greater political and security cooperation? Without their taking a leading role, the credibility of that move and of the development of a dialogue with the U.S. would be greatly affected.

Fourth, what would be the role of West Germany? Would it prefer to wait and see what developed with the Soviet Union? And would an increase in European cooperation, with a strong German commitment, appear as a danger or complication to the development of a relationship in between the two Germanies and with the Eastern bloc?

Our objective should be to return to an understanding on a basic strategy. To do this required initiative and leadership. Europe had to take the initiative and tell the U.S. that it was going to take action. To delay would exact a high cost for European unity and overall joint security.

A number of Germans made remarks about their country's role in a new European strategy. One said that all parties in Germany were prepared to participate in closer defense cooperation. But another worried that there could be new strains between West Germany and the rest of the Alliance. Some Germans might not want closer European cooperation in defense because they preferred the *status quo*. Whatever strategy Europe followed, said a Dutch speaker, it must avoid splitting Germany. There was a greater convergence of views there than there had been in a long time. Our strategy had to be to try to keep the German government and opposition as united as possible, and not to undermine that unity.

With respect to France, several speakers called for a greater role in and and some new thinking about European defense. A French speaker agreed that his country had a major responsibility, and that it was time to move. In fact, France had done a good deal, but perhaps too secretly. Now it was time for France to lift what remained of the ambiguity of its position in the event of war. This probably required a closer integration of its conventional forces. But it should keep its independent nuclear weapons. It was because France had this force that it could afford to be more cooperative with the Alliance in the conventional field. We should agree to exchange a higher nuclear threshold for France for a lower one in the Alliance. But France would take on this role only if it was clear that deterrence remained the focus of Western defense.

In order for the Alliance to have to develop a new strategy toward the Soviet Union, said an American, we had to understand three important changes that had taken place over the last decade with respect to East-West security problems: (1) the growth in Western public opinion of antinuclear feeling; (2) doubts expressed in Washington about the sustainability and desirability of deterrence; (3) the shift in Soviet strategy under Gorbachev in which the Soviet Union had substituted an earlier strategy of nuclear build-up for one of nuclear build-down through arms control.

The problem we were now faced with was to address the continuation of Gorbachev's strategy of attempting to maximize his conventional options in Europe by reducing or eliminating all nuclear weapons and turning Europe into a *de facto* nuclear-free zone. In approaching this problem, we had to be guided by three principles. First, we could no longer practice a policy of co-opting the arguments of our opponents. We must make the case publicly for maintaining

some level and mix of nuclear weapons in Europe for the defense of the Alliance. We had to draw the line between the zero option and some level of nuclear capabilities. Second, we must avoid Soviet efforts to discriminate among different members of the Alliance. An arms control agreement that left some Europeans less vulnerable to Soviet missiles and others more vulnerable was an approach to avoid. We also had to avoid being left with an unusable deterrent—one based on battlefield systems. Third, any further nuclear arms control agreements should be linked to progress in conventional arms control. And we should avoid adopting the idea of conventional deterrence. We could not totally eliminate nuclear weapons.

With respect to this last point, another American felt that, in reaching a common U.S.-European strategy, we had to keep in mind the disparity of assumptions prevailing within the two pillars of the Alliance. Americans wanted to believe President Reagan when he spoke of SDI rendering nuclear weapons ineffective and obsolete, because nuclear weapons, for them, meant the possibility of the U.S. being fired on by a hostile power for the first time since the War of 1812. Europeans, on the other hand, grew up with a war cycle, and nuclear weapons symbolized the hope of breaking and ending that cycle. We had to strive for a solution that preserved a minimum number of nuclear weapons to avoid a return to the war cycle in Europe.

A number of participants worried that we faced self-imposed obstacles in developing a strategy toward the Soviet Union. A French speaker said he was not optimistic because he did not see a strong leader anywhere in the West. All the Western governments were weak. And if no leader was there to take the right initiative, nothing would happen. The only leader today who had the initiative was Gorbachev.

An Irishman questioned the effectiveness of the deliberations of Western leaders. Political leaders devoted inadequate preparation and insufficient time to their discussions. They failed to think out issues with open minds, and to listen to each other rather than declaiming at each other.

An International participant felt that the failure to develop a common strategy was due to the lack of cohesion and of proper consultation in the Alliance. This was not so important in the past, with a more or less predictable Soviet Union, but, with Gorbachev, it was a different situation. As an alliance, we looked in disarray, and this was bad for our publics' perceptions of our leadership. This lack of cohesion and consultation went further than arms control, to our dealings with the Soviet Union on many matters. Either we had the wrong institutions, or we didn't use the ones we had properly. Certainly, NATO was not used properly by its member states. They talked about arms control but not about the other political things which were just as much the business of NATO as of other organizations. The consequences of our failing to get our act together would be serious in the end.

It was an American's view that there might well be an historic opportunity for a breakthrough in relations with the Soviet Union. But we were in danger of missing it because of the way we were manoeuvring. We were not making proposals that were in the mutual interest of both sides. We were not being honest with ourselves. The U.S., at the present time, did not have a strategic view for a number of reasons. Nor did the Europeans really know what they wanted. Both the U.S. and the Europeans had to analyze what they really wanted and needed, and, in making proposals, recognize the mutual benefit. We didn't seem to know what our opportunity was. It was up to us to define it.

II. POLICY TOWARD TRADE AND PROTECTIONISM

Working Paper

Hopes or Illusions? on GATT Negotiations

I.

Some optimists believe that the new round of trade negotiations which began with Punta del Este marks the resumption of liberalization in trade in a world economy increasingly disrupted by a multitude of trade barriers. If we regard this from a wider historical perspective we may feel that at the present this is more or less wishful thinking. Of course it was important that an agreement be reached to start a new round of trade negotiations. It was important that multilateralism prevail over bilateralism. Nevertheless the appalling discrepancy will persist between the development of imbalances in the flow of goods and services throughout the world and the development of currency movements. Trade restrictions of various forms and their containment (at least) will be discussed; but at the same time uncontrolled and increasingly unpredictable exchange rate developments will continue to influence and distort the flow of goods and services beyond all historical experiences. And these distortions will be many times worse than the effect of any trade policies however bilateral or multilateral they may be in the long run.

Even optimistic forecasts over the next five years show sluggish growth of the world's real gross national product and of world trade, no evidence that the basic disequilibria will be eliminated, in particular the current account deficits of the United States will continue to remain above \$100 billion thus exerting continued pressure on the real effective dollar exchange rate.¹

Whether progress will be achieved depends largely on which nation assumes leadership. The issue at stake is not whether this leadership role is desired. It falls upon the strongest, and this will continue to be the United States. However, if this is not assumed, and assumed in a credible way, then the world market for goods and services, and eventually the financial markets too, will be doomed to fragmentation. The price of fragmentation will be increased poverty worldwide, and less equality among the community of nations. Frameworks such as a new round of trade negotiations are a worthy environment, but they are not substitute for leadership.²

II.

If we consider world economic data over a long perspective, then the developments during the 30 years after the Second World War present us with an extraordinary scenario. So extraordinary in fact that, had futurology been in vogue at the time, anyone who had written a "concise history of 1987" at the end of the Second World War would have been consigned to the land of fantasy by even the most outrageous optimists if his vision of the state of development had approximated to the reality of the mid-seventies. This still applies even a decade later.³

1 Wharton Economic Forecasting Associates, World Economic Outlook; December 1986, Vol. No. 4.

2 G. Klepper, The Next GATT Round; Bilateralism versus Multilateralism. *Intereconomics*, September/October 1986, p.236.

although expectations have become somewhat different—more of a feeling of the morning after the night before.

Never before in history have so many enjoyed such lasting benefit so suddenly. It may be debated whether they have been made happier, but a decision about that would presuppose that anyone could agree on a definition of what it means to be happy. However, if we take a positive attitude towards life, then there is at least one yardstick of success that is beyond dispute, and that is the fact that we have succeeded in substantially extending the human lifespan. It may well be, although not very unexpectedly, that international distribution of income has not become more just, and that not all nations have partaken in equal measure of the general success. The fact is that today some four billion can be fed less badly than 2.5 billion were in 1950. To interpret this outstanding performance to be a failure, leading to disaster was the prerogative of the 'seventies—exactly that change in expectations which we mentioned earlier.

III.

A unique paradox becomes evident against this background. One can hardly conceive of any other area in economics where the conflict between economic insight and policy reality is more apparent than in trade policy. Economists are almost unanimous in supporting free trade as a good thing, yet there is practically no country which actually practices it except for Hong Kong, if the term country can actually be applied to the colony, and follows the economists' lead: nor does empirical data impress. The call is for trade barriers to protect jobs; yet in the most heavily protected areas in the industrial countries, jobs were not saved but lost.⁴

To take one telling example: During the period 1973-84, the United States lost 22% of the jobs in the textile industry, 18% in the clothing industry, and 54% in the iron and steel sector; the EC lost 46%, 43% and 42%; and Sweden 41%, 56% and 25% respectively.⁵

However, R. A. Gephardt, the first Democrat to declare for the Presidency, is reported to have taken a hard line on trade: "The next President, must be as tough in negotiating terms of trade as this President has been in negotiating with the Russians." In an article "Real-world Trade Policies are Making a Come-back", R. Kuttner proposes "an ingenious plan to auction import quotas to the biggest bidders, thus allowing the Treasury (of the United States) to collect some extra money for deficit reduction and to protect domestic producers—not mentioning, of course, who is to pay the difference.⁶

Quite clearly, the continually growing exchange of goods and services on an international level accounts for a very substantial share of this unique development, the characteristic feature of which was a movement step by step towards a free trade system. And the main reason for the system being able to develop in this direction at all can be very largely attributed to the world's biggest national economy, the USA. As history in general shows, *the development towards a free trade system is largely determined by the fact that the system is forced by a "hegemonic power"*. A comparison here might be the role of Prussia during the days of German Customs

3 It speaks for the viability of the "GATT-system" that the 1973 oil price shock initiating a turbulent decade of changing relative world market prices together with a world-wide recession comparable only to the Great Depression set off quite a different reaction than then—the "New Protectionism" in the form of sector agreements and country specific NTBs notwithstanding—through this was largely achieved through the recycling efforts of the private financial institutions condemned so vigorously a decade later.

4 The paradoxon is based on the unique assumption that if everyone in a group of individuals or firms had some interest in common, then there would be a tendency for the group to seek to further this interest. It was supposed that if workers, farmers, or consumers faced monopolies harmful to their interest, they would eventually attain countervailing power. However, a larger number would at best succeed in advancing the cause to a small (imperceptible) degree. They therefore will not act in their self-interest. The same is true for governments. If governments produce only collective goods that go to everybody there is no inducement to contribute to their support. It is different when governments provide something else than collective goods. Then special interest groups gain leverage and are able to act contrary to the common good (the most protected have continued to decline such as agriculture, textiles and steel; with similar prospects for the US automobile and chip industry) despite enormous cost to the consumer.

M. Olson, *The Rise and Decline of Nations; Economic Growth, Stagflation and Social Rigidities*; New Haven; 1982, p. 21 ff.

5 *International Trade* 85-86, GATT.

6 *Business Week*, March 16, 1987.

Union, or of Great Britain within the terms of the Cobden-Chevalier Treaty during the second half of the nineteenth century.⁷

In the case of the USA this may appear to be something of a paradox, since measured against the GNP, foreign trade played and still plays a relatively modest role in the United States.

Many explanations have been put forth to explain the divergence between theory and practice, each of them adding to the understanding of the complexity of trade policy. *However, recognizing the obstacles on the way towards a liberal international trading system does not in itself suggest ways of removing them.* A look back at history shows that protectionism per se is nothing new. The roads to liberalization must be analyzed in a longterm perspective. The moves towards and away from free trade demonstrate the interplay of economic, political, institutional and other factors which determine the fate of international trading systems.

If there is to be an international flow of goods, then there must also be a working system of payments. And here the USA took on the role of world banker. *This system, however, could only function as long as the USA was prepared to subordinate its own national monetary policy to the requirements of world monetary policy,* a position it compromised on with the advent of the Great Society and its involvement in the Vietnam War and ceased to re-attain ever since.

IV.

More Freedom was introduced step by step into international goods exchange until the start of the 'seventies. The agreement which formed the framework for this concerted action was the GATT, an entity unique in international law inasmuch as it did not involve an international institution of the same kind, for example, as the International Monetary Fund, but was rather an agreement of a recommendatory nature, subject to the scrutiny of a secretariat with regard to its implementation. A secretariat, moreover, which reported back to its members and which occasionally carries out recommendations.

The tendency towards more freedom went cheek-by-jowl with a monetary system which was based on the principle of a gold-dollar standard, and which regarded the free play of market forces with great caution; something which was initially expressed in the system of fixed rates of exchange.

This trade and money system bore very much the hallmark of Lord Keynes, whose worst fear of all was a post-war recession and speculative short-term inter-state flow of funds, which would cripple the continuous development of trade flows due to deformed rates of exchange. As we know, he only succeeded in pushing his ideas through in part, but he was nevertheless not slow to take a lesson from history.

How well the system operated depended very much on one single country, the USA. In the perspective of world history, it will go down as one of America's great contributions that she took on this responsibility. One might point out that America, as the only country to emerge truly victorious from the holocaust, could afford to do this, a country whose economic and therefore also political power was unmatched; one might point out that this role also worked to America's own advantage, and that it was not nearly so selfless as has often been maintained. But whatever the judgment, the fact remains that the United States maintains to this day the economy with the highest gross domestic product per capita, as well as being the most prosperous nation in the world. But as the world of today shows, this need not have been the case. Reactions could have been different, and there were sufficient forces within America itself to have presented an entirely different policy.

To sum up, then, we should emphasize that the world economic system has worked, even though the non-monetary sector was organized differently from the monetary policy sector, without relinquishing any rights of sovereignty. *And the reason was that the powers that be in the world lent both their policies and weight to ensuring that this random separation would not be allowed to come into effect.*

⁷ G. Klepper, op.cit., p.236 ff.

V.

But the world has changed a lot since that start of the 'seventies. Thirty years of increased international intermeshing has made the globe truly more global. But the world monetary system was abandoned, and no replacement was found. Theoreticians have talked about flexible rates of exchange to do away with the inequalities and to build barriers against inflation, but instead the inequalities have become greater. *Now there is excessive freedom for capital flows, and increasingly more pressure to restrict the free flow of goods and services between different nations.*

VI.

To date, little has changed in the potential leading role of the USA. Nevertheless, this position is not so unassailable as it once was, both politically and economically. America's dominating position has been challenged more and more successfully in the political and military sphere by the USSR and the nations allied with her; in other words, by a semi-theocratic system which confronts a union of pluralistic and democratically-organized societies.

Against the backdrop, the adherence to multilateralism and free trade acquires great significance, even if the continued creation of regional zones of integration—the EC being at present the most important, although by far from the only example—runs directly contrary to the principle of creating an intergrated world market.⁸

We mentioned that the importance of agreements, which the parties cannot actually be forced to follow, lies in the fact that they allow national economic policy to seek a cure from short-term symptoms. This can be seen from the incessant round of electoral strife which are endemic in the democracies of the most important partner nations in the world economy; offering, too, opposition to laws of economic good sense, in the direction of more protectionism.

VII.

At Punta del Este, the 92 contracting parties to GATT succeeded in achieving a consensus on the subject matter, aims and procedures for the negotiations to take place over the next four years, adding yet another round, the Uruguay Round, to its seven predecessors. Given the present atmosphere, it did not seem at all assured that such an agreement would be struck. During the preparatory discussions, attention seemed to be frequently drawn away from the global common aims of the contracting groups. These conflicts have not been settled, and will have to be dealt with in the future.

Artur Dunkel, General Director of GATT, said in a lecture in Vienna on October 14, 1987 that "... the meeting was successful beyond all expectations, and the content is very hopeful."⁹

⁸ Governments do not operate in a political vacuum. It is difficult to develop a responsible economic policy against powerful special interest groups (see footnote 3). In order to develop greater understanding for adjustment needs and growth requirements GATT can provide (and has provided) valuable support; not infrequently GATT obligations help to withstand pressure in order not to lose face internationally. There are strong arguments to make GATT obligations enforceable within the individual member countries. Juridical review by national courts could provide for a more de-politicized means of protecting individual rights and non-discriminatory foreign trade competition than diplomatic efforts.

R. Adlung; GATT and the "Uruguay Round", *Intereconomics*, January/February 1987;

G. Lehbruch; Interest groups, government and the policies of Protectionism; *Aussenwirtschaft, Heft, II/III*, September 1986, P. 111;

E.-H. Petersmann, *Trade Policy as a Constitutional Problem*. On the "Domestic Policy Functions" of International Trade Rules. *Aussenwirtschaft, op. cit.*, p. 243.

⁹ A. Dunkel, *Welthandel: eine Bestandsaufnahme nach der GATT Ministertagung in Punta del Este*; Vortrags-Manuskript.

What exactly were the challenges of Punta Del Este, and what is supposed to be achieved? The tasks were considered to be those of freeing the world trade system from the anti-GATT measures which had piled up over previous years, strengthening the world trade system, preventing uncontrolled protectionism, and adapting the world trade to the changes in the world economy.

And what was achieved? An extensive catalogue of declarations of intent was produced regarding all the measures which did not conform with GATT, a standstill and a rollback were declared, and agreement was reached on a monitoring system. This group of measures included voluntary self-restraint agreements, market division accords, price agreements, and similar grey area measures. This does not signify, indeed, an acknowledgement of multilaterality over bilateral control of trade problems. In addition, it is intended that the trade system will be strengthened, and that a later disintegration of the liberalization standard will be prevented. Accordingly, the agenda included the examination of the GATT regulations, and the protective clauses and reconciliation procedures which have been worked out at the Tokyo round. The ministers settled on a further liberalization of customs formalities and on a number of non-tariff impediments, and declared to negotiate proprietary rights and the regulation of direct foreign investments. Finally, the sector of services was also included in the round of negotiations.¹⁰

Indeed, an impressive array. In Dunkel's words: "A major effort to keep world markets open." In more moderate terms the significance of Punta del Este can be summarized in one sentence: *Its importance is the fact that it took place at all.*

What are the chances, then, that the declared aims can actually be turned into reality? Trade flows in a global world economy, in which there are not many markets but one single market, require co-ordinated flows of payment as well. If the flows of payment become disconnected from the flow of goods, then tensions and stresses arise which cannot be selectively relieved. Changes in rates of exchange, which are the result of discretionary national finance policy, can have far greater significance than all the tariff and non-tariff trade obstacles put together, as the latest development clearly shows. *And how is that essential growth in the world economy supposed to come about, which is the absolute prerequisite for turning the catalogue of intent into reality, if the yields from the finance markets substantially surpass those from investments into the real economy?*

Of course, the interconnections did not go unconsidered at Punta del Este. They were, however, expressed in a very restrained manner as part of a detailed declaration, boiled down in effect into two sentences:

Negotiations shall aim to develop understandings and arrangements "... to improve the overall effectiveness and decision-making of the GATT as an institution, including, inter alia, through involvement of Ministers; to increase the contribution of the GATT to achieving greater coherence in global economic policy-making through strengthening its relationship with other international organizations responsible for monetary and financial matters."¹¹

It would be no surprise if the actual content of this part of the declaration of aims holds the key to solving the problems of the world economy, problems of which the importance seems to be proportionally inverse to the amount of attention which was paid to the non-monetary economy aspects in the Ministerial Declaration on the Uruguay Round—for reasons which should be entirely obvious. When the success of the "glorious thirty" (J. Fourastié) will remain a unique epoch in modern world history—as some believe—whether we witness the trough of a Kondratieff-cycle—as some others think—or tribute is paid to the historically unique phenomenon of a truly global world in every respect which offers unlimited growth potential will be decided—though only in part and unfortunately so—during the four years to come, the envisaged

span of time in which negotiations of the Uruguay Round will take place. For optimists the latter scenario is conclusively thinkable as described in "A Concise History of the Future 1974-2024" by N. Macrae.¹²

12 N. Macrae; A Concise History of the Future 1974-2024; London, 1984.

Opening Remarks from the Panel I.

The forces of protectionism in the U.S. Congress continue to be very strong. Most members have in their districts a plant or factory whose products are threatened by what they call "cheap foreign imports." The political power of voters whose jobs are in jeopardy is a lot stronger than the more rational but less focused arguments favoring free trade.

Nevertheless, for all the talk, it is worth noting that no protectionist legislation has actually been enacted in the United States in the last six years. A trade bill is likely to be enacted this year, but it appears that it will feature a number of positive measures, including provisions permitting us to make our own exports more competitive and to more effectively open up foreign markets, rather than too heavy a load of protectionist measures. It is premature to be overly optimistic about U.S. trade legislation this year, but there is reason for more optimism than existed a year ago.

U.S. trade policy decisions take place within a framework of global economic developments and policies. In the past four years, we have had the good fortune of a favorable economy in the United States. We have had continuous real growth for over 50 months. If growth continues, as expected, through October 1987, the current recovery will be our longest peacetime recovery.

Within this healthy economic picture, we do have severe problems. Large trade and current account deficits accompanied this vigorous economic activity. Our current account deficit rose from \$9 billion in 1982 to a record \$145 billion in 1986.

This record level of U.S. trade deficits has created the concern that our businesses and farmers can no longer compete in international markets. But even with a record deficit last year, the U.S. exported over \$370 billion worth of goods and services.

Yet there are ways to enhance the U.S. manufacturing and farming base. Experience all over the world shows that the surest path to increased competitiveness and increased economic prosperity is through greater reliance on free market forces. The Reagan Administration has developed a competitiveness initiative designed to reduce government intervention in economic activity and more fully unleash the power of market forces.

Our competitiveness initiative is a wide-ranging set of proposals aimed at increasing our investment in human and intellectual capital, boosting our scientific and technological development, refining our legal and regulatory systems, and creating a more favorable international economic environment.

The centerpiece of the trade proposals in the Administration's competitiveness package is negotiating authority for the new multilateral trade round. As we have done since the end of World War II, the United States strongly supports an open and liberalized trading system. An open trading system is the cornerstone for promoting growth in the U.S. and around the world. Trade creates productive new jobs and profitable investment opportunities. It stimulates innovation and entrepreneurial activity.

Last September, we joined 73 other major trading nations in launching a new trade round—the Uruguay Round—under the auspices of GATT. The United States and many other countries worked hard to ensure that the agenda for the new round would be more comprehensive and ambitious than past rounds. We place importance on developing rules for many areas of economic activity which are not now included, such as agriculture, services, investment, and intellectual property.

Agriculture is a particularly important negotiating area of the Uruguay Round. Government intervention in agriculture has run rampant, creating tremendous market distortions and huge economic and political costs. Government support programs, in the U.S. and elsewhere, have severed the link between free market signals and production decisions. As a result, we face

10 Though there are a number of "imperfections" which prompt R. Wartenweiler to entitle this observation "An Adventure in Trade Policy with Uncertain Results." There is hybrid negotiation structure which is programmed for discord. The services are negotiated outside of GATT. The Punta del Este Conference was called as a conference of the Contracting Parties. Hence participation was restricted for obvious political reasons. Thus the Soviet Union and the GDR—both seeking GATT participation—could be easily excluded at the sacrifice of the universality of a liberal world trade order. (the Tokyo Round was launched in 1973 as an open ministerial conference.)

R. Wartenweiler, EFTA Bulletin 4/86.

11 Ministerial Declaration on the Uruguay Round, General Agreement on Tariffs and Trade, September 20, 1986.

massive overproduction worldwide; gluts prevail in nearly all major agricultural commodities. The financial burden of this extensive government intervention is becoming unsustainable; the total cost of farm-support programs in the industrial countries has soared to over \$140 billion a year. International disputes over agriculture are multiplying and complicating relations among friends and allies.

Agriculture is a global problem, which requires collective action to solve. We hope that agriculture will be a focal point of the upcoming Venice economic summit and the Uruguay Round talks. In particular, we believe that the E.C., U.S., and Japan must take the lead, working together and in GATT, in molding the trade and domestic reforms that will make agricultural production throughout the world more market-oriented.

One more important element of U.S. trade policy is our efforts to eliminate protectionist practices by other countries which unfairly penalize foreign competitors. The Reagan Administration has aggressively defended the right of U.S. companies to compete in markets abroad. We believe that markets should be open and open equally, so we have sought to eliminate discriminatory practices.

We will not, however, start a trade war in any sense of the word. Even in our highly-publicized recent action regarding Japanese semiconductors, the practices affected only \$300 million of trade, less than .5 percent of all Japanese exports to the U.S.

The Administration recognizes that increasing market access and eliminating unfair trade practices are not the only solutions to the U.S. trade deficit. Nonetheless, attacking foreign barriers is an important and essential component of U.S. trade policy. Our efforts to dismantle foreign practices are necessary to maintain and preserve the principle of equity and openness on which the international trading system is built. Only if all countries are willing to be bound by a commitment to fair trade, can we hope to maintain support for free markets and the real economic growth which free trade generates.

In the past four years, the United States economy has been strong. Our dedication to market-oriented policies has facilitated this economic activity. The major trading countries need to work together, through GATT and otherwise, to provide for active, free trade around the globe. By sticking with free-market principles, we are confident that we can continue to enhance the economic prosperity of the United States and of the world.

Opening Remarks from the Panel II.

Looking at the causes of the current wave of protectionist sentiment, it is evident, from the U.S. perspective, that the intensity of these pressures reflects the size of our trade deficit. It provides the focus for concern and for specific interests in protectionism. That the deficit is three and a half to four percent of GNP does not suggest the magnitude of protectionist pressures. But the deficit is equal to 15 to 20 percent of manufacturing output. Taking this into account, someone is bound to feel the pain; and it intensifies structural weaknesses that were there already.

It is also true that, from the American perspective as the largest and also the marginal supplier of agricultural commodities to the world, when you have a worldwide glut developing, the marginal supplier feels it particularly strongly, and is inclined to see the problem as arising from the practices of others.

As far as the rest of the world is concerned, certainly the relatively slow growth and the unemployment in Europe and Japan have inhibited constructive responses to the trade problem and have prevented them from carrying the banner of liberal trade at a time when it is difficult for the U.S. to do so.

Exchange rate volatility has also contributed to the current problems. Many businessmen feel they are not in control of their competitive destinies when there are such large fluctuations in the value of the dollar. That kind of volatility creates a climate in which businessmen look out for anything that creates a bit more stability, presented as an assurance of competitive fairness.

There appears to be a growing gap between the doctrine and ideology of free trade and what people actually want. We have more and more change in our economies because of technology

and their very openness. We apparently are not talking simply about a struggle between particular and general interests. Presented with a trade-off between growth and more stability, most businessmen would opt for stability over growth, and would be willing to take a little protectionism. The semiconductor industry in the U.S. is an example. It's a new industry—not much more than ten years old—and there is a feeling that it is unfair that it is being taken away.

As to the consequences of protectionist pressures, the world's economy is in a particularly vulnerable position. Protectionism risks inflation and recession, and it complicates an already sluggish situation in Japan and Europe. The U.S. House of Representatives bill is barely tolerable in terms of the existing world trading order, and the danger is that it will go downhill from there. A lot has already been added, and there are even greater dangers coming from the Senate.

The Administration's strategy, in addition to straightforward opposition to protectionism, has involved exchange rates and the need for depreciation to make industry more competitive. This was politically necessary and economically justified, and part of any reasonable strategy. But it is a strategy of natural limitations, and we have probably reached them in terms of any net benefit to the world economy.

The next step should be a more consistent pattern of macroeconomic policies among the U.S., Europe, and Japan. It has been said that Europe and Japan should do more to provide a stimulus to expand the world economy. There is frustration in the U.S. that Europe and Japan have not done much to accelerate growth. In Europe and Japan, there is frustration that the U.S. has not done much about its budget deficit and about making room in its economy for more exports. The old problem in the international monetary and financial system is that there is not much leverage to get the surplus countries to move toward equilibrium, nor, from the European point of view, is there much leverage to get a reserve-currency country in deficit to do the same thing.

The question is how to bring about pressure on our governments without bringing down the house of free trade. There are dangers in working too much on the exchange rate side. As for protectionist legislation, most supporters in Congress say they are not really protectionist but are merely using pressure and would remove the measures if there was an appropriate response. But there are dangers in this approach.

It would be useful to inculcate in U.S. legislation the notion that, if we think retaliation in the form of restraints is justified, we ought to be able to get some other countries to join us in taking the same action. If other countries would join us, it might determine if the approach is justified. There is obvious potential for such a multilateral approach directed at countries with structural surpluses, like Japan and Taiwan.

In the longer term, it might be worthwhile to re-examine the merits of tariffs. All post-war trade negotiations have concentrated on reducing or getting rid of tariffs. Recently, we have gone in the reverse direction in terms of erecting non-tariff barriers. Is there a possibility of rewriting the rules of the game so that, within defined areas, there would be room for at least temporarily invoking tariffs, instead of taking other kinds of trade-restraining measures? The time has perhaps come, given the degree we've retreated on the restrictionist front, to begin thinking of approaches that enable us together to better drive the frustrations that give rise to barriers in more constructive, identifiable, and temporary directions.

Opening Remarks from the Panel III.

With respect to trade, there is a certain degree of disarray because no initiative is forthcoming from anyone.

There is a very serious ambiguity over the strength of the anti-protectionist intentions of the major economic players. Everyone is against protectionism in principle, except in those areas where one or the other is clearly a dominant player. The voices speaking up in organized structures have less clarity than ever before. In Europe's case, there is the overriding concern about unemployment which remains a basic constraint on any political decision making. Anything that might appear to worsen it in the short term would be very difficult to carry out.

Two elements of instability have influenced the world trading system. First, Europeans sense

the fall of the dollar in their competitive posture more in relation to a number of newly industrialized countries whose currencies are linked to the dollar, than to the U.S. itself. The consequence is not to affect the U.S. trade deficit, but to increase the trade surpluses of others. Second, a return of the mercantilist approach is now expressing itself in the overall cult of an export surplus. A country with an export surplus shows how competitive it is, how well it is doing, and how good its people and products are. In Japan, there is a degree of resentment about being damned for being so successful. Perhaps the targets we have selected to adjust to the situation are the wrong ones. Trying to open the Japanese market is a correct objective, but it involves a long-term effort. We should have been talking about such things as the level of the Yen much earlier in the game. There have been no real, fundamental consultations among the U.S., Europe, and Japan on issues like this. The E.C. has tried to take action with the U.S. but has always been turned down on the grounds that it would be unfair to Japan.

The world is now a much more complex place. The technological revolution has changed how industry and manufacturing work. There are trade consequences and there are consequences having to do with the autonomy of development. This plays a big role in the semiconductor industry, for example. How can you keep control over your technology? If you don't have the technology, how can you develop? Will technology that someone else has been available to others? All of these questions increase the ambiguity about protectionism.

Europeans are enormously concerned about what happens in the U.S. The U.S. has been the main player and the driving force behind the multilateral system. But this is not true today. There is concern about what Congress might do, and a lingering doubt about what the Administration really wants.

On the European side, over the last two or three years, concern has moved toward the increasing competitiveness of Europe. Those advocating the large market by 1992 don't know what it is really about. They tend to believe it is just getting rid of barriers and making exports from one European country to another easier. But that is not what is at stake. The point is to have one market in which differentiation does not exist and in which you can do something in somebody else's country that you can do in your own. When that is realized, maybe there will be less enthusiasm.

It would be a mistake to misjudge what is happening in agriculture in Europe today. For the first time, there is an acceptance in the majority of political circles that agricultural policies must be modified so as to take into account the balance between need, cost, and requirements. The possibility of a negotiation on this exists. It will not be a short-term process, but will take five to six years to make adjustments. The question is how to keep a consensus among the various parties for that period of time.

Another area of concern in Europe is technology, which is the main issue with respect to Europe's capacity to compete. Regarding Japan, the situation is difficult to assess. Are they still apt to produce a small initiative just in time to avoid a big hit on the head? That would not basically change the contribution that Japan should make.

There are also political dangers. The real bitterness in the transatlantic trade debate is striking. It is not now just a part of the rhetoric of negotiation, but is genuine, and will be an element of permanent bother in the next eighteen months. One example is the dispute arising from Spain's joining the E.C. Some perceive this as a change in American policy, which traditionally accepted that there would be some economic cost to Europe's coming together. Another example is the Airbus-Boeing situation. The feeling in the U.S. that Boeing, with 80 percent of the market, can be threatened by Airbus is resented by Europeans as an attempt to exclude them from growing technology.

Bilateralism is another grave danger we face. It is all right for fine tuning or damage control or to avoid a dispute, but now it has become a basic element of policy. Bilateralism invites the me-too syndrome, in which other countries want the same treatment. It happened in the textile area with woeful results.

As to the GATT, the satisfaction expressed after Punta del Este was not really justified, because nothing happened that could influence short-term problems. This is the problem of GATT; the institution is only as good as its members.

What can we do? The first thing is for Europe and Japan to stimulate growth. Otherwise there will be a recession in the U.S. We need quantified contributions of the various parties to the solution. How much can Japan contribute to infrastructure, to third-world country debt restructuring? The U.S. must reduce its budget deficit. The E.C. must pursue and be supported by the economic operators in the large market-opening activity to restore competitiveness,

regain confidence, and not be preoccupied with slowing down the reality.

Multilaterally, we can increase tariffs. Talking about that has been viewed as protectionism and therefore taboo. But there are a number of areas where tariff increases are economically justified. If it is done multilaterally, it is less dangerous. We need the will of the participants to commit themselves to a multilateral solution. Throughout the trading system, short cuts are being taken. A multilateral body, not the individual countries, has to establish if a case really exists on things like dumping. Then there has to be a mechanism for dispute settlement. We need to give some teeth to GATT. If we can do these things, then we will be back on the multilateral path, and we will have set objectives for ourselves.

Opening Remarks from the Panel

IV.

What are the causes of the rise of protectionism? In a wider historic perspective, one can see that free trade eras have been carried by hegemonial powers based on political, technological, and economic superiority. Whether these developments—free trade followed by protectionism and crisis—are part of long waves, known as Kondratieff cycles, remains to be seen.

Free trade has never had great popular support. The individual benefits are extremely marginal, yet, for the economies involved, they are of serious magnitude. The advocates of protectionism are always comparatively few, the short-term benefits large, and the burden they cause to the consumers are so broadly distributed that they are insensitive to the direct impact of the measures introduced.

Protectionism has the potential to be popular because it is a way to blame others for one's own shortcomings. This is also the real reason for the widespread use of non-tariff protectionism, because at the heart of the matter are not relative prices, but the availability of goods and services of high quality and reliability. This anxiety that consumers might be prepared to pay a higher price as long as they get the goods they want is the reason for the proliferation of non-tariff protectionism.

It seems there is a natural human tendency against change, in particular when one has lived well under a certain constellation and has become affluent. We can expect resistance to change and adaptation in the current atmosphere. We are in a period of ever-shortening product cycles, in which the very essence of the success of the industrial revolution economies of scale and modification of the human to a tool in the material process of production is questioned and is substituted by a need for flexibility, a highly educated and dedicated work force, and a need for reorganization of the command structure in industrial relations away from hierarchical systems which were developed for mass armies. Protectionism, in the last analysis, seems nothing other than the visible expression of such resistance.

When one looks at the various forecasts, the future looks, from revision date to revision date, more dismal. It might well be that we are on the way into the fifth Kondratieff cycle, if there is one—the imminent breakdown of the world economy. Such a development is not inevitable. One way to escape this trend is to stop blaming others for one's own shortcomings. To repeat, this is what protectionism is all about.

Progress can be achieved only in a growing world economy. Such growth cannot be achieved when an important section of the world is stripped of its purchasing power to repay old debts. Then, instead of being a net capital importer, it becomes a net capital exporter. The restoration of this purchasing power cannot be left to the private sector. Reconstruction of Europe and Japan after World War II was not left to the private sector. Compared with the cost of a major war, the debt settlement that is needed is of small proportions indeed. It should be noted that the problems involved, however, need more than the simple transfer of money (which made the task after World War II comparatively easy).

Agriculture is an area in which progress can be made, despite the power of vested interests and the political consequences, because the present arrangement is so wasteful that it will not be sustainable for much longer. There is a chance of making progress, and Europe, in particular, could make an important contribution in changing the climate toward cooperation.

Instead of calling for penalties on current-account surplus producers, we should pursue

transforming them into exports to be handled by multilateral financial institutions.

There is no doubt that protectionism is, in the end, an extremely dear way of avoiding adaptation, with no chance of succeeding. It would seem logical to spend much less to speed the unavoidable process of adaptation. All this needs is leadership. The question is where it will come from.

Adaptation will come about, but protectionism will not be the means to bring it about. The only question is whether it will be forced upon the world economy or be engineered by those who will suffer the consequences if it is not.

Discussion

An International participant opened the discussion with a rather gloomy analysis of developments in the world trading system. On the one hand, negotiations had begun in GATT, and there was an agreement to move in the direction of a new trading system. But on the other hand, the day-to-day practices of governments were not in keeping with free trade, there was doubt about whether that was still an appropriate objective, and there was increasing bilateralism and politicization of trade disputes. The trading system was moving rapidly in an entirely different direction from what was envisaged—toward things like voluntary export restraints and, more generally, cartelization of trade. In this atmosphere, there was a growing chance of trade wars.

The tendency toward bilateralism was particularly dangerous, both politically and economically. Its objectives were completely alien to the system of reciprocity. A case could be made that we were faced with the same kind of dangers that existed in the 1930's, when protectionism, as characterized by the Smoot-Hawley legislation, was a major factor in bringing on depression. Though no measures that severe were currently on the horizon, we could not ignore the dangers of continuing the practices going on today. The world economy was vulnerable and our financial and monetary systems were fragile. Our financial markets tended to react violently to such things as announcements of trade retaliation. Bilateral actions and retaliatory practices could well lead to recession. Our countries were faced with a need for major adjustment, continued the speaker. The U.S. had a very large trade deficit, while Japan, West Germany, and other countries had very large surpluses. It was primarily the OECD countries that would have to absorb these adjustments, and if we wanted to facilitate this process, the last thing we should do would be to make the trading system more inflexible and to cartelize trade. Rather, we should make markets open and flexible in order that the huge changes in market shares and trade flows could take place with minimum disruption. And we had to adjust our economic policies to this process. Instead of the U.S., Europe, and Japan calling for each other to change their policies, we all had to take action.

In the view of another International speaker, the major problem we faced was competition—that was at the heart of our problems. What governments and the private sector were seeking was competition, as undistorted as possible. In textiles, steel, autos, agriculture, and high technology, this problem had not been tackled satisfactorily. We had to recognize that progress was more related to insuring undistorted conditions of competition than to reducing tariffs and attacking non-tariff barriers. Competition was increasing the pace of change, and there was, among a number of industrialized countries, a resistance to the challenge of competition. If competition was a source of adjustment, if adjustment meant change, and change meant growth, then one of the major challenges facing the world economy was reconciling real growth with resistance to change.

Industrialized countries were resisting change because of such factors as unemployment, while, at the same time, the newcomers in the competition understood and accepted it. The desire of China and the Soviet Union to join GATT exemplified this.

The general consensus of the participants in the discussion was that the resurgence of protectionism was largely due to political considerations. A Swiss speaker pointed out that it was the voters who decided whether or not we had more or less free trade, or more or less protectionism. A countryman attributed protectionist sentiment to short-term thinking on the

part of government, industry, and labor, all of which were looking for rapid, tangible results.

Applying game theory to the rise in protectionism, an Italian argued that the losers in the economic game were using political strategies to defend themselves and to become winners. Individual players in the economic game could choose to adopt either an economic strategy—stay in the system, adjust, and try to become a winner—or a political strategy—try to become a winner by voting. The political strategy was becoming increasingly attractive because the group of losers in the economic game was becoming less and less stable. One could be a loser, no matter what industry one was in. Bilateral measures were attractive to losers because they offered the means of retaliating quickly.

It was a British speaker's view that, if the voters were asked if they wanted to continue to enjoy the benefits of free trade in the form of agricultural products and consumer goods, they would answer overwhelmingly in the affirmative. But a fellow Briton wondered if that would be the case if they were told they might lose their jobs at the same time. An American argued that the reason that protectionist legislation was being considered in the U.S. was precisely because people were saying the price of free trade was too high, in terms of loss of jobs, of industries, and of opportunities.

In the 1950's and 1960's, continued the speaker, the world trading system was built around the Marshall Plan, which provided a unifying consensus. We no longer had that consensus today. We needed to find a new vision in terms of the current needs of the global community. Another American agreed, saying that we had no consensus on what kind of system we really wanted. There had been fundamental changes since the post-World War II trading system was created—capital mobility, rapid technological development, the growth of mixed economies, the emergence of China, etc. The assumptions of the post-war era were no longer valid. We had to re-examine the true nature of the trading system. It was no longer politically acceptable for the U.S. to be the great open market. We had to reach a new consensus, and that might mean managed trade to some extent.

It was true, said a Swiss speaker, that the world economic order had changed considerably in the past 50 years. We needed new rules, and new safeguards to avoid retaliatory measures. The cost of protectionism, in the long run, was higher than any other alternative. We had to find a way to make people more patient and to speed up the results of non-protectionist policy.

Reflecting the sentiments of numerous speakers, an Italian, while agreeing that the trading system had changed, argued that there was still no alternative to trying to strengthen the open, multilateral system. If we abandoned that system, warned an International speaker, we risked making trade policy a part of bilateral deals that cut across all aspects of international relations. One of GATT's strengths was that it allowed trade problems to be isolated from other aspects of international relations.

Several speakers felt that GATT was the appropriate institution in which to take action, but, as with other international bodies, we did not use it properly. We had the right institutions, said an Austrian, but we had not given them the power to do the job. In a world of increasing globalization and interdependence, he continued, we still relied on the framework of the nation-state of the last century. We needed more international cooperation and action. A Belgian agreed, expressing concern about the diminution of the influence of international elements on the conduct of national policy.

There was, agreed a German, a general decline in international approaches. To re-establish one, we needed more than little solutions here and there. We needed to undertake a bold initiative, something that might create a framework for dealing with other issues. For example, if we could join together to tackle a problem like the debt crisis, this would give a psychological boost. An Austrian agreed that it made sense to try to pick out some targets—the debt problem being a logical one—but it would be very difficult to find a global approach to solving all our problems.

An International speaker agreed that trade policies alone were not the answer to our problems. We had to address macroeconomic policies, fiscal policies, debt policies, currency relationships, etc. A Swiss speaker called for parallel progress in these areas, but no formal linkage, as a precondition, to progress in the trade area.

A concerted international effort to adjust macroeconomic policies was advocated by a number of participants. A Greek felt that there was a lack of consistency in our macroeconomic policies, and we had to make an effort to improve their coordination in order to stimulate the needed growth in Europe and Japan and to make the necessary adjustment in demand levels. A Turk pointed out that we were embarking on a trade round in slow growth conditions. We needed high

global growth for the round to be successful; otherwise trade liberalization would produce unemployment. We needed to address the problem of structural adjustment and to create a new macroeconomic policy geared to growth.

Exchange rates were an area of concern to several speakers. An International participant felt that currency stability was the centerpiece of free trade, that we could not have free trade without it. An Italian voiced concern that a further rapid and substantial decline of the dollar would bring a worldwide recession. It was an Austrian's view that, in the present situation, financial flows were increasingly decoupled from trade flows, and this was a situation that had to be addressed.

Volatility of exchange rates was one cause of protectionism, said an Italian. It was due largely to the dominance of financial transactions over trade-related transactions. There had been a recent trend toward liberalization of capital markets, while protectionism was on the rise in trade. As a means of reducing exchange rate volatility, trade imbalances, and protectionist pressures in the trade field, was protectionism in financial markets and capital movements a possibility? Was there a trade-off between trade protectionism and financial protectionism? And would such measures as taxation of capital transactions and dual exchange-rate systems be preferable to outright restrictions on capital flows?

An American's view was that financial transactions in the U.S. were so large and complex as to make them very hard to effectively control. We were past the point where an approach of that sort was practical.

A German was strongly opposed to any notion of currency regulation, which had been tried without success. Erratic foreign currency movements were preferable to financial protectionism. Once introduced, currency controls were very hard to remove. Even the most erratic currency movements were easier for the business community to overcome than protectionist measures, because the free market would find a solution. We did not need a new Bretton Woods agreement.

Other participants worried about the problem of budget deficits. A Canadian wondered if anything could be done in societies where expectations had built up over a generation, and where tampering with social programs or raising taxes had become unthinkable. Was healthy multilateral trade possible if budget deficits could not be reduced?

An Italian speaker was particularly critical of the U.S. in this regard. The U.S., he said, had to take a leadership role, adopt restrictive policies, and deal with its domestic imbalances, especially its budget deficit. But, because of political considerations and the presidential campaign, it would be impossible for the U.S. to raise taxes in the next two or three years.

An American response to this was that, yes, the U.S. should shoulder part of the blame for the current situation and should take the lead in finding solutions. It was doing something about its budget and trade deficits. Reduction of the budget deficit was legally mandated by the Gramm-Rudman legislation. And the U.S. was taking steps to decrease the trade imbalance by increasing competitiveness.

Another American agreed that the U.S. had to do something about its budget deficit, but disagreed that nothing else could happen until it did. Europe, as well, had to make policy adjustments. In particular, given the size of world imbalances, Europe would have to absorb increased exports from Japan if the U.S. was to make the kind of adjustments it was supposed to. And with respect to the debt crisis, if that was ever going to be solved, Europe would have to absorb more from the developing world. The problem of adjustment caused by Europe's large surplus would have to be worked out by Europe, and, with no growth, it would not be easy.

The problem of the debt and the need for growth in the developing world was an area of concern to several speakers. An Austrian felt it was manageable, but not by the private banking community alone. Governments had to address the problem. It was up to the surplus producers to shoulder a larger burden and use their surpluses in helping to solve the debt crisis. It was very important, added a Swiss speaker, that our markets be open to the exports of developing countries.

The developing countries, said a Canadian, were becoming increasingly important. Many of them were quickly gaining technological expertise and management skills. Their success was no longer dependent merely on low wages. They would be a powerful influence in the GATT negotiations and would press for liberalization of imports. If the debt problem could be solved and new industries created, these countries could become what Europe and Japan were to the U.S. in the post-war era.

But a Dutch speaker worried about how we were to deal with the problem of our own industries, like the semiconductor industry, moving to other countries. The E.C. had to have a

policy of maintaining certain basic industries, if its members wanted to have the right to define their own destinies and not be dependent on others for high growth.

It was in the Western interest, said an American, that we let China and the Soviet Union join GATT. They were large, underdeveloped countries with low debt, and they enjoyed good credit in the West. By increasing their imports and exports, they would become more market oriented.

The entry of China into GATT was being negotiated, said an International speaker, while the Soviet Union was still waiting in the wings. GATT already had several members with planned economies. But it had never been able to solve adequately the relationship between a centrally-planned economy and a market economy. There was little problem with the smaller nations, but China and Russia would present problems, particularly with their pricing systems. We had to be careful in our negotiations with China to define the respective rights and obligations. Otherwise, the relationship would be poisoned by disputes. It was better not to rush, but to settle the rules at the outset and have a peaceful relationship.

The problem of how to deal with Japan was a major concern of participants in the discussion. Japan seemed to be in a state of policy paralysis, said an International speaker. It had no policies to deal with the practical problems it was facing—a currency very much appreciated by a strong trading relationship with the U.S., and excessively large savings. The Japanese did nothing, but we had to be careful not to think we could push them to take action. We had to be cautious and wait for the appropriate time for a thorough policy debate with Japan.

It was an American's view that we should be impatient, rather than patient, with Japan, both in terms of their reluctance to share in the global economy as consumers and in the fact that newly industrialized countries tended to follow the Japanese model of focusing on exports and restricting imports.

A Dutch speaker expressed similar frustration with the Japanese, saying that we only got concessions from them when they did not mean anything. Our discussions on concessions and agreements with them should be on the basis of reciprocity. The Japanese practiced the popular tendency to favor free trade when it was in somebody else's country. Every institution in Japan was dedicated to making it number one. They had targeted areas of the world and would not let anyone get in their way. The content of our talks with Japan so far meant nothing.

Speaking about Japan from the U.S. perspective, an American said that his country had a difficult trading relationship with Japan, and had had a hard time getting Japan's attention. It had now taken some strong measures and felt it had gotten Japan's attention. There was reasonable hope that Japan would be forthcoming with some meaningful proposals. The U.S. could not continue to have a deficit with Japan while devoting eight percent of its GNP to defense, while Japan devoted only one percent. The Japanese had to pick up a greater share of responsibility in the world, particularly with respect to developing countries.

Most speakers agreed that we would be in for trouble if we failed to solve our trade problems, and our other economic problems. A protectionist trade bill in the U.S., warned an Italian, would have dangerous implications for our political relationships. Protectionism would bring economic nationalism, leading to a dangerous decoupling of the U.S., Europe, and Japan.

As long as there was no real debate among these countries about where we wanted our economies to go, warned a Belgian, we would continue to have disputes, and short-term considerations would always prevail over long-term ones. There were no quick fixes. The fundamental question was whether democracies had the capacity to deal with long-term issues.

An American speaker said that the openness of U.S. markets had been one of the most important factors in the economic success of the U.S., Europe, and Japan. If it was going to be preserved, we had better find a solution jointly. The U.S. trade deficit had gotten worse during a period of prosperity. If we had a downturn and unemployment, it would become impossible to keep U.S. markets open. And if the bitterness that was creeping into our rhetoric continued to escalate, it would overflow from trade issues into other economic, political, and military issues, and would damage all of us.

III. THE PUBLIC SECTOR AND ECONOMIC GROWTH

Outline for Discussion

The Role of the Public Sector in Growth

Should the public sector be viewed as a prime engine of economic growth in modern industrialized and developing societies? Is there danger that certain types of public sector intervention can have an adverse impact on growth?

There are at least four ways in which governments have an impact on the economy:

1. As a regulator
2. In its impact on the environment
3. As a provider of social services
4. As a direct producer of goods and services.

Government's role as a regulator can have a powerful impact on growth either positively or negatively depending on the nature and implementation of the regulations. Should regulatory bodies consider the promotion of growth as a priority consideration in the preparation application of regulations?

In prescribing laws relating to the physical environment, governments also have an opportunity to promote or restrict growth. To what extent should measures designed to protect the long-term quality of the environment be modified or set aside in the interest of promoting short- or medium-term growth?

The role of the state in providing social services in such fields as health, education, child care and benefits for the aging is generally today viewed as a necessary and accepted activity. Many governments have done a good job in this regard. In some countries, the growth rate of these services is accelerating at what may prove to be an unaffordable pace.

Does public ownership of major industrialized sectors contribute to or diminish the prospects for sustained economic growth? What should be the determining consideration in government's decision to own and operate major industrial sectors? Should productive facilities in the hands of government be turned over to the private sector if there is reason to believe that economic growth would be promoted in so doing? What other contributions should be taken into account?

It seems likely that governments will continue to be involved in all of the four areas which have just been outlined. But in terms of the promotion of economic growth, in which of these areas should government place primary emphasis? Should it, for example, diminish its role as a producer of goods and services while strengthening its role in providing social services? Should it reconsider its role as a regulator in providing social services? Should it reconsider its role as a regulator, by example in terms of its impact on the environment, so as to give more impetus to growth?

Are we now facing a new regulatory problem which results from the international impact of scientific and technological innovation? In some instances, these innovations have beneficial effects, as in the case of hybrid seeds and improved agricultural technology. In other cases, the effects can be harmful, as in the case of acid rain and the chemical pollution of internationally used bodies of water. But to cope with these developments will require a new level of international understanding, cooperation and control. Are we presently equipped to deal adequately with this multiplying type of problem?

Growth and Employment

To what extent do aggressive growth policies tend to have an adverse or positive impact on full employment?

If growth and full employment policies are not compatible which should be given the higher priority?

Is Sustainable Growth Still Possible?

To what extent and how are protectionism and sustained growth linked or in conflict?

The Club of Rome advanced the theory that population growth and natural resource limitations will make impossible world-wide sustained growth in the future. Does this proposition have validity? If so, what is the outlook for the world economy? To what extent does man's ability to emphasize renewable resources and find substitutes for those which are not renewable diminish the validity of the Club of Rome's dire predictions?

Are growth prospects better or worse in Third World countries than in the industrialized nations? What are the primary reasons for a different outlook? What are the obligations of the industrialized world toward the Third World? Are they primarily motivated by pragmatic self interest or are they based on moral considerations?

Third World Debt Crisis and Growth

Growth both in developing and industrial nations, is said by many to be an essential ingredient in solving the present crisis in Third World debt. Is this true? If so, what measures should be taken to ensure sustained growth?

Can Third World debt crisis continue to be dealt with on a case by case piecemeal basis or does it require more radical solutions? If the latter, what should these be? Are there radical solutions which will deal with the debt problem without closing out future access by debtor nations to world credit markets?

Should a solution to the Third World debt problem seek to pay off or write off the debt or, rather, should attention be focussed primarily on enabling the debtor nations to service their debt? Which resolutions of the debt problem will encourage the revitalization of Third World economies?

Opening Remarks from the Panel

I.

There are some paradoxes in a discussion of the role of the state. In France, the effort to privatize has to be examined in the light of a series of phenomena. The first is that the size of the public sector in France had reached a level which was out of proportion to what it was in most countries with comparable economies—that is, free countries. Nationalized industry represented approximately 40 percent of industry, and more than 90 percent of the institutions granting credit were nationalized. The situation was, therefore, excessive.

In spite of eternal debates, the French never resolved anything about the comparative efficiency of a nationalized as opposed to a privatized economy. Two factors in particular justified a policy of privatization in France. Nationalization means a specific introduction of politics into companies, made possible by the temporary nature of positions of responsibility. It is not good for the state to have so much power. A state which controls, directly or indirectly, more than 90 percent of the credit distribution and 40 percent of industry is too powerful. This is, in part, what gave rise to the French experiment, which was launched a year ago.

What characterizes the French experiment in privatization is, first of all, its size. It involves privatizing 65 firms, including practically all the commercial banks, over a period of five years, with a value of between two and three hundred billion francs. France is, in other words, engaged in a program which will represent between 40 and 60 billion francs per year. If all goes according to plan, it means that the Paris stock exchange capitalization should rise by 30 percent in five years. Two major companies, have already been privatized, St. Gobain and Paribas, and two others, the General Electricity Company and Société Générale will be privatized by this summer or soon after. So, in less than a year, four major companies, not to mention many smaller firms, will have been privatized, representing a figure in the region of 50 billion francs.

Apart from its size, the French program is characterized by its creation of a global juridical framework. New rules are not needed every time a company is privatized. There is one law, one definitive rule, in which are fixed a certain number of principles. On this basis, year after year—or, more correctly—month after month—the minister in charge of privatization will decide who and when to privatize. This gives us the advantage of speed, flexibility, and efficiency.

The firms to be privatized are placed on the market at a fixed price. There is no call for an offer or bid. There is always great demand, and it is necessary to decide each time to what extent this demand should be met.

So far, privatizations have met with great success. There are now 3.8 million new shareholders of Paribas, and 1.5 million for St. Gobain. Uniquely French, also, is the fact that ten percent of the shares are reserved for employees, who agree to certain conditions in each case. Because of this, privatization in France is perhaps the most important development in a long time, not only in terms of reconstructing the market economy, but also of establishing a more democratic economy.

With respect to the subject of the state, it, first of all, plays a role in privatization as a shareholder. The directors of public firms sometimes find it hard to understand that they must take into account the wishes of the public shareholders just as they do the wishes of the private shareholders. This is one of the justifications of privatization. The state is a shareholder and therefore it is the state that decides when and if to privatize, and how. There are rules for the protection of the national interest. The finance minister can decide that nobody, be they French or foreign, can hold more than five percent of the capital. On the day of privatization, foreign interests in a company cannot exceed 20 percent. But the next day, trading can go on freely. In certain cases, the finance minister can create a "golden share" to protect an industry in a strategic sector. Up to now, this option has rarely been exercised, but it has been for the Agence Havas. This is because Agence Havas concerns, to a large extent the press, and therefore freedom of communication. And it seems prudent, in a five-year plan, to take precautions.

Another role that the state plays in privatization is in distributing its holdings widely to the population. Consider some figures. Less than a year ago, there were only 1.5 million direct shareholders in France; now, there are four million. There is a commitment to having workers as shareholders. This is one facet of privatization which hopefully will encourage a change in the social climate of our country, and in certain industries.

If privatization achieves its objective, and becomes an integral part of our system, will the state become powerless? No. First of all, there will still be an extremely important public sector. And practically everything having to do with energy and with transport will be left untouched by privatization. So will the nuclear industry—not the manufacturing of products for it, but the industry itself. We are also keeping a certain number of national credit companies.

Perhaps the final justification of such an extensive program of privatization is that, in France, the state had gone much too far—much farther than any other country—and to return to a market economy means a much greater privatization effort than anywhere else. Not until the end of this first phase, when these 65 companies will have been privatized, can it be said that France has returned to the level of other Western countries. The French tradition is not that of a weak government, and the French people are not ready to absolve the state of its responsibilities to assure the solidarity of the economic structure. This is why, no matter how important and far-reaching our privatization program, it should not be seen to compromise the traditional foundations of the French economy and society.

In the last ten years, there has been a real revolution in the debate over role of the state in the economy. There has been a crisis in our planning policies that has led to the setting of quantitative parameters to our economic system. Now the state is less pervasive in economic life, as seen in developments ranging from Proposition 13 to the new French policies.

But it is impossible for the modern state to diminish public expenditure under a certain level. The experience of the last ten years has shown us that there is a limit to how far we can reduce public expenditure. Our societies have come to accept the welfare state as a political reality, and governments have generally not been successful in diminishing the cost of the welfare state. The developments of the last ten years have been useful in pushing governments to spend public money more efficiently, and to allocate public expenditure more efficiently, but a substantial diminution of social spending has proved completely impossible, not only because of political resistance, but because people feel it's the state's most important role.

We should not oppose the presence of the state in the economy, but rather its excesses. Among these are surely the dimension of the government as a direct producer of goods and services. Here, we have had a real change in the Western world, namely, the privatization process. It has been a major change not only in France, but in many European countries. The departure point in the United States was completely different. The difference in the dimension of public ownership in the U.S. and Europe was not only due to a different political philosophy, but to a different size of the market. The reason we have so much privatization in Europe today is because the size of the market has increased. It is now possible to privatize, where it was completely impossible in the old days.

In Italy, the public sector never expanded because of a socialist ideology, as in France and the U.K. Its growth was instigated by Mussolini, who wanted to do something for the ailing companies. Throughout Europe, the size of the market could not sustain economic development without direct state intervention. Competition, efficiency, and productivity are compatible in a big market, but not in a small one. Now, with the E.C. we are in a new era.

It is important that Europe has behaved very rationally, even if we didn't like the policies. In the beginning of the E.C., we had a merger policy inside each big European country. Each country had flag companies. There were many more mergers of American companies in the 1950's and 1960's than there were in between European companies because European countries were trying to become strong before entering into the European oligopoly.

Now we have a different policy. We have international mergers, new competition, and privatization. In spite of all the criticism, the E.C. is really functioning, and the new European competition is emerging more and more. Connections among European companies are increasing as never before. We should not judge the E.C. from the point of view of what goes on in Brussels or of the problems in agriculture, but rather, from the perspective of the new competition, and the new oligopoly that is being built. This is an important new chapter, and a precondition to denationalization. You cannot liberalize from a public monopoly to a private one. The political system will not stand it.

Each European country has done a lot to change its infrastructure. There has been a great deal of privatization in the U.K. since 1979, and many people moved from the public to the private sector. In Italy, we had a smaller movement in the sense that we did not have a general policy aimed at liberalization. But we have had an empirical process of liberalization, due to the fact that a good portion of the so-called nationalized industries in Italy are owned publicly but behave like private companies, and are quoted on the stock exchange. Selling minority shares in the stock exchange makes for a smoother privatization process.

It is important to stress that this is a general movement in Europe. The result is that Europe is becoming like the United States. This explains why European companies are active now in the U.S., just as U.S. companies were active in Europe. Of course, the change in the rate of exchange is a factor. But the reality is a new one. In the new Europe, we shall have many companies behaving like American ones.

There is another trend. Companies are becoming privatized through international mergers. It is becoming increasingly likely that there will be international mergers of public companies. If you merged a French company with an Italian company, you would have a new entity that was unideological, but could afford the new competition.

General Remarks from the Panel
III.

Rather than try to present a complete or coherent analysis of the topic under consideration in ten minutes of introductory comments, I hope you will allow me to offer twenty-five rather summary points—trusting that some one of them might be provocative. That will average about 20 seconds per would-be provocation.

(1) I take as given the general view that market-oriented policies stimulate greater innovation and growth.

(2) As a general matter, the world seems to be inching in a more market-oriented direction.

(3) This observation is probably more valid for the rest of the world than it is for the United States—but of course the U.S. is working from a more market-oriented base.

(4) Within the U.S., the most dramatic market-oriented economic change of the Reagan Revolution has been in the structure of the federal tax system—involving a series of tax reforms that started in 1981 and culminated in 1986 with the most comprehensive tax reform in the history of the country.

(5) The net positive effects of American tax reform are greater incentives for work and productive investment, and more market-orientation in the allocation of capital—all ultimately increasing productivity and growth. The net negative effect has been the reduction of the revenue base below the politically acceptable minimum spending level—that is to say, the enlargement of our structural deficit (to around 3–4% of GNP) and the associated accumulation of debt.

(6) I say “below the politically acceptable minimum spending level” because I believe the Reagan Revolution has come close to testing the limits of spending reduction—and has failed to undo the basic middle-class entitlement and social insurance programs that account for the main upward deviation from historical shares of GNP within the federal budget.

(7) These middle-class entitlement and social insurance programs are unlikely to be reduced significantly (as a percent of GNP) by any American administration. They have a wide base of popular support among voters (much more so than do programs for the poor). And they seem now to be a fixture in modern democratic societies—a protection against downside risk that is probably a practical political necessity if risk-taking, market-oriented democracies are to remain such. (Japan is the notable exception to this rule, with more of the risk underwritten on the private side.)

(8) Although farm price-support programs are increasingly subject to well-deserved criticism at home and abroad, I would include these among the middle-class (or near-middle-class) entitlement programs—and express a note of skepticism as to whether domestic or foreign political realities will soon allow the rationalization that most can identify as economically desirable in this area.

(9) Even with a well-managed effort at budget compromise in the U.S., it is unlikely that federal spending will be reduced below about 22% of GNP. With revenues at 19.5%, this would still leave a structural deficit of roughly 2.5% of GNP.

(10) That gap may be closed further in the U.S. by privatization—but not by much. Unlike some countries, the U.S. government has acquired assets principally as a result of pragmatic historical accident (so to speak) rather than as a result of ideological commitment. As a corollary, the ideological shift toward privatization is not, in fact, likely to produce much divestiture in the U.S. The current shift may result in additional one-time revenue gains on the order of \$10 billion—that is, merely a marginal contribution to reduction of the structural deficit.

(11) It is virtually certain, therefore, that there will eventually have to be an upward adjustment of the U.S. revenue base through some form of tax increase. What is uncertain is the particular form and its timing.

(12) My own bet is that the form will be first additional excise taxes and later, perhaps, additional energy-related taxes. In addition to reducing the fiscal deficit, this should have the favorable effect of reducing slightly the U.S. propensity toward current consumption. I do not think the U.S. will reverse course on the tax rate structure in the foreseeable future.

(13) As to timing, I would suggest that it is highly desirable that the revenue adjustment be part of a more comprehensive, negotiated settlement on both our budget and our budget process—and that that settlement ought best be negotiated in the next few months. It is desirable economically. And looking at this from the perspective of the next Presidency—with an interest in having a strong, popular and effective successor to the Reagan Presidency (whether Democratic or Republican)—it is desirable to get the fiscal policy correction out of the way now (that is, in what is probably the last chance before the next Presidency). Notwithstanding what seems to be the obvious merit of this view, I would put the chances of its prevailing at only 50%.

(14) Whether the further U.S. fiscal correction comes sooner or later, the ultimate resolution will likely leave the total governmental share of GNP at slightly over one-third. Thus, the U.S. would likely remain at about the same level as Japan—which is to say with a public sector that is substantially smaller as a percent of GNP than that of virtually all other OECD countries. (This assumes that for a variety of cultural and historical reasons, and notwithstanding favorable trends toward privatization and increased incentives for economic efficiency, the European economies will likely remain in the range of 45–50% governmental.)

(15) Given that likelihood, and assuming that the U.S. does not turn self-destructively protectionist, and assuming also that the U.S. increases its investment in non-defense, applied R&D and in human capital development—assumptions I think it not unreasonable to make—I would expect the U.S. and Japanese economies to show somewhat more dynamic growth than the European economies. Or putting the point more positively from the European perspective: Europe will have what is arguably greater potential for additional, growth-oriented policy change.

(16) Japan, of course, will have to move in the direction of the Maekawa report over the medium term—a process likely to be advanced not only by pressures from without, but perhaps more importantly, by the forces of generational change within. In the meanwhile—perhaps a rather long meanwhile—Japan will continue to accumulate large surpluses, most of which will have to be recycled. The direction of that recycling will be an increasingly important variable in foreign policy—with significant potential implications for politico-economic evolution and the balance of power. In general, the recycling should increase market-oriented growth; but what is still unclear is who will in fact be the beneficiaries of the necessary recycling.

(17) In the past few years, clearly the U.S. has been a principal beneficiary. Indeed, as a related matter, one might suggest that given its deficit, the U.S. could not have financed its growth over the past five years had it not been for the perception of “Eurosclerosis” and the reality of the third-world debt problems. (I recognize that this is a somewhat perverse line of thought.)

(18) Continuing with this somewhat perverse habit of thinking, one might note that another side-benefit of the third-world debt problem has been the opportunity it has created for the negotiation of debtor country policy change involving external parties—negotiation of change in directions that are both more market-oriented than before and more market-oriented than would otherwise have been the case.

(19) As a corollary: While there is need and room for refinement of the debt strategy, one should not wish to see modifications that would reduce the capacity to negotiate market-oriented change.

(20) In this process of negotiation, there has been an obvious increase in the role of the multi-lateral public sector—i.e. the World Bank and the IMF. But at least as currently oriented, this increase in international public sector activity has been consistent with an increase in market-orientation and growth.

(21) So too, has been the increase in the vitality of the Group of Five and the creation of the Group of Seven. The somewhat more systematic approach to exchange rate issues now

associated with these groups—even though it may at times involve greater intervention—can be valuable in sustaining market-oriented growth. And, more generally, these public sector groups, however imperfect, have improved the capacity of their member countries to coordinate more fundamental policies in the pursuit of market-oriented growth.

(22) At a more parochial bi-lateral level, I would note that amidst the protectionist fervor, the U.S. and Canada are quietly negotiating the larger part of a North American Free Trade Area that has great and largely unnoticed potential to expand and secure market-oriented growth on one resource-rich continent.

(23) Notwithstanding all these generally favorable tendencies toward greater market-orientation and growth, there is much risk in the evolving system. U.S. protectionism is rising. U.S. unilateralism is rising. Debt and some key interest rates are rising. Political stability in the world is not.

(24) But risk is inherent in the quest for progress.

(25) The key is to keep working incrementally to expand market-oriented policies—in ways that are sensitive enough to political realities and political limitations as to allow market-oriented policies to be politically sustainable. Unfortunately, that calls for a mixture of boldness and balance that is all-too-rare—thus raising a final question as to whether it is really prudent for this distinguished group to gather in a single room at the same time.

Thank you very much.

Discussion

In an International speaker's view, there had been a remarkable evolution in the thinking of industrialized countries about the government's role in the economy. There was a general recognition that, in terms of macroeconomic policy, the public sector, instead of being the correcting element in an unstable economy, should be the stable, predictable element in order to allow room for a flexible private sector.

While government had come to realize that, in terms of expansion into the social field, the public sector had become too big, not enough thinking had been done, especially in Europe, about how to reconcile economic and social objectives. Government intervention in market economies had become a negative influence on growth, income, and unemployment—the very opposite effect of what social policies had been trying to achieve. All the industrialized countries were now trying to find a reconciliation between these apparently conflicting objectives. We had pretty well found the upper limits of the public sector, and agreed there was a lower limit where the state played the role of the protector of last resort. But every country was different, and it was impossible to arrive at an optimum public sector size applicable to all countries. What was more important than size was the quality of the government.

This view—that, with respect to growth, qualitative aspects of government policy were more important than quantitative ones—was subscribed to by several participants in the discussion. Said an Austrian, growth could be enhanced by such public sector measures as those that stimulated private investment or supported exports, and such future-oriented measures as expenditure for research and development and education. A Norwegian agreed that different policies had different impacts on economic growth and public welfare. For example, an increase in expenditure for retraining the unemployed would have different consequences from an increase in pension payments.

Addressing the state's role as environmental regulator, speakers felt that it was important for the state to continue to play a strong role. Environmental regulations, said a British participant, were not always the enemy of growth. It was important to have a means of assigning the costs of pollution properly, and to show populations that growth and maintenance of the environment were not incompatible. Added a Norwegian, tough environmental regulations today were needed to avoid future expenditures detrimental to growth.

The politicization of decision making was seen by many speakers as one of the chief faults of state intervention in the economy. This was a particular problem with state ownership of companies. In an Italian's view, the power of the state in the economic field had its strongest expression in political control over corporate managements. Political influence on the running of nationalized companies, said a Norwegian, made them harder to control democratically. The old socialist theory that public ownership was a safeguard for democratic control was not true. A Briton agreed that there was a great temptation to politicize decision making. In the British nuclear program, for example, bad decisions had been made by bureaucrats in such things as reactor choice, speed of growth of the program, and even the necessity of the program.

Privatization, continued the British speaker, was beneficial from the point of view of enforcing environmental and land-use regulations because it assured an arms-length relationship between regulators and industry. The worst coalition, from a regulator's point of view, was that among trade unions, managers, and bureaucrats united in favor of retaining present employment and production patterns. The fundamental purpose of privatization, concluded the speaker, was not simply growth, but also the creation of conditions where growth could occur more freely by removing the alliance between industry and the bureaucracy.

Another drawback of state-owned companies pointed out by speakers was that they could not adjust as quickly to changing conditions. To be able to achieve the benefits of international trade, said an American, firms had to make rapid adjustments; state ownership was a barrier to such adjustment. For example, ministries tended to oppose greater imports. So privatization was an important tool in achieving free trade.

But making quick adjustments was not only a problem for nationalized countries, said an American. Some large private firms were as slow as governmental organizations to adjust. And with respect to decision-making, pointed out a Briton, large private companies, too, had made mistakes in planning and in investment policy.

Several participants felt that it was not always clear that private ownership was more desirable than state ownership. In the opinion of an Austrian speaker, there was no black or white answer. Some objectives could be better achieved by letting market forces prevail, and others by state intervention. No matter who were the owners, industrial companies and financial institutions had to be managed competitively. A countryman agreed that it made little difference who the owners of a company were; what mattered was how efficiently the job got done. Regardless of ownership, our industries required entrepreneurization and, in some cases, restructuring.

Nor did it matter a great deal from the worker's point of view whether a company was publicly or privately owned, said an American. If efficiency, productivity, competitiveness, and economic growth were the objectives, then worker involvement was very important. And as far as that was concerned, the quality of management and leadership transcended questions of ownership.

It was generally agreed that privatization did not mean the state would no longer have a major role to play in economic affairs. The public sector had to be part of any policy mix. The state, said a French speaker, had a continuing important role as the regulator of economic life, writing the rules and making sure they were obeyed. An Italian agreed that this was very important in order to avoid countervailing forces to privatization. We had to develop regulatory bodies governing such things as competition and anti-trust issues, or we would risk a return to nationalization.

With private sector growth, added a Turk, the role of the state as regulator and as manager of budget and monetary policies would increase in importance. A countryman stressed that privatization did not automatically bring about growth, nor did it dispense with the need for appropriate macroeconomic policies. Privatization made room for growth by speeding up structural adjustment, but an appropriate competitive environment was still needed. Therefore the state's role in such things as trade liberalization remained crucial.

A number of speakers rejected the notion that there was a correlation between the size of public sectors and growth rates. A Swede pointed out that Switzerland and Finland had public sectors in the size range of the U.S. and Japan, but had not achieved the same rates of growth. A Briton agreed that statistics did not tell the whole story. With respect to Japan, it could not be said it was really a free market economy or that the state was not heavily involved in it.

Two speakers from Scandinavian countries spoke about how difficult it was, with absolute majorities of the electorate in their countries, Sweden and Denmark, dependent on the public sector for their income, to achieve public sector reduction or privatization.

An American worried that the emphasis in the discussion upon economic growth meant little unless it had some direct bearing on the people it was supposed to benefit, particularly those who were severely disadvantaged. How did growth relate to people who were really hurting?

How to deal with those whom even growth could not help, who would still be unemployed, was indeed a problem, agreed another American. But a remedial program, priced at today's technology to deliver it, to feed, cloth and educate these people would require more surplus than was there to reallocate and still have a rising standard of living. Instead, we had to have growth extensive enough to provide a large enough surplus to deal with these people, in addition to a technological breakthrough in providing services, which was more apt to come from the private sector.

In another exchange between two Americans, one expressed concern that the U.S. was not doing enough to increase its productivity, which, the speaker felt, had been hurt by the recent tax legislation. There needed to be some measures to moderate the increased effective tax burden on corporations and on investment created by this legislation.

A countryman's response was that, while it would not be profitable to reopen the debate on U.S. tax reform, it was true that the legislation did not adequately address the American propensity to consume rather than to invest. The next upward adjustment in taxation should therefore be on the consumption side. Yet it had to be realized that the corporate income tax was a relatively minor factor in the productivity and competitiveness of U.S. industry.

There was wide agreement among participants in the discussion that, in seeking to achieve economic growth, it was essential that we deal with the problems of the developing world, particularly with respect to debt. In an International speaker's view, there was a direct relationship between the management of the debt crisis and growth in the industrialized world. It was, in a sense, a vicious circle. Growth in the industrialized countries was not likely to be as high as we would like. Corrections of trade balances had been done mainly on the import side. Economic growth in debtor countries had been very low, and these countries were reluctant to go on paying very high interest rates. Better policies were needed to stimulate growth in debtor countries; creditor countries had to produce better incentives for debtor countries to adopt better policies. What was needed, in short, was the development of some criteria for debt relief.

What should be our approach to the problems of the developing world? In the view of a Greek speaker, in those countries where even the most basic human requirements were absent, our approach should be based upon ethical considerations. Such countries would not achieve high growth rates for many years. But there were other developing countries where populations were no longer destitute and where sufficiently trained or trainable work forces existed so that extremely rapid growth rates from applications of existing technology could be achieved. In the case of such countries, our motivating concern should be enlightened self interest.

A renewed flow of capital to the developing world, while it would not solve short-term problems, was critical in the medium term, because, in the next recession, the U.S. would find it difficult to provide the kind of fiscal and monetary stimulus it had given in the last recession. We needed a common Western strategy toward developing countries to help them adopt Western-style economies. We had to influence them to follow rational economic policies, and we had to have as a priority the provision of a greater flow of funds, though not necessarily from governments. In particular, we needed to persuade Japan to provide surplus capital to the developing world.

Both public and private sectors had roles to play in this effort, agreed participants in the discussion. The public sector, said a Portuguese speaker, could help promote investment as a partner, or as an accelerator of privatization. A Swiss speaker argued that involvement of the private sector, which was vital, depended on the public sector's helping to assure the right kind of environment for committing funds. The domestic policy alignment had to inspire the private sector's confidence that there would be relative freedom in the years ahead and that industries would be able to sell to the industrialized countries.

In the last analysis, said a Belgian speaker, growth depended on a withering away of the nation-state. We needed to take international action. An American agreed, saying there had been a fusing of national and international interests. The international system was under stress, with budget deficits, trade imbalances, and third world problems, and international solutions were needed.

Our challenge, said a Frenchman, was to find the system that best assured growth in the world, which was indispensable for the developing and developed countries alike.

IV. CURRENT EVENTS: CHINA

Opening Remarks from the Panel

I.

China is the most dramatic and historically important panorama in the world today. It is also one of the most complex. China was the Middle Kingdom for thousands of years. In the 17th century, it began to fall behind Europe. From the mid-19th to mid-20th century, it was humiliated by outsiders. In the last 40 years, especially the last 10, China has reasserted itself, and is now determined to become the Middle Kingdom again, whether in the next century, or later.

To get there, China faces two fundamental challenges. The first is how to develop the economy without losing political control. There is a traditional Confucian Chinese fear of chaos, now overlaid with a modern Leninist Chinese imperative of maintaining party dominance. The second challenge is how to obtain outside technology without forfeiting Chinese culture and identity. In current parlance, this means pursuing economic reform but upholding the four cardinal principles which boil down to Communist Party control and socialism. It means also pursuing an opening to the outside world, but opposing bourgeois liberalization—Westernization.

The challenges facing China today are unlike any in its history because (1) in the age of technology and information, development requires much greater decentralization within the country and linkage with the outside world, and (2) in the age of television and telecommunications, visitors, and returning students, the doors are open wider, permanently. China may aspire to be the Middle Kingdom in the sense of being the predominant country in the world, but it cannot again be the Middle Kingdom in the sense of being self-reliant and secluded.

Deng's modernization program has made considerable progress—in agricultural production, income for peasants and for some urban dwellers, consumer goods, overall growth in living standards, and political stability. In accomplishing these things, Deng has been facing a dilemma that all reformers face. He has to go fast enough to maintain momentum, but slow enough to maintain control. He has to overcome various entrenched interests but not allow them to coalesce into an effective resistance. Thus since 1978, there have been pauses when Deng has encountered problems—economic slowdowns, tightening up of the cultural and political scenes. He has been skillful at consolidating when he has run into trouble—protecting his flanks, building a new consensus, and then moving forward.

The current phase is by far the most serious Deng has faced. First, he faces economic difficulties. Until 1984-85, he did the relatively easy part—agricultural reforms and adjustments in the industrial sector. He is now entering the more difficult phase of meshing a market economy and a socialistic one. The present economy is a hybrid that can't work for the long term. Deng is facing the fundamental dilemma of centralization versus decentralization. The economy is now overheated. It has done very well in producing consumer goods, but there are bottlenecks in the infrastructure—energy, communications, and transportation. The result has been inflation, which hits a historical raw nerve in China, and gives rise to fears of urban unrest and of workers and students linking up in protest. There are budget deficits and a foreign exchange squeeze. There is also the ongoing problem of too many people and too few of them educated. The leadership is not biting bullets on key issues like price reform, enterprise reform, bankruptcy law, labor mobility, etc. Nor is it facing up to key political reforms needed to go along with economic reforms, notably the role of the party.

Deng is also running into political and social strains—of rising expectations and of disparate income levels between sectors of the population and sections of the country, against the egalitarianism of the last 30 years. There is resistance from mid-level, timid bureaucrats and party cadres whose power is threatened. There is even resistance among some people who prefer the security of the iron rice bowl to the insecurity of the need to work harder. And there are increasing signs of outside influences—corruption, white collar crime, prostitution, black markets, and even stirrings of democratic ideas. All of this illustrates Deng's two big dilemmas:

how do you make domestic progress without domestic disorder, and how do you gain foreign assistance without foreign contamination?

This was the backdrop to the student unrest of last December and January, the fall of Hu Yaobang, and the expulsion of selected intellectuals. The current Chinese line is that of energetically reassuring the world that the reforms and the opening to the outside world will continue and that there is political consensus. This is largely sincere, and there is much evidence to back it up. On the economic side, there has been a slowdown, but not a reversal. Many core economic reforms have been untouched, some are still going forward, others are postponed, and the economy continues to do well in many areas.

On the political front, we are not seeing the kind of bloodletting or tremendous instability of the Cultural Revolution, or anything since. The political campaign is relatively controlled, few people are being picked out, and they are not being humiliated as much as in the past. The Chinese people are going through the motions on the ideological lessons they are now getting, rather than climbing on the bandwagon and attacking those who have been singled out.

There is much momentum in the reforms. Most people are better off. There is a thick web of ties to the outside world, through economic investments, student exchanges, etc. It would be hard to reverse the reforms or the opening on a broad scale. No one wants to go back to the ideological frenzy, the economic disasters, and the xenophobia of the Cultural Revolution. Deng and the other leaders can't be neatly categorized as either conservatives or reformers. He and the others, he says, are reformers with respect to opening the inside with the economy and the outside with foreign connections. At the same time, he and the others, he would claim, are conservatives in upholding the four cardinal principles and in opposing bourgeois liberalization. Even the conservatives want some market economy and some opening, and the reformers want political and cultural control. Thus, the debates center to a large extent on pace and degree—how much and how fast—rather than direction.

The debates now taking place are nevertheless intense and important. There is a struggle to decide the top party and government positions, and a struggle over economic policies. Is the cure to slow down and have more controls, or to speed up, institute more far-reaching reforms and have fewer controls? The Chinese say they have had a continuous policy of following both tracks since 1978—that is to say reforms and opening at the same time as adhering to the political principles and opposing bourgeois liberalization. But until last December, they really were following only the first track. Now there is equal emphasis on both, with conservative themes dominating the media and propaganda and Zhao and other reformers paying careful homage to these themes. The most profound effect of recent events has been the crushing of the literary and artistic spirits.

Thus, if there is a consensus, it is formed at a more conservative point along the spectrum. Furthermore, the removal of a party secretary in a communist country by extraordinary means must add up to something. Deng was probably disillusioned with Hu to a certain extent. He wondered if he had the steadfastness to lead. He had an impetuous style, and threatened order because he was moving too fast on political and cultural reforms. Deng himself is a conservative in these matters. And there was considerable opposition from the army and from conservatives. His not putting the students down quickly enough was the trigger for his demise. But Deng probably would have preferred to wait for the Party Congress in October and a more orderly process. Stability and an assured political succession had been among his prized achievements.

Deng is still the number one person in China, but he needs a consensus more than ever. The succession is up in the air, and the next prime minister and key seats on the politburo are up for grabs. Zhao will become the party secretary in October. Economic reforms are stalled or will be implemented cautiously when they do come about. Political reforms are postponed and will be limited. Intellectuals, artists, and students are cowed and bitter. Self-censorship is deeper and wider than ever before, precisely at a time when China needs new ideas to go ahead. Fewer students may return from abroad.

The central question on the domestic side is whether we are witnessing the emergence of fundamental contradictions which will lead toward stagnation and political tensions, or a consolidation and regrouping which will lead to resumed momentum on reforms and opening. The answer has clear implications for China's economic interactions with the West and its strategic orientation toward the West.

Chinese foreign policy is totally geared to their domestic imperative of modernization. On a strategic level, they seek to protect their security in the coming decades while concentrating their energy and resources on modernization. On a specific level, they deal with a complete spectrum of countries—from Iran to Israel to Nicaragua to South Korea—pragmatically, not ideologically, for economic assistance, military cooperation, and political influence. In the early 1970's, China opened to the West because of its geopolitical concern about Soviet encirclement. In the late 1970's, it tilted toward the West because it thought the Soviets were on the offensive and the U.S. was on the defensive. In the 1980's, the Chinese have followed a more even-handed policy toward the superpowers because they've seen the Soviet problems and they think the U.S. has rebounded.

China's basic strategy is, first, to look to the U.S. to maintain the global and Asian balance. They need a steady, responsible American role in the world. They want a strong U.S. presence in Asia through deployments, for example, in Japan, South Korea, and the Philippines. They work with the U.S. in areas of direct geographic security concern to them, like Afghanistan, Indochina, and even Korea. Elsewhere in the world, they pursue an independent line for ideological reasons, for influence, and sometimes out of genuine tactical disagreement with us. Bilaterally, we have broadened the relationship well beyond the geopolitical through high-level and working visits, and through a military relationship that has expanded enough to catch the Soviets' attention but not enough as to be provocative to our Asian friends. In the economic, cultural, and scientific areas, we have greatly expanded our contacts. Our main problems remain Taiwan, which is being managed quite effectively, and some economic tensions which have arisen. These are really a sign of progress in our relationship, as our two greatly contrasting societies interact.

What are China's policies toward the West more generally, including Europe and Japan? They seek to obtain Western capital, technology, and management. Recently, they have been giving heavy and favorable emphasis to Europe in terms of high-level trips and increased trade. They believe Europe does a better job of transferring technology than either the U.S. or Japan. They are particularly ambivalent about Japan for a variety of reasons.

There has been a reduction in tensions between China and the Soviet Union. The Chinese can't afford to take the Soviets on in the near future. The relationship was improving before Gorbachev, and has picked up momentum since, in the form of visits and exchanges, and an increase in trade. There is even improvement on the political front, although the Chinese deny it in order to keep pressure on the Soviets and not jeopardize their Western connections. There is some movement on the border question.

China is also pursuing better relations with Eastern Europe. Relations with Moscow will continue to improve, but pose no threat to the West. There are built-in inhibitions to Sino-Soviet relations of a geopolitical nature as well as other factors which will keep the situation from becoming dangerous. They are two large empires rubbing up against each other, with disputed borders, overlapping ethnic populations, and other racial and historical factors. The Chinese know the long-term threat comes from the Soviet Union, not from the West, and they know that over the long term, their economic destiny lies more with the West. Thus they hope to get help for their domestic development and buy time in security terms, to get through the next decade when they are vulnerable and to reach a point early in the next century when their economic strength is translated into military strength and they are better positioned to maintain their security.

What has been the impact of recent events on their foreign policy? There is a broad consensus among conservatives and liberals alike on Chinese foreign policy. It has not been an issue in the domestic debate except at the margins with respect to the cultural contamination of outside influences. There has been a marked increase in tensions with Japan recently, but they have always been there. There has been no impact on foreign policy with respect to the U.S., the Soviet Union, or Europe, or on approaches to the Third World. Nevertheless, it is difficult to say that the domestic debate and turmoil might someday not lead to foreign policy changes. To the extent that the Chinese lean more toward a centrally planned economy—an ideological affinity with the Soviet Union—this could have an effect over the long run. There is much logic to their current foreign policy. Their basic geopolitical and economic imperatives will maintain the basic lines of their foreign policy through Deng and beyond.

Will China continue to go on a course toward reform and opening? The Chinese themselves cannot be sure. The least risky forecast is yes, but more slowly, zig-zagging for the next few years, with more wariness of foreign influence. The last few months have brought home to the

world and indeed to the Chinese the awesome magnitude of their challenge. The world's oldest civilization and most populous country is venturing forth on totally uncharted terrain. One wishes them well, for the sake of the Chinese people and for the sake of Asian and global stability.

Opening Remarks from the Panel

II.

At the end of March this year, the Chinese Minister of Finance, Mr. Wang, presented the accounts for 1986, and he surprised many foreign observers. The deficit of just under eight billion Yuan amounted to only three percent of the budget of 230 billion Yuan. It was not, as many had expected, the case that Chinese revenues had fallen, but that they had instead risen 3.7 percent higher than estimated. The deficit was primarily due to increased expenditures by provinces and towns, which, because of decentralization in the domestic and international economic sectors, had recently been given financial decision-making power.

After an extremely strong expansion which had, from mid-1985, led to severe economic imbalances on the home and foreign fronts, the People's Republic of China succeeded, in the first years of the current five-year plan, in returning to the more moderate path the plan foresees.

With respect to the domestic economy, the eight percent economic growth announced for 1986 is a noteworthy success. While agriculture in China only expanded by three percent, development mainly came from industry, which was responsible for a good 40 percent of the national income produced. Strong expansion was above all seen in businesses with foreign capital investments, where technical equipment and management experience is above the Chinese average. In spite of the small role of these businesses in China's total production, they play a leading part both in technical and economic modernization and in the willingness of Chinese companies to innovate.

What is decisive for China's future development is the continuation of the reforms begun in 1978. A major element of the domestic transformation is decentralizing decision powers down to the company level. Discussion last winter concentrated heavily on the transfer of all production responsibility to works management, not the political cadres as in the past. This management style is already being practiced in four percent of all industrial works, on a trial basis. However, because of political developments in the face of the student unrest at the turn of the year and because of the criticism of the former Party Chairman Hu Yaobang, the concept of a nationwide introduction of this important reform of urban industries was not presented for approval at the Fifth National People's Congress this March.

Price reform, the second prop of China's progress, was also delayed, insofar as stability in consumer prices has been determined to be a principal objective for 1987. This can be seen as a precaution against possible solidarity between China's workers and the demonstrating students. The consequence of this price freeze is that industry cannot freely increase prices, and thus impulses for rationalization, quality and satisfying market demand cannot be brought into effect speedily.

There were structural successes in the way consumer goods developed. The planned growth figure of 13 percent was achieved, which compares especially well with the six percent growth in machine and plant construction. Rural reforms, which have already made greater progress in the direction of better serving market demand, showed the first signs of success.

There is a long way to go before this transformation is felt in machine and plant construction, in spite of technical modernization seen particularly in machines, energy production, and transport. Disagreements over authority among the administrative bodies, the lack of parts and supplies, shortages of raw materials, transport difficulties, and foreign currency shortages are constant problems. Nevertheless, the main obstacle to the development of Chinese companies and thus for the whole economy, is the lack of both management and technical know-how. The Chinese government recognized this years ago, and has therefore declared the import of know-how to be a goal of economic policy.

As regards the international economy, in 1985 imports into China led to a balance of trade deficit of \$15 billion. This was largely due to import levels rising above the planned level as a

result of the decentralizing of foreign trade power. By contrast, last year's imports were severely cut back, with only a 1.6 percent increase and a reduction in the trade deficit to \$12 billion. And currency reserves, which had fallen about 30 percent from 1984 to 1985, dropped only \$1.5 billion, to \$10.5 billion, from 1985 to 1986. China's state planning commission has stated that, for 1987, only high technology and key equipment should be imported. Purchases of conventional machines, as well as of consumer goods, are to be foregone.

In order to balance the trade deficit, China has, in recent years, tried to improve the production structure and quality of its export goods. This has been done by cooperating with Western businesses in such things as licensing agreements and joint ventures. Thus, 1986 saw agreements on projects amounting to \$4.5 billion in energy, transport, machinery, electronics, mineral oil, chemistry, metallurgy, and light industry. Despite considerably reduced proceeds as the result of price decreases in agricultural products and crude oil, as well as devaluation losses on the Yuan, China's finished product exports almost doubled last year. Western industrial nations purchased 12 percent more finished goods from China last year.

The Chinese application for membership in GATT is aimed at helping China's exports increase further. However, the acceptance of such a large economy, which operates on state trading principles, must be viewed with extreme caution in order to protect the present GATT member states. In this context, the Soviet Union's desire to join GATT must also be kept in mind. Still, it is a step in the right direction.

The Chinese government's idea of financing part of the current-account deficit with long-term borrowing has only been partly realized. Credits from Western banks, governments, and international organizations have indeed increased rapidly. At the end of 1986, debt rose to a net \$7.6 billion.

In Chinese law, there is a basic dissent between foreign investors and their Chinese partners which has developed in recent years into a major problem for joint ventures. Foreign firms want to supply the Chinese market, while the Chinese primarily want to import technical know-how and to earn foreign currency through exporting. The importance of joint ventures as import bypasses has hardly been recognized in China thus far. At the same time, joint ventures are faced with great problems, including the lack of foreign currency, expensive labor, and shortages of raw materials.

Many attempts have been made to draw the Chinese government's attention to possible solutions to this problem. Directives and agreements since the autumn of 1986 indicate that the Chinese government is really attempting to improve investment conditions.

China's most important partners in industrial cooperation are Japan, Hong Kong, the U.S., and the Federal Republic of Germany. But it is worth noting that trade with the Soviet Union, at \$2.5 billion last year, reached the highest level in the last 25 years. In 1986 alone, projects worth \$3.5 billion were agreed upon. The Soviet Union has thus become China's fifth largest trading partner. This is a welcome sign of a renewed Sino-Soviet dialogue.

Discussion

China's chances for success in its modernization program were viewed with a degree of skepticism by several participants in the discussion. In an American speaker's view, it was very difficult to introduce incentives into a centrally planned society without challenging so many vested interests that insoluble political problems would result. How could China's leaders be politically conservative and still bring about economic reforms when the main obstacle was the Communist party. Were we not now seeing stalemate rather than a continuing process? A response from the panel was that this was indeed a dilemma for China's leaders. Yet they would say that political reform will come, not in the form of a much looser society or much greater decentralization, but as a streamlining of the Communist Party, with more authority being given to factory managers versus party representatives, for example.

A German, observing that both the Soviet Union and China were embarked on reform programs at the same time, wondered which of them would reach its goal first, if at all? He was not inclined to bet on China for three basic reasons: it was ungovernable, the question of its future leadership was up in the air, and its population growth was out of control. Through 4,000

years of history, China had swung between extremes of governability and ungovernability. The Communist leaders had continued the ancient Chinese tradition of palace intrigues and regular upheaval, as in the Cultural Revolution. It was hard to believe that this was going to change and that there would not someday be another Cultural Revolution or similar upheaval. With respect to leadership, Deng's sun was setting. Two potential successors had fallen from grace, and a struggle for succession seemed to have begun. Would Deng be able to impose his will? Or would his ideas die with him? And finally, China was faced with the problem of population growth. The success or failure of its family-planning scheme would determine the success or failure of its whole reform effort. There were now indications that China was losing this battle, and this would have dire consequences for economic modernization.

Another potential problem for China was pointed out by a Briton. He recalled noticing, on a 1979 journey to China, that the economic fortunes of some agricultural and factory workers whose incomes had increased due to the crude system of bonuses that was then in place, were better than those of army officers and party functionaries, whose fixed incomes were being eroded by inflation. If it was still the case that some sectors of society—especially the army and the party—were benefiting less from economic reforms than others, was this not a potentially explosive situation?

Speaking in response to these views of China's chances for successful reform, neither member of the panel agreed that the Soviet Union had a better chance of successfully modernizing than China. One panelist argued that China had distinct advantages. It had started its reforms earlier. The Soviet Union had had centralized economic authority for 40 years longer than China. Structural problems in the Soviet Union were greater, such as the distance of the raw-material producing regions from the industrialized regions, and tremendous ethnic problems resulting from the growth of the non-Russian population. It would be far harder to solve the Soviet Union's structural problems and to reform its economy than China's. The other panelist agreed, adding that the Soviet Union had a more entrenched bureaucracy than did China. In addition, with 4,000 years of history behind them, the Chinese had far more self-confidence than the Russians.

Both panelists agreed that the chances of a second Cultural Revolution were small. One felt it was unlikely because so many Chinese already were experiencing the advantages of the new economic course. Said the other panelist, the Cultural Revolution had been very traumatic. It was even viewed by some in China as a blessing in disguise because it showed how bad things could get. Rather than collapse into another such upheaval if the economic program did not work out, China was more apt to slow its program down, and to adopt more of a Soviet model.

Regarding the leadership succession, a panelist pointed out that the leading conservatives were as old as Deng for the most part, while those in their 30's and 40's were more Western-oriented, and more "freewheeling." As to the population problem, growth had been slowed down by a forceful family planning policy. It was true it had been somewhat relaxed, but the situation still appeared to be under control.

As to the problem of different sectors of the population sharing unequally in the benefits of economic modernization, a panelist agreed that the ingredients for a blow-up were there. But still great progress had been made in the last 10 years, and the majority of people were better off today. Also, the atmosphere was much freer. All of this gave much momentum to the reform movement.

In the realm of foreign policy, an American wondered how the Chinese currently viewed the role of the United States around the world. In the early years of the relationship between China and the U.S., what the Chinese wanted more than mere contact was for the U.S. to maintain the balance of power in Asia, particularly with respect to the Soviet Union. They wanted a predictable American foreign policy that showed an understanding of the geopolitical balance of power. What, the speaker asked, did the Chinese think of the current U.S. posture? Was there a danger that if the U.S. seemed too anxious to improve relations with Russia then the Chinese might start to make compensating moves in the same direction? Did the Chinese view American policy as stable or as idiosyncratic?

A panelist responded that, in the Chinese view, the U.S. had rebounded economically, militarily, and in terms of national self-confidence. They had tilted toward the U.S. in the 1970's because they felt the Russians were on the offensive around the world, while the U.S. was weak and disorganized in the aftermath of Vietnam and Watergate. They wished to right the balance.

Today, the Chinese applauded America's new strength and felt the current administration had done well around the world. If the Chinese view of the U.S. as being stronger did result in an easing of Sino-Soviet tensions, we should not be overly concerned, because there were limits to how far such a thaw could go. What was most important from the point of view of China was that the U.S. maintain a steady, responsible role in the world.

Several speakers wondered about China's foreign policy in the region, especially with respect to Hong Kong, Taiwan, Vietnam, and Japan. A Canadian asked if China was likely to leave Hong Kong's capitalistic system intact after taking over from the British. Would domestic political pressures and ideology allow them to? An American who had recently been in the colony reported that he found members of the financial community there to be optimistic about Hong Kong's future under the Chinese. The prevailing feeling was that China would be unlikely to tamper with Hong Kong because of the colony's great importance to China as a source of capital and technology. In addition, how China treated Hong Kong would surely have a significant bearing on what might happen with Taiwan. A panelist agreed that China had a major incentive to make the system of one country/two systems work. The question was did they have the subtlety to maintain investor confidence. One could take some encouragement from the fact that Hong Kong had always been left alone by China, even during the Cultural Revolution.

With respect to Taiwan, a panelist said there were two big issues of concern to the Chinese at the present time. One was American arms sales, which they did not like but tolerated as long as such sales were gradually diminishing. The other issue was the U.S. role in advocating a reconciliation between Taiwan and the mainland. China was particularly concerned about the growing opposition party on Taiwan advocating independence and felt the U.S. should take a greater role in promoting reconciliation—a position the U.S. was rightly not willing to take. In any event, what happened ultimately in Taiwan would be determined to a large extent by China's conduct toward Hong Kong and Macao.

A Briton was curious about China's relations with Vietnam, and wondered whether China saw itself as the guardian of prosperity in Malaysia, Singapore, and elsewhere in the region. A panelist reported that there was great hostility in China toward Vietnam. This was the greatest obstacle to better Sino-Soviet relations. China held the Soviet Union accountable for getting Vietnam out of Cambodia. The Chinese felt that time was on their side with respect to Vietnam. Keeping troops on the border with Vietnam was costly, but it did give Chinese troops battlefield practice. And China felt it was keeping Vietnam from pressuring Thailand.

An International participant felt there had been some curious exceptions to China's pragmatic foreign policy. Why had China become involved in Africa, financing the construction of a railroad in Zambia and supporting Mugabe in Zimbabwe? What advantage were they seeking? Were they likely to become similarly involved again in Third World regions? The response from the panel was that China's involvement in Africa took place in an earlier period when it was more ideological and more in competition with the Soviet Union for influence. They had since cut down their involvement in the Third World.

Finally, a panelist provided an interpretation of China's policies toward the developed world. As to Japan, the two nations very much needed each other. But the scars of World War II were still very fresh, and there were economic tensions arising from Japan's failure to transfer technology to and invest in China. China's attitude toward Western Europe was somewhat dichotomous. On the one hand China wanted a more multipolar world, with more powers than just the U.S. and the Soviet Union. For this reason, they wanted Western Europe to be more independent of the U.S. Yet they also wanted the U.S. and Europe to stick together. The existence of NATO provided a strong flank to the Soviet Union's west, which eased Russian pressure on the Chinese border.

Looking ahead 100 years, a German speaker saw three possible scenarios for China. First, it might still be a huge developing country with little chance of modernizing. Second, it might become a "kind of yellow Brazil," modernized and industrialized on its seaboard, but backward and impoverished in the interior. Finally, it might become like Japan, a success story of reform and modernization—a possibility that would cause "frightening problems" for the West. In view of this last scenario, in which China might attain the per capita export level of Japan and swamp world markets with \$800 billion worth of goods, we might well ask if we really wanted China to succeed.

A panelist acknowledged that already we could see the beginning of a problem along these

lines. China was starting to present a challenge at the low end of the scale; in 1986, it was the top volume textile supplier to the U.S. Nevertheless, we should wish for the Chinese to succeed. Over the long pull, they would modernize, with Western help or without it. The best course for the U.S. and Europe was to work together in establishing links with China, and in using leverage—such as the Chinese desire to join GATT—to get them to open up their economy. Otherwise the considerable commercial, cultural, and scientific benefits of participating in China's modernization would go to others.

V. THE ARMS CONTROL DEBATE

Working Paper

Arms Reductions, Ballistic Missile Defense, and Strategic Stability: United States and Europe

During the past few years there seems to have evolved a very general sentiment that the strategic nuclear arsenals of the U.S. and the Soviet Union must be reduced by very large cuts. This represents a change from previous, less ambitious arms control efforts, including the Nuclear Freeze (which was in fact aimed at stopping weapons technologies, not reducing numbers). Thus far, reports from various negotiations with the Soviets, and statements by various arms control experts both from the United States and in Europe, have expressed serious interest in various levels of total reductions in strategic forces. These levels have ranged from reductions of 50% over current deployments, to reductions of 90% and even to the complete removal of all strategic nuclear warheads.

It is important to recognize that the probability of initiation of strategic nuclear conflict is not in any direct way a function of the size of the nuclear arsenals of the superpowers. Any doubts one might have had concerning this point have been largely dispelled by the past 35 years of growth to huge strategic nuclear arsenals. Thus, the principal motivation for reducing the size of nuclear arsenals is to reduce the total damage that could occur should deterrence fail. Reductions can also strengthen deterrence if particularly destabilizing weapons are eliminated.

Now, however, if the context proposed is one of major reductions, one must examine carefully the nuclear balance, its stability and the security of each side. That is to say, the reduction from 10,000 nuclear warheads apiece to 5,000 apiece might not present a serious problem for stability; but to reduce as far as 1,000 warheads per side, or a few hundred, must be seen as a matter of serious concern for the preservation of strategic stability.

Such large reductions raise these concerns on three different accounts. First, one must ask whether deterrence based on a balance of strategic offensive forces still exists. For instance, even if a common measure of number of warheads is agreed upon, one must recognize that the Soviet Union has a significant advantage over the U.S. in deliverable payloads for strategic missiles. Thus it would be possible to exploit this payload advantage with heavier warheads of higher yields. An acceptable scheme for disposition of strategic firepower on both sides must be arrived at before one can have confidence that a stable strategic balance would continue to exist. In a sense, these are accounting problems; but they are extremely important and difficult accounting problems, and one cannot be guaranteed that solutions which are both equitable and acceptable exist, or can be reached.

The second major source of concern is that, with strategic warheads in the few hundred range, defenses based on currently existing technologies begin to matter a lot. Whatever one thinks about the efficacy of defending against unlimited strategic strikes where the threat involved is 10,000 or more warheads, one cannot reasonably discount the military value of widespread defenses against a few hundred such warheads, particularly when the number of interceptors may well be in the thousands. Serious asymmetry currently exists relative to this concern. That is, the Soviet Union has widely deployed air defenses—upwards of 10,000 individual interceptors, and over a thousand radars—and is currently deploying a highly capable anti-tactical missile system, also in large numbers. None of these missiles has the strong ballistic missile defense capability of the ABM-X-3 system being upgraded around Moscow, but in overwhelming numbers they cannot be judged negligible against small attacks. In addition, the ABM-X-3 system itself has essentially open production lines. Although the Soviets are for the present remaining within Treaty limits for their deployment, the U.S. could not deploy, much less extensively deploy, such a system in the next several years.

The third source of concern arising from large strategic warhead reductions is the obvious fact that at levels of a few hundred warheads, cheating begins to matter a lot. In the case of mobile ICBM's, it is entirely possible that the Soviet Union could have in ready storage twice as many

serviceable ICBM systems as are permitted by a Treaty, without our having any positive indication that they exist. Thus, cheating could essentially double the military power of reduced ICBM forces, and when coupled with defenses this leverage can be, overall, much larger. Here, too, the situation is asymmetric: the U.S., would not seek to cheat, and even if it did, it would not likely succeed in concealing such cheating from the Soviet Union. The secrecy of their society thus offers them an additional advantage that is not likely offset by on-site inspection acceptable to the Soviets.

So when we consider reductions of or beyond 90%, we should be seriously worried about whether we are ending up with too few strategic warheads, and we should be fully aware of the Soviet advantage in offense (payload being the only quantity that really matters in projection of total offensive power), defense (both deployed and deployable) and the possibility of cheating on agreements.

Therefore, if we wish to negotiate such reductions and maintain deterrence and security, we must recognize that there are only three logically possible alternatives to pursue in such a negotiation. Either we must require Soviet offense to be less than that of the U.S. (significantly less, with some accounting rule to discount the existence of their defense); or we must convince the Soviets to get rid of their defenses, while arriving at some otherwise straightforward offense accounting; or we must deploy some sort of defenses (or at least be fully prepared to deploy them) ourselves.

We cannot expect a negotiation in which we propose to lower Soviet offenses in recognition of their defenses to be practically successful. This is partly because of the evident difficulties of trading off their defensive capabilities against our offensive capabilities: We would have to arrive at a mutually agreed upon formula for both the cost and effectiveness of both kinds of systems, an eventuality unlikely in the extreme. However, even if this were possible, negotiating away Soviet air defenses to permit our strategic missiles to penetrate would be unacceptable to them on the grounds that we are trying to eliminate only the marginal capability of a system whose primary value (air defense) they still want and need.

This leads one to the conclusion that if large scale reductions are to be practical, and to give us in the long-term more security than we have now, and to lower the probability of initiating nuclear war, we must be prepared to deploy defenses at the same time we cut the forces. Put another way, a treaty which required major reductions to equal offensive forces but prohibited one side from deploying strategic defenses (SDI) would be very dangerous indeed.

This requirement for defenses is a common problem of the Western Alliance. NATO as a whole is now paying to maintain an extremely vulnerable deterrent; the criticality of the situation, in term of the stability of deterrence, can only increase in the event of deep cuts in strategic nuclear weapons. In fact, the parallelism extends to the specific cases as well as to the general case: both the U.S. and its European allies face an increasing force of Soviet SLBMs; both face Soviet bombers and Soviet cruise missiles, both air launched and sea launched; and both face a land based ballistic missile threat.

There is some difference in the particulars of this land based threat, ICBM's for the U.S. vs. IRBM's and shorter-ranged missiles for Europe. However, the distinctions are more political than military or technical. For instance, both offensive systems will require that defenses employ early warning, acquisition and tracking systems, and modern (that is to say, improved performance) interceptors. In terms of the many requirements placed upon a defensive system facing these ballistic missiles, the overall difficulty of the two technical problems is roughly the same. Differences in warning times, altitude and shape of trajectories, radar cross section of re-entry vehicles, ease of deploying decoys, terminal velocities, and other such factors roughly (that is, to the extent that we are able to calculate such things accurately with current knowledge) wash out in the overall analysis. Finally, the Soviet perception of this problem is relevant and perhaps dominant: The Soviets themselves do not draw hard and fast lines between missiles to be used against the United States and missiles to be used against NATO. Thus, currently deployed ICBM's that we now view primarily as a threat to the U.S. should also be viewed as a direct threat to Western Europe.

All this says that we need an intensive R&D program in defensive weaponry, but it also says that a significant portion of that program should be directed toward some deployable defense, including a defense with some capability to defend Western Europe. This logic does not require that such a defense system be absolutely perfect; in fact, an important part of the logic supporting such a defense is the existence of an imperfect but still militarily significant Soviet defensive system. The clamping of offensive weapons at low levels relieves the question of

marginal costs (an appropriate question when dealing with nationwide defenses against unconstrained threats). Against a well constrained threat only the total cost (and, of course, the effectiveness) of the system matters. Finally, in the presence of such reductions, the prospects for an eventual R&D success in leading toward a nationwide defensive system are greater.

None of this is to argue either that we should begin to deploy some elements of a defense designed to be nationwide now, nor that we should renounce the ABM Treaty now; these issues must be decided on their own merits as parts of larger questions. The argument made here is that if we are seriously to discuss large scale reductions in offensive forces, we must also seriously discuss deploying the necessary defenses to make such a reduction strategically stable. Which, of course, means that we must in that event be prepared to deploy some such defenses.

So the objective is to be fully prepared to deal with the defensive half of an arms control agreement involving major offensive cuts, and to provide strategic stability both between the two superpowers and Europe. The question then becomes: What technologies must one emphasize now to achieve this joint objective? There are at least five major technology areas that must be vigorously addressed:

- Improved satellite warning and tracking systems, especially against SLBM's.
- Design and operation of a new detection capability for short-range missiles.
- Operational airborne acquisition and tracking systems.
- High frequency, high power, high-capability battle-management radar.
- High-velocity interceptors with high-performance homing sensors and high lateral-divert capabilities to close with the target.

In addition to these technologies, one must develop detailed architectures to meet the U.S. and European defense goals, system designs strongly linked to the actual threats that must be dealt with.

All of these items, except the second (which is for the European mission only), are currently part of the Strategic Defense Initiative program. The design and extent of those projects is beyond the scope of the present discussion.

In addition to the above individual technologies, of course, important questions of systems integration, including battle-management software, must be examined. A functional prototype for such a system must be built, tested and improved upon to gain the necessary confidence that it can accomplish its military mission. That mission, initially, is to offset the capabilities of the Soviet defenses, and to provide protective stability to our European deterrent.

To meet the extended capability which will be required of a nationwide defense of the United States, several additional technologies are needed. Prominent among these are the capability to intercept missiles in boost phase and discrimination of re-entry vehicles from decoys.

The European defense mission and the nationwide defense of the U.S. both require major new technological capabilities. Fortunately, we are in the midst of a raging technological revolution stimulated by the Strategic Defense Initiative as well as other military and commercial R&D. As a consequence, there are some exciting and surprising developments and progress is being made across the board. However, it is important that we focus our attention, at least for the present, on these more pressing issues, which are near-term both in the technologies that can accomplish them and in the political necessity of our facing up to their challenges.

Offensive reductions are in the air. Considered by themselves, such reductions can only be safe and stable if they are not only made but held to. This criterion in itself presents a major challenge to our negotiators and to verification and compliance capabilities, a challenge we should not underestimate. Then, assuming that offensive forces remain firmly reduced, the necessity for defenses adds a further challenge. If the defenses that we are in fact technically capable of implementing do not keep pace with these arms control successes, the overall result may be to lessen the security of everyone.

Opening Remarks from the Panel

I.

The INF issue used to be known as the "gray-area systems problem," referring to nuclear weapons that were not covered by any arms control regime. The withdrawal from Europe of American INF systems in the late 1960's resulted in a Soviet monopoly of weapons that had not been captured in any of the earlier arms control negotiations.

The introduction of the SS-20 in 1976-77 represented more than a modernization of Soviet INF systems. With considerably improved capabilities, it was essentially a decoupling weapon of political intimidation, deployed during a period of growing Soviet strategic nuclear strength. NATO's reaction was the 1979 decision to first deploy U.S. systems to counter the SS-20 and also to fill a gap in the deterrent spectrum made all the more dangerous because of the state of the strategic balance, and then to try to find an arms control outcome that would address this problem.

Our first objective when we began the current negotiations was simply to have negotiations. We wanted to persuade the Russians to negotiate on the basis that U.S. deployments in Europe within range of the Soviet Union, in support of U.S. and Allied security, were legitimate responses to Soviet weapons which threatened directly only Allied territory, not the U.S., and to negotiate on these systems independently of U.S. and Soviet strategic negotiations. In this we succeeded. Secondly, we insisted on an outcome which encompassed equal rights and limits at the lowest possible level. From 1979 on, at Europe's suggestion, the lowest possible level was understood to be zero. Another point was that the talks had to be global, as did the conclusion. We could not accept an outcome that dealt only with the systems in Europe, given the capabilities of the Soviet systems and the need to recognize the security requirements of our Asian allies.

We made clear that the agreement we were seeking dealt only with U.S. and Soviet systems. No third-country systems could be included in any way. We insisted there be no adverse impact on our conventional forces—meaning that we didn't want aircraft included at this stage. We had to have concurrent global constraints on U.S. and Soviet short-range INF (SRINF) to prevent the undermining of an agreement. And we needed effective verification.

The underlying thesis was that a negotiated outcome which met these agreed Alliance criteria could enhance overall Alliance security, with the recognition that a reduction in this element of the nuclear component of deterrence implied that, absent a fundamental change in Soviet behavior, other nuclear forces be as modern and effective as possible and conventional forces be strengthened. In other words, if a gap were left in the deterrent spectrum, it should and must be as narrow as possible, taking into account that we would have greatly reduced the threat posed to us by Soviet long-range INF (LRINF) missiles.

Where do the negotiations stand today? The U.S. has tabled a treaty incorporating all the above objectives. The Soviets tell us they will be tabling a treaty in this round, and we expect it soon. On long-range INF, we and the Soviets agree on the basic outcome. There would be reductions to equal global levels of 100 warheads on U.S. and Soviet missiles. These 100 warheads would be restricted to U.S. and Soviet Asian territory only. We still have to resolve the question of the location within those two areas of the remaining systems. At any rate, the result would be zero in Europe. Despite the fact that we will agree to this approach, we have on many occasions made clear to the Soviets our strong preference for an outcome that would be a global zero. We will continue to urge the Soviets to stop hanging on to these remaining 33 SS-20's with their 100 warheads. We have pointed out to the Russians that there are good reasons for this, in their as well as our interest. Verification will be eased, made more certain and less costly. Several relatively minor elements which remain to be resolved will be resolved if the Soviets remove these 100 warheads. And, as we told them, if they mean what they've said about improving relations with Asian countries, they could demonstrate it by removing these missiles.

On the question of verification, we have an agreement in principle on the basic elements, including on-site inspection. However, we are awaiting the fine print from the Soviets to determine if an agreement in principle will translate into an agreement in detail. They are talking a good game, but it remains to be seen if it really is one.

As to short-range INF, we need to bear in mind a few facts. They have been part of the negotiations from the very beginning. They are not, as the Soviets tend to say, something we've

just added, or a new obstacle. At one point, the Russians agreed with us that SRINF had to be part of the negotiations, and even incorporated an article in their draft treaty in the previous negotiations dealing with these systems and using language rather similar to ours to describe the problems these systems created. In the SRINF area, there are two systems we are looking at, the SS-23, with about 300-kilometers' range, and the Scaleboard, also known as the SS-22, with 925-kilometers' range. The Russians have 130 launchers of these two systems throughout the Soviet Union, and several times as many missiles and warheads, as the launchers can be reloaded. Roughly a third are located in Eastern Europe (East Germany and Czechoslovakia), a third in the western Soviet Union, and a third in the eastern Soviet Union.

The U.S. has zero SRINF missiles today. We agree with the Russians on the need to constrain these systems in the context of an INF agreement. The Soviets have said they will unilaterally remove and destroy the systems in Eastern Europe upon the signing of an INF agreement. They have further suggested they could agree on the global elimination of all SRINF. They have talked vaguely about separate negotiations on SRINF while also saying SRINF could be covered in an INF treaty. It is difficult to imagine a separate negotiation given the fact that the U.S. has no SRINF missiles. The only possible subjects of such a negotiation could be the Soviet schedule of reduction and the verification of the end result. In any case, the Russians tell us they will be flexible on this issue and will work to find the most practical result.

The Alliance is now engaged in intensive consultation on how to respond to the latest Soviet proposal on SRINF. There are a number of possible ways of going. We could agree on equality for U.S. and Soviet systems at the current Soviet level—that was our position starting out, and remains our basic position. We could agree to an equal ceiling at a finite number below the current Soviet global level. We could agree to equality at a global level of zero. We could agree that there should be no constraints on either side and everyone is free to do as they wish with these systems. We could come up with alternative negotiating approaches. But we would need to take into account the fact that the Soviets are saying they are ready to unilaterally reduce and eliminate this group of systems. No single solution will be perfect. It is not going to be an easy problem to deal with, but it is also one we need not despair over.

In sum, while the negotiations are far from over, our fundamental negotiating objectives have been or are within range of being reached, assuming that the rhetoric on verification is matched by the details. In purely trade-off terms, we will be eliminating some 300 deployed LRINF missile systems in return for the Soviets eliminating well over 1400 such systems, plus the possibility of further Soviet reductions, if not elimination, of several hundred SRINF missiles and up to 130 launchers. Under this option, we would have to give up the option of deploying SRINF of our own with ranges of above 500 kilometers.

Finally, even if all these points were agreed upon today, we would still face painstaking work in producing a treaty. There are armies of commas and battalions of semi-colons waiting out there to trap us, and many young Congressional staffers waiting to find one of those little errors to prove that we made a horrible mistake. But we'll do our best to prevent that from happening.

Where are we outside of the negotiations? From the very outset, INF has been as much if not more related to the long-term Soviet effort to break up the NATO Alliance and to the Allied determination to prevent that from happening than to arms control *per se*. The SS-20's and their ilk are powerful and dangerous weapons. But a major, if not the principal, target of those weapons is NATO's political will and cohesion. To some extent the SS-20 has been used in this political role already. The fear their deployment inspired helped lead segments of western public opinion to conclude that NATO's own INF deployment would literally bring the skies down and make an arms-control agreement impossible. But we did deploy, and the Russians did return to the negotiating table.

But we cannot expect the Soviets to enter into an agreement that meets only our objectives. They want these American missiles out of Europe, and they don't want to see new ones deployed there. They are negotiating for their own military and political reasons, which in some ways are the reverse image of our own. Nevertheless the long-term results of these negotiations are very much in our hands.

The basic agreement taking shape now can strengthen Allied security by, among other results, at last eliminating effectively a class of Soviet nuclear weapons which pose a threat to Europe and other U.S. allies. It will be a result achieved by demonstrated Allied cohesiveness and determination. But in addition, we should take advantage of the opportunity provided by such an agreement to take steps to insure that our Alliance deterrence remains strong in a post INF-treaty security environment. This means not forgetting we are dealing here with only

ground-launched missiles in a certain range band. Other nuclear weapons will remain available as part of the deterrent. Secondly, we need to state firmly our intention to maintain and modernize our remaining nuclear forces and to do it. In this connection we should continue to carry out the commitments made along these lines at Montebello, when we unilaterally took out 1400 additional U.S. nuclear weapons from Europe. We need to move ahead on programs to strengthen NATO's conventional forces. We should reinforce our efforts to spend scarce resources more effectively and face up to the need to spend more on conventional defense in a situation where nuclear weapons play a less prominent role. We have to recognize that arms control cannot be a panacea for all our security problems. Defense cannot be placed in second place. For without a strong defense there can be neither a basis for deterrence nor for realistic negotiations.

There is time before the negotiations are completed and years before the last U.S. INF missiles leave Europe—time enough to map out and implement a plan to adjust our deterrence to take account of the reduced reliance on nuclear weapons which will eneluctably follow an agreement reducing or eliminating INF missiles; and time enough to insure that flexible response will remain the basis of our defense and deterrence doctrine. Rather than wringing our hands that the Soviets appear to be accepting our position in the negotiations, or for that matter applauding ourselves prematurely, we should be rolling up our sleeves to insure that the Alliance gains the full benefit of an INF agreement.

Opening Remarks from the Panel II.

In judging military balances it is important not just to look at the offensive forces on both sides, but also the defensive ones. When one is considering the reduction of offensive forces, one must guard against the possibility of an asymmetry that might exist with regard to defensive forces. Both the U.S. and Europe face similar offensive missile threats—from submarine-launched and ground-launched ballistic missiles. The Soviet Union has deployed ballistic missile defenses against ICBM's and is now deploying ballistic missile defenses against tactical missiles. The West has not deployed any ballistic missile defenses.

The U.S. has initiated the Strategic Defense Initiative (SDI) as a research effort to find out what is possible with current and foreseeable technology in defending against ballistic missiles. Most ballistic missile defense technology, in terms of components and systems, is common to the defense needs of the U.S. and Western Europe.

Is a ballistic missile defense possible? The answer must be qualified. Yes, it is possible if you don't insist that it be perfect and if you are willing to provide modern technology, and deploy systems in sufficient numbers to meet the threat. No, it is not possible if you require perfection, or if you are only willing to field forces that are perhaps a tenth the size of the offense they are supposed to counteract. So, an effective defense is a matter of degree, of quality and quantity, and of tactics and will.

What about the technology for such a defense? We are in the midst of a raging technological revolution, one that has been going on for a couple of decades and is likely to go on for a couple more. This revolution is especially in the area of electronics, of sensors, of beam weapons, and of concepts for using these technologies. For example, a number of things that are critical to a ballistic missile defense have been demonstrated, even at this early stage. Overhead, there are satellites that can detect, with high reliability, missile launches from the Soviet heartland and from Soviet submarines. New satellites are under development that can not only provide warning of launches, but can also provide detailed tracking information on missiles launched. In addition, incredible precision has been demonstrated in pointing, tracking, and guidance. It has also been demonstrated that land- or airplane-based lasers can shoot down missiles. New kinds of radar have been developed that permit the examination of objects coming into the atmosphere and the determination of which ones carry nuclear warheads. New kinds of ground-launched interceptors have been demonstrated, which could be effective at both high and low altitudes, and in outer space.

Congress has asked the SDI office to formulate an initial concept of a ballistic missile defense.

They have created blue teams, which put together a configuration of defensive systems, and red teams, which try to figure out where that configuration is vulnerable. That done, the blue team must go back to the drawing board to come up with a better system. Over the next six months or so, the SDI office ought to be able to come up with a considerably improved concept of at least how to use available technology.

Any engineering development will require the carrying out of tests of the components and of the system. This is permissible now for defenses against tactical ballistic missiles in the European theater, but not for a strategic defense of the U.S.

As to costs, the Nitze criteria say, simply put, that, at the margin, the defense should cost less than the offense. But the following points are true. We don't know the costs, or what the system will be. We don't know the incremental costs to the Soviet Union of their offensive systems better than a factor of two. And we do know that, given the way the U.S. procurement system works we could cut our cost by a factor of two, or better. The challenge for us to learn how to reduce the costs by a factor of two, given our bureaucracy, is more difficult than the challenge to provide the technology to do the job.

Opening Remarks from the Panel III.

There is a common theme in this conference. For arms control and for defense, for dealing with protectionism and debt, for acquiring economic prosperity, you have to know where you want to arrive, not just from where you have departed.

The train has left the station in INF. The station we have left has been that ambitious goal of "real disarmament" and "deep cuts." The dilemma over the zero option in Europe is that we are finding that zero is not necessarily the best arms control result, if arms control is to help establish stability and trust.

In finding a way out of the zero-option dilemma, we must ask where we want to arrive. We should want to arrive at a situation of stable deterrence in Western Europe, which is now dependent on doubtful battlefield weapons or on far-away and escalating strategic systems. We should have something militarily and politically sound. We should couple the removal of doubtful systems in Europe with the introduction of more reliable ones, and rely in future on sea-based cruise missiles already on American ships in European waters. They are intermediate, less vulnerable, and reassuring without being provoking. They should be given to the NATO military commander, have Europeans be involved with them, and they should be linked to deterrence in Europe.

INF is only one issue, and perhaps an isolated one. Arms control is wider. Here, too, we have to know where we want to arrive. The tasks are daunting. We are facing a transition to new technologies that must be managed under conditions of stability. Let's not reopen the debate on SDI. Clearly defensive technologies will come into arsenals. The question is how do we integrate them without upsetting stability. New technologies make the survivability of command and control much more questionable. How do we manage this? How do we manage the return to more stable offensive strategic weapons that do not give a premium to first strike, or, through their vulnerability, make it imperative to launch them before one knows whether the war has really started? We must move away from multi-warhead missiles which are too valuable to lose on the ground.

We need to manage the transition in the conventional field. We need to have arms control on conventional forces, yet we discuss this issue as though the background were static. It is not. Western conventional forces are under very considerable pressure and are bound to diminish, regardless of arms control, over the next few years. In seven years time, West Germany, which has the largest land force in Western Europe, will have available half the number of conscripts it now takes. In the U.S., zero growth in the defense budget, coupled with long-term commitments and costly procurement programs, make it likely that cuts will be made in forces stationed in Europe. In the U.K., a costly nuclear modernization program is coupled with a decline in real terms of defense expenditures. And some smaller countries, like Belgium and Denmark, do not seem to be in a position even to renew conventional weapons in the foreseeable

future. Thus, we have a daunting task of reshaping the basis of conventional defense in Western Europe, while at the same time negotiating with the Soviet Union, which, if all it wants is fewer Western forces, needs only to sit back and wait.

How do we manage nuclear proliferation? The record so far is not bad. But the relative inactivity in the West about reports that Pakistan may have the bomb is worrisome. This reflects a decline in political awareness and concern in the West.

Arms control is the management of competition, not an auction. The zero optioners and deep cutters are using a chainsaw to tend their garden. We must get away from the primitive approach of deep cuts. It is bad for the West because we have smaller arsenals and cannot win by cutting indefinitely. And it is bad for arms control because it doesn't solve the problems but rather exacerbates them, and it doesn't create stability and confidence.

Where do we want to arrive? We have, in the past, given hostages to fortune. Let us not get tied up, however tempting it may be, in a bitter debate over the wisdom of the zero option. Let's get through it fast, with minimum damage, and then afterwards, sit down in an enclave of Western leaders to finally reach a consensus on where we want to go. There is a saying that goes, "if you don't know where you want to go, every way will take you there." If that becomes the Western motto, we'll have neither arms control nor security.

Discussion

An International participant began the discussion with his analysis of the current arms control situation. NATO's military mission was to deter aggression and intimidation, the latter being the Soviet objective with respect to Europe—namely to put the Alliance in a military posture such that the Soviet Union could "intimidate, coerce, and blackmail us." The Alliance's strategy for dealing with the threat was flexible response and forward defense. The three possible responses to a Soviet attack were: (1) a direct offense to defeat an attack or to force the burden of escalation onto the aggressor; (2) deliberate escalation on our part to include the potential first use of nuclear weapons; and (3) a general nuclear response—the "ultimate guarantor of our deterrence." From the military point of view, the vital factors in our strategy of deterrence were (1) the option of first use of nuclear weapons, and (2) the capability to strike Soviet soil with land-based systems based in Western Europe. While the Soviets might doubt we would escalate to nuclear weapons, they could not be sure, and this uncertainty was a vital component of credible deterrence.

Should deterrence fail, the most probable scenario was a Soviet conventional attack and, because of NATO's deficient conventional capacity, a resulting early use of nuclear weapons by the Alliance—most likely after a few days. We would not want to use nuclear weapons on our own soil in the first instance, but rather on non-Soviet Warsaw Pact soil and selectively on Russian soil in order to send a message that the Soviet Union was not immune to attack.

The rationale behind the 1979 two-track decision was to fill a gap in NATO's spectrum of deterrence. At the time, the F-111 was the only weapons system capable of reaching Soviet soil. Further, there was a need to tighten the coupling between Europe and the U.S. by placing American missiles on European soil. The negotiating track was adopted in order to get the political consensus for the deployment track.

In 1981, President Reagan announced the zero option, by which we would remove the Pershing 2 and Cruise missiles if the Soviets removed the SS-20's. But the SS-20 was not the reason for the two track decision. It was to fill a gap in our deterrence irrespective of the SS-20.

While it made political sense, the International participant continued, the zero option made no sense from a military point of view. All the advantages went to the Soviet Union because we would again be in a situation where we had, on the one hand, disadvantaged conventional forces, and, on the other, our strategic nuclear forces, with only the F-111 and some shorter-range missiles in between as escalatory options.

The approach to arms control of NATO's military leadership was to favor balanced, verifiable accords and to reject agreements that impacted unfavorably upon Western security. Any arms control proposal was examined in the light of a series of key questions: (1) Would the proposal reduce the threat? (2) Would it enhance our response to the threat? (3) By accepting an

agreement for one category of nuclear forces, would we become more vulnerable to other categories? (4) What was the level of risk and whose risk was it—the U.S.'s or Western Europe's? (5) What was the impact on our continuum of escalation? (6) What did it do for nuclear burden-sharing among the Allies? (7) What would be the effect on the size of the remaining weapons stockpile that would be needed?

While the negotiating track in the INF decision was the more visible one, it was the deployment track that brought the Russians back to the bargaining table. Western governments had convinced their people that the zero option was the way to go, and now, it seemed political credibility of governments was of greater importance than the credibility of our deterrent. This was hard to accept, because, while administrations and parliamentary governments came and went, the constants were the people whose futures were affected, irrespective of governments.

However, politically, we had no choice but to agree to the zero option. We had been hoist by our own petard. We were back to the pre-1979 situation where only the F-111 gave us the possibility of hitting Soviet soil, and its task was greatly complicated by having to fly through both Eastern European and Soviet air defenses. The zero option did not provide greater stability. It did reduce the threat, but it reduced the credibility of our deterrent. We would not be able to hit time-urgent targets on Soviet soil with Pershing 2's, but would instead have to rely on air-breathers.

The military position was that the zero option would be unacceptable unless the agreement captured shorter-range Soviet weapons, the SS-22 and -23. In addition, there would have to be some movement toward achieving a balance of conventional and chemical forces before the zero option could be accepted. The Russians had now thrown in the SS-22 and -23 and had said they were ready to negotiate conventionally.

There was a danger that, with the zero option, we were beginning to move toward the denuclearization of Europe. Would the next step be to move toward capturing forward-based systems of dual-capable aircraft, and would that be put in language we politically had to accept? We were moving too fast in arms control, and no one was calling time out. We had to be certain we knew what we were buying before taking any further steps.

Some were saying that, even with the Pershing 2 and cruise missiles removed, we would still have some 4,600 nuclear warheads in Europe. But we could not necessarily strike Soviet soil with these. With air-breathing systems instead of ballistic missiles, you had to take into account pre-launch survivability, reliability, and the ability to penetrate defenses in determining whether you could hit the targets. Would 4600 be enough, under these circumstances?

Substituting Poseidon and Polaris sea-launched missiles for theater weapons made no sense, because Soviet detection systems could not distinguish whether or not they were from the strategic arsenals of the U.S. and U.K. In the case of sea-launched cruise missiles, their mother ships had to be tethered to the coast in order for their guidance systems to work, and they would do us no good if they weren't where we needed them.

Faced with these obstacles, what should we do? First, we needed to link the total elimination of our INF weapons from Europe to a satisfactory agreement on conventional and chemical systems. Ideally, each side should be allowed 100 INF weapons. As to SRINF, we should agree to Gorbachev's proposal to scrap his 42 forward-based systems and seek an agreement allowing us to match what he had left by converting deployed Pershing 2's to Pershing 1B's. If we went to a zero level for SRINF, we should try to protect West Germany's 72 Pershing 1A's, and persuade the Germans to modernize them in order to balance the forward-deployed Soviet SCUD systems. And if the Pershing 1A's had to go, we should draw the range line at 300 kilometers in order to capture the SCUD's. But we had to protect our own weapons platforms for air-to-surface missiles.

Concluding, the International speaker said we could not get rid of the nuclear deterrent without expanding conventional forces. We needed to develop the means to suppress Eastern European and Soviet air defenses and enhance our aircrafts' ability to penetrate to targets on Soviet soil. This might mean forward deployment of B-52 or B-1 aircraft, with air-launched cruise missiles, which would have to be counted as theater and not strategic systems. We had to insure that the U.K. and France kept their independent nuclear forces. And we should move forward with the modernization agreed to at Montebello. And we had to get sea-launched cruise missiles under NATO military command when deployed in-theater, specifically in the Mediterranean. Finally, we had to exploit our technological advantages and not become captives of preemptive concessions where we rejected a new system because we did not think it would

work or felt it would be too expensive, and so failed even to evaluate its mission- or cost-effectiveness.

Addressing himself to the concern that the zero option would leave a gap in NATO's spectrum of deterrence, a German participant wondered why it was so important for the Alliance to be able to strike Soviet soil with missiles based in Europe. Did this imply that American nuclear weapons would be used in defense of Europe only if they were deployed in Europe, and that the American strategic arsenal would be used only in the event of an attack on the U.S.? Assuming this was not the case, even without INF weapons in Europe, the Russians would still face an unacceptably high risk in attacking Europe because they could still not be sure of the American response. Our strategy of deterrence could still be maintained by strategic and battlefield nuclear weapons. We had had 30 years of security before we had INF weapons, so why were we so worried about losing them now?

But several speakers cautioned against relying on battlefield weapons and strategic systems for deterrence, especially as regards Europe. A Greek pointed out that the Soviet Union could strike Europe with a tiny percentage of its strategic arsenal, and he warned that strategic weapons had been targeted on Europe before and could be again. As for battlefield weapons, they were fine for the Russians in an offensive situation, but they were useless and risky for the Alliance in a defense. A speaker from Liechtenstein wondered if battlefield nuclear weapons were not heading toward obsolescence anyway. Western military technology was moving in the direction of replacing nuclear warheads with more intelligent and effective conventional systems. But, an American responded, while the accuracy of many weapons systems had increased to the point that nuclear weapons were no longer necessary to strike certain targets, other, more dispersed targets could only be effectively destroyed by nuclear warheads.

A Canadian cautioned against selling short the deterrent effect of battlefield nuclear weapons. Surely the Russians viewed as a deterrent the prospect of their conventional forces being incinerated. A German agreed that the Russians were not indifferent to the use of nuclear weapons of whatever category in Europe.

A number of participants supported the strategy of using other weapons systems to fill the gap left by the elimination of INF systems. What was important, in an American's view, was that the Alliance make it clear to the Russians that their goal of a Europe in which the only nuclear weapons were the Soviet strategic arsenal was not something we would let them have. If we agreed to the zero option for INF, then we should draw a line—possibly at 500 kilometers—beyond which we would not agree to any reductions. In that range category, we should be developing new systems.

But several speakers expressed concern about how NATO's deploying new types of nuclear weapons might be perceived by our publics. A Belgian felt that the credibility of our governments was at stake here. Our publics viewed the zero option as the first step toward the eventual elimination of all nuclear weapons. What would be their reaction when we announced our intention to deploy different kinds of nuclear weapons after agreeing to get rid of the INF missiles? Were we saying there were good and bad types of nuclear weapons?

That, in the view of some participants, was exactly the case. Said a German, we needed fewer and better nuclear weapons. Europeans could not expect to influence Alliance strategy, he continued, unless they recognized that NATO had to have a nuclear component that would directly and visibly affect European soil. An American interjected that, if we were moving to a situation where Europeans were unwilling or unable to deploy American nuclear weapons on their territory, was it possible to maintain the credibility of flexible response? The consensus was that there was no better strategy available, and, rather than abandoning it, we had to make it work within the context of the zero option for INF.

A number of speakers worried about the decoupling effects the zero option might have. A Greek argued that, to couple politically and militarily, one needed the power projection furnished by nuclear weapons. If we got rid of all INF weapons, there would be countries in regions of NATO that would be completely strategically decoupled from those in other regions. From there it was a short step to political decoupling.

It was a Dane's view that the two pillars of the Alliance had stood together when they decided to arm Europe in the two-track decision. But they had not when Europe was partially disarmed

by the zero option. Europeans had not been present at Reykjavik, nor were they present in Geneva, and they had to rely on sympathetic Americans to put forward their views.

An American countered that there had been full and frequent consultation among the Allies during the course of the negotiations, and, indeed, the zero option had originally been a European proposal. As to coupling, it was wrong to look at one class of weapon as the be-all and end-all of coupling. Coupling was more than a weapons system or class of systems. It was a series of links that drew the U.S. and Europe together. The U.S. was not committed to the defense of Europe for any other reason than its own self-interest, and, in dealing with the Soviet Union, the self-interest of the U.S. and that of Europe were the same.

A French speaker agreed, saying that coupling was, first of all, a political phenomenon, based on the conviction of the American president, whoever it might be, that the defense of Europe was inevitable for the U.S. The practical conditions of coupling in terms of weapons had already changed several times and could do so again. This should not concern us, provided arms control agreements were carefully negotiated and did not compromise Western security.

If an agreement calling for the elimination of INF from Europe was a foregone conclusion, as most speakers felt it was, then, in the opinion of many participants, we had better do something to correct the considerable disparity between the conventional capacity of NATO and the Warsaw Pact, and about the Soviet Union's chemical and biological warfare capacity. In the opinion of an International speaker, if we were entering a period where there would be fewer nuclear weapons, then the conventional and chemical aspects would become more important, not just militarily, but in the public mind as well. We would have to justify our remaining nuclear deterrent at least partly on the conventional imbalance. Therefore, we had better be seen to be doing something about that imbalance, which, so far, we had not taken very seriously. It was doubtful that we would be able to significantly increase our own conventional capacity, given the paucity of resources our governments were prepared to allocate to defense. So the alternative was to get talks going—a process fraught with obstacles, if the bogged-down MBFR negotiations were any example. Yet it was urgent that we address this problem.

In view of NATO's conventional inferiority, the zero option agreement was a particularly bad deal, in a Briton's opinion. We seemed hell-bent on rushing into an INF deal just because it was on offer, and worrying about a conventional deal later on. We had done nothing to pressure the Russians on conventional forces, and now we were giving up our only leverage—to insist on a linkage between nuclear reductions and conventional reductions. The INF deal was one made in isolation and in a hurry, and we would surely come to regret it.

An American responded that negotiations had been going on for five and a half years, so one could hardly say we had rushed into the INF deal. Further, to link the elimination of INF weapons to a reduction in Soviet conventional weapons would be to take an approach different from the one agreed to.

A German argued that we still had battlefield nuclear weapons as a bargaining chip for conventional reductions. But a countryman was skeptical about how useful this would be. How could the West negotiate the reduction of nuclear weapons in order to get Soviet conventional reductions, while at the same time reserving the right to increase other types of nuclear weapons? It seemed to be trying to link the unlinkable. In any event, the speaker continued, the conventional imbalance was exaggerated. The West had made significant improvements in its conventional capacity in the last few years, and the Russians viewed these developments with apprehension.

A few comments were made on the subject of verification. An American said that verification could not make a bad agreement good, but could only make a good agreement viable. The Soviet offer of verification in the zero option agreement was not a good reason to enter into it. Another American stressed the difficulty of verification. Even if those doing the verifying were convinced, how could they convince the rest of the world? And even if verification was possible, what about compliance? What was there in the current proposals about measures to be taken in the case of violations?

In an American participant's opinion, our dialogue on arms control was characterized by conceptual disarray. We needed to go back to the basics of what arms control was and what it was supposed to accomplish. To think coherently about arms control, we first had to think

coherently about strategic doctrine, and to have a consensus on military strategy.

For 40 years, the West had had a consensus on deterrence. Our doctrine of deterrence had not been static, but had been adjusted according to changes in Soviet military capability. We had moved from massive retaliation to flexible response and forward defense, and we had adjusted flexible response to afford greater strategic flexibility. Now we had to ask whether we wanted to stick with or to abandon the doctrine of deterrence. If we adopted a strategy of cutting strategic forces by more than 50 percent and deploying strategic defenses, we would be changing to a strategy of defense instead of deterrence. This would be a fundamental change in Alliance strategy and in the possible use of American weapons in defense of Europe. The problem in accomplishing such a change in strategy was to do it in a stable manner.

In addition to a coherent military strategy, we also needed to determine how to marry defense policy with arms control policy. We seemed to be moving in contradictory directions. In the U.S., we were trying to deploy mobile MX missiles while trying to ban them in an arms control treaty. Or, as in the zero option agreement, we were becoming more dependent on battlefield weapons while seeking in our military doctrine to become less dependent on them.

Another American argued that our domestic debates had consistently frustrated our attempts to mesh our strategic planning with our policy of deterrence. Starting with the Nixon Administration, the U.S. had tried to develop a plausible war-fighting scenario which was more than just killing millions of people. Calculations as to the appropriate number of missiles and warheads to counter the Soviet force were made. Yet these calculations were whittled down by successive administrations so that no one today knew what the composition of the U.S. strategic arsenal was supposed to accomplish. Because of this failure to think coherently about military strategy, we were in danger of sliding into the same position with respect to SDI as we were in with INF. We were making a whole series of propositions in order to sell the project—an approach that, sooner or later, we would find would not work.

The Soviet Union had some 20,000 anti-aircraft missiles. Was it a perfect air defense? No. Was it a huge obstacle to NATO? Certainly. No one had dared to suggest that perhaps the best way to start the process of negotiation on SDI was to ask the Russians to eliminate their air defense and give us a free run into their country. Thus, mutual assured destruction would be guaranteed. We had no air defense. We could then cut our missile forces. It would be a simple, cheap solution. But everybody would say it was a preposterous proposition.

With respect to SDI, we were being asked for perfection, survivability, cost-effectiveness, no testing, and a ten-year moratorium before any deployment. It was argued that the moratorium was only the amount of time it would take to develop SDI anyway. But we should not fool ourselves. If that was as long as it took, we should take that time. We should not rush it. But we should proceed.

SDI could perform the task of complicating Soviet calculations, of discouraging third-party attacks, and of making limited blackmail more difficult, among other things. It was an astonishing argument that a defense of the U.S. made Europe less secure, because the conclusion would then be that Europe had been less secure when the U.S. had an atomic monopoly than it was now that the U.S. was totally vulnerable. We were inflicting upon ourselves, with respect to defense technology, a set of self-imposed limitations. The Europeans were driving the U.S. into making a distinction between research and deployment, which guaranteed we would never get to the point of deployment. No one ever challenged Soviet deployments.

If we wanted to negotiate SDI, we should say we were committed to deployment, and research was our own business. We were willing to negotiate the level of deployment of defenses in relation to the level of deployment of offenses. If the Russians were willing to lower their offenses, we would be willing to lower our defenses, and we were ready to discuss those principles right away. Otherwise, we would find, in five years or so, that we had, because of our internal debates, given SDI away in our own proposals, from which we could not withdraw.

We could not have a strategy we were unwilling to implement, or one that, if we implemented it, would destroy us. We could not rest the defense of democratic publics on mass extermination of civilian populations, and then, not only deprive ourselves of a defense, but of systems which had a certain automaticity of response (which was the advantage of the INF weapons—the Soviets could not be sure if the Western military commander would be authorized to release them before they were overrun.) To give all of this up and not to build a coherent strategy, to fail to understand that many of the zero-option supporters also supported no first use of nuclear weapons, and to believe that deterrence could be covered by the U.S. strategic arsenal, was an intellectual incoherence that would ruin us.

CLOSING REMARKS

We had come too far on the zero option to turn back; we had to avoid doing the same thing with SDI. We had to avoid putting ourselves in a position where the Russians had both an air defense and a missile system, while the Allies insisted their protection was their own vulnerability, which they intended to guarantee. If we failed to develop a strategic doctrine we really believed in we would continue to stumble from dilemma to dilemma. If we could not get an improvement in the situation now, with new Soviet leadership, we were in deep trouble.

The new Soviet leadership, as exemplified by Gorbachev, was indeed something we should be taking advantage of in our dealings with the Soviet Union, said an International speaker. We seemed to forget that it was the Russians who had proposed the zero option at Reykjavik. Yet we seemed determined not to believe Gorbachev when he said his objective was not to destroy Western values. We had to remain on our guard in dealing with the Russians, but, if we refused to see even a glimmer of hope that our relations with them could change for the better, then our policies would surely fail.

A German agreed, saying that our policies should not be too much driven by military imperatives. Statesmen should not listen too closely to their military advisors lest they denied themselves a chance of giving a new political shape to the order of things. We should continually be assessing the Soviet threat. What was the chance that it was lessening under Gorbachev? We should avoid giving our publics the impression that we were more interested in preserving the threat than in furthering the possibilities for change.

Sometimes, added an American, statesmen had to take risks that military men would not. The Soviets, we should remember, were going to zero in INF, too. Yes, there would be a gap in our deterrent spectrum, and, no, the outcome would not be free of risk. But the elimination of a class of weapons would be worth the risks, which we ought to be able to handle, if only we were prepared to do what had to be done in a world with fewer nuclear weapons. We had before us the opportunity to create a new situation, and if we handled it correctly, we would find our security enhanced rather than diminished.

Many of the factors in the arms control debate—deterrence, coupling, security, etc.—were in part psychological, several speakers argued. An American said that if we did not feel intimidated, we would not be, and he wondered how an alliance of such economically strong partners could feel intimidated. In a Frenchman's view, the European partners in the alliance tended to show fear and apprehension in too many situations. They were afraid when the U.S. negotiated and when it did not; afraid when the U.S. deployed weapons and when it wanted to withdraw them; afraid when the U.S. was strong, and afraid when it was weak. We needed to show some confidence in an alliance that had served to keep the peace for 40 years, in spite of all sorts of problems. We should avoid feeling psychologically weak.

An Italian speaker warned that the threat was more than military. It was also the Soviet objective of taking advantage of European insecurity to exert political influence. This was the main challenge and threat to which Europe had to respond. It implied not just defining a strategic doctrine, but also a commitment on the part of Western European governments to undertake a common effort to strengthen conventional forces.

A German saw encouraging signs that Europeans were beginning to face up to this responsibility. There seemed to be a new recognition that deterrence, which had been viewed as almost disresponsible in recent years, was essential to European security, that life would be worse without deterrence. And Europeans were talking about closer defense and security cooperation. We needed to move ahead quickly and with as little dissent as possible in negotiating the zero-option agreement in order to give our governments the credibility they needed to ask for the conventional initiatives needed in a world with fewer nuclear weapons.

In closing the thirty-fifth Bilderberg Meeting, Lord Roll expressed his view that, in terms of both the quality of the discussion and the physical surroundings, the conference had been exceptional.

On behalf of the participants, Lord Roll thanked all of those who had made the conference a success. He noted, in particular, Giovanni Agnelli and the Italian hosts; conference organizer Alfredo Ambrosetti and his staff; the Bilderberg Secretariat; the General Manager and staff of the Villa d'Este; the security staff; and the interpreters. He also acknowledged the contribution of the working paper authors, the panelists, and the session moderators.