PREPARED STATEMENT OF RICHARD D. ERB

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before the

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Mr. Chairman, I am honored to have the opportunity to testify before your committee on the subject of "U.S.-European Economic Relations". My name is Richard D. Erb and I am a Resident Fellow at the American Enterprise Institute for Public Policy Research. I am testifying today in my personal capacity and not as a representative of the American Enterprise Institute. I have served in the U.S. government as Deputy Assistant Secretary of Treasury for Developing Nations Finance and as an Assistant Director of the White House Council on International Economic Policy.

Your letter of invitation has raised important questions which are not easy to analyze, let alone answer. They are difficult to address not only because they concern interactions among the realms of security, politics, and economics, but also because it is not possible to analyze the security, political, and economic interactions between the United States and Western Europe without putting the analysis within a multilateral context. In effect, it's like trying to play multidimensional chess without knowing the size and shape of the board and without knowing the number and characteristics of pieces used in the game.

In the first part of my testimony, I will address the broader questions raised in your letter concerning the relationship between economic, political, and security matters as they affect U.S.-European relations in connection with the Soviet Union and the Middle East. Although there are important economic interests at stake for Europe and the United States in connection with the Soviet Union and the Middle East, the dominant issues, and the major sources of dispute in my judgment are political and security in nature. In short, the resolution of those issues lies primarily in the security and political realm, not the economic.

In the second part of my testimony, I will focus more specifically on the economic dimension of relations between the United States and the European nations and identify what I believe to be the central economic problems and suggest policy directions which may deal with those problems.

Part I

Politics-Economics-and Security

European Relations with the Soviet Union

There has been a tendency in the United States to overestimate the degree to which changes in economic relations have brought about changes in European political and security attitudes toward Eastern Europe and the Soviet Union. If anything, it is the other way around: changes in political and security relations laid the basis for changes in economic relations. In turn, economic factors then came into play and worked to slow the growth in economic relations. My reasons for these views are briefly summarized below.

In the early 1970s, detente contributed to the growth of European exports to the East not only because detente encouraged European governments to explore and encourage ways of expanding economic linkages, but also because detente encouraged private companies to establish economic ties in order to sell more goods and encouraged private sources of finance to aggresively lend to the countries of Eastern Europe and the Soviet Union. Detente altered the sovereign risk assessments of the private bankers and led them to increase their exposure to the eastern countries.

As shown in Table I, reported exports and estimated export volume (i.e., exports adjusted for inflation) from the members of the European Economic Community (EEC) to the nations of Eastern Europe and the Soviet Union grew rapidly during the first half of the 1970s. Although not shown in the Table, exports and export volume from other countries, including Japan and the United States, also increased. During the second half of the 1970s, nominal exports to the East continued to grow, but the growth reflected inflation. Although a lack of price data make the estimates tentative at this stage, export volume declined from 1975 to 1978, and then increased slightly in 1979. The apparent lack of growth in export volume during the second half of the decade in part reflected underlying economic factors including not only poor economic performance within the Eastern European economies and the Soviet Union in the second half of the 70s, but also a sharply growing external debt. The latter caused concern not only among the private bankers who were lending to the Eastern European countries, but also among the political leaders of the Eastern European countries and the Soviet Union.

As a result of the export patterns already cited, it is not surprising to find that the relative share of total EEC exports destined for Eastern Europe and the Soviet Union increased during the first half of the 1970s. In other words, at least as measured by overall export patterns, trade with those countries became more important to the EEC members during the first half of the 1970s. This development is shown in Table II for not only the EEC as a whole, but also for the major EEC members including Germany, France, Italy, and the United Kingdom. (The relative share of total EEC exports to the East is higher than the shares for individual members since total EEC exports exclude intra-EEC exports, while the exports of individual members include exports to other EEC members.) Given that EEC export volume to the East declined during the last half of the seventies, it is not surprising to find that the share of EEC exports destined for Eastern Europe and the Soviet Union declined after 1975. It is interesting to note, as shown in Table II, that the relative importance of exports to Eastern Europe and the Soviet Union increased also for Japan and the United States during the first half of the decade and then remained stable for the United States and declined for Japan.

Concerns about the economic dependence of Europe on the Soviet Union are often raised in the context of natural resources, in particular oil and gas. With respect to oil, however, European imports of oil from the Soviet Union have not grown significantly during the last decade. Soviet oil exports to all of Western Europe rose from .68 million barrels a day in 1972 to 1.0 million barrels a day in 1978, the last year for which oil export data are currently available. Thus, Soviet oil accounted for less than 1 percent percent of Western European oil consumption in 1978. For 1979, Soviet oil exports to Western Europe probably remained around the 1978 level of 1.0 million barrels a day level of 1978.

Approximately 40 percent of Soviet oil exports to Western Europe are imported by three countries: France, West Germany, and Italy. The other major importer of oil, accounting for 20 percent of Soviet oil exports to Western Europe,is Finland. As shown in Table III, in 1979 Soviet oil is estimated to have accounted for only 4 percent of France's oil imports, 6 percent of West Germany's oil imports, and 8 percent of Italy's oil imports. Looking to the future, European dependence on oil imports from the Soviet Union is likely to decline given that Soviet production is expected to level off, if not decline, over the next five to ten years and given Soviet oil commitments to the Eastern European countries.

Soviet exports of natural gas to Western Europe grew rapidly during the decade of the 70s, but Soviet natural gas accounts for a relatively small percentage of European gas consumption. As shown in Table IV, Soviet natural gas exports to Western Europe rose from a level of only .04 million barrels a day of oil equivalent to a level of .32 million barrels a day oil equivalent in 1978. In 1978, Soviet gas accounted for around 8 percent of total gas consumption in Western Europe. I estimate that natural gas exports to Western Europe may have risen to .5 million barrels a day oil equivalent in 1979.

The largest importer of Soviet natural gas, West Germany, imported in 1978 less than a quarter of a million barrels a day oil equivalent from the Soviet Union. That amounted to about 25 percent of West Germany's total gas consumption in 1978. Natural gas accounts for 17 percent of Germany's total energy consumption.

Although Western Europe's natural gas imports from the Soviet Union are likely to grow over the next decade, there exist a number of uncertainties. For example, the Iranian revolution has disrupted current and expected gas exports from Iran to the Soviet Union. Thus, future Soviet gas developments which were to be dedicated to supplying Western Europe may need to be used to supply those areas of the Soviet Union which had expected to rely on Iranian gas. In sum, while Soviet gas exports to Western Europe are likely to grow over the next decade, the magnitudes are not likely to be very significant.

Your letter of invitation specifically asks what economic motivations may have influenced the European allies' response regarding economic sanctions against the Soviet Union in response to the Soviet Union's invasion of Afghanistan. Recognizing that judgments about other countries' motivations can only be speculative, I would like to make the following observations. First, Europeans are in general much more skeptical about the effectiveness of economic sanctions as a lever to achieve political ends. Indeed, the argument is often made that such policies have the opposite political consequences from those desired. Secondly, until the United States develops a more consistent approach to the use of economic leverage, we should not be surprised if foreign governments are reluctant to follow twists and turns in U.S. policy. Although the United States has traditionally been inclined toward using economic sanctions to achieve political objectives, the United States has not developed a consistent policy regarding the relationship between economic levers and political objectives. From a European perspective, the United States has been rather erratic in its application of the linkage concept as it relates to the Soviets. President Nixon and Henry Kissinger's concept of linkage was dramatically altered by the Congress and the Jackson-Vanik concept of linkage, which in turn was modified by the broader human rights approach of the Carter administration. The Afghanistan invasion triggered the ad hoc use of sanctions by the U.S. government but there apparently was little if any discussion with the Europeans (and other major exporters) regarding their willingness to participate in the use of trade sanctions and more importantly, the type of sanctions that were to be imposed and the conditions for tightening or loosening them.

Finally, and perhaps more importantly, the political capital spent in persuading reluctant allies to join in the use of economic sanctions, detracts from the more fundamental political and security steps that need to be taken in response to Soviet actions not only in Afghanistan but also in other parts of the Middle East and in Africa. Instead of focusing on sanctions, and making the acceptance of the use of sanctions a major test of political support, the U.S. government should spend more of an effort to enlist the political and security assistance of the Europeans, and I might add, the Japanese, in dealing with the more fundamental risks confronting all countries as they relate to the Soviet Union. This does not preclude the use of economic pressures, but if economic levers are to be pulled, there ought to be a unified agreement beforehand regarding which levers and the conditions under which the levers are to be pulled--or released.

European Relations With the Middle East

From an economic perspective, Europe has become significantly more dependent on the Middle East, and in particular on the Middle East oil producers--including Iran, Iraq, and the oil producers on the Arabian peninsula. Oil imports in 1979 from the Middle East oil producers accounted for 60 percent of total Western European oil consumption. Among the major European oil consumers, Middle East oil accounted for 32 percent of oil consumption in Germany, 45 percent for the United Kingdom, 88 percent in France, and 90 percent in Italy.

The Middle East oil producers also have become an important and growing export market for Western Europe. For example, EEC exports to the Middle East by 1976 exceeded EEC exports to Eastern Europe and the Soviet Union. By 1978, exports to the Middle East oil producers amounted to $22.5 billion, or 10 percent of total EEC exports. As a result of a reduction in exports to Iran, EEC exports in 1979 declined to $21.5 billion, which amounted to 8 percent of total EEC exports. (EEC exports to Iran declined from $7.5 billion in 1978 to $3.1 billion in 1979.) Given the expanded domestic budgets of the Middle East producers, EEC exports to the Middle East should continue to grow rapidly in the near future even if exports to Iran do not rise.

The trade data cited above do not include EEC service exports to the Middle East producers, which also grew significantly after 1973. In addition, Europe's financial linkages with the Middle East oil producers have expanded. A significant proportion of their financial surpluses have been deposited in banks located in EEC member states. The Middle East oil producers also have been making other investments, including direct as well as financial investments, in companies in the EEC. Finally, a number of EEC governments, including Germany, have borrowed directly from the oil producers of the Middle

East, in particular Saudi Arabia.

Although Europe's economic links to the Middle East are broad-based and growing, a similar statement can be made for the United States and Japan. In addition, the economies of Europe, the United States, and Japan, are linked through each other to the Middle East. For example, a cut in oil exports from the Middle East to Europe would have an indirect impact on the United States not only in terms of its impact on the international oil markets, but also because the economic consequences of a cut in oil to Europe would affect European exports and imports from the United States. To a large extent, commercial issues or conflicts which arise among the major industrialized countries in connection with oil, trade, capital, and money can be dealt with in the context of existing bilateral and multilateral relations among the major countries.

Looking to the next five years, I am less concerned about unfavorable economic shocks eminating from economic factors per se. For example, I do not see an economic basis for expecting a significant reduction in production targets among the major oil producers. Kuwait and the United Arab Emirates may lower their pre-1979 production targets, but such a decision on their part would not have a significant impact on the international oil market given that such reductions would probably not exceed .25 mbd. Iraq continues to expand its domestic development program and thus is likely to increase its production over the next few years. Saudi Arabia will probably return to its production target of 8.5 million barrels a day, but as long as the Saudis continue their ambitious domestic development program, they will not have much flexibility to lower their long-term production target of 8.5 mbd.

The greatest threats to European and U.S. economic interests, however, as well as the economic interests of many other countries including Japan, lie in the political-security arena. The political and security risks include the following. First, should another Arab-Israeli war break out, oil, trade, and financial flows would probably be disrupted or redirected. Although a settlement per se is not likely to have a significant impact on oil, trade, or financial flows, a settlement would reduce the risk of economic disruptions. Secondly, there is the risk of revolution or a change in leadership within one of the major producers. For example, a change in leadership in Saudi Arabia could result in a sharp reduction in domestic expenditures and provide the government more flexibility to reduce its oil production target. A third source of risk relates to the intentions of the Soviet Union: to what extent does the Soviet Union intend to use its military power to gain access to oil in the Middle East? A fourth risk is the possibility of an armed conflict among the major producers. For example, a conflict between Iraq and Iran could cause a cut in Iraq's production. A fifth source of risk is the risk of terrorist acts against the oil fields.

Although these risks exist, the major industrialized countries do not seem to be making much effort to jointly explore and develop ways in which the risks cited above could be reduced. As importantly, the major industrialized countries need to explore and develop ways in which they will cooperate (beyond oil-sharing agreements) when a crisis actually breaks out. Otherwise, there will be a repeat of the conflicts and misunderstandings that have arisen in connection with the Iranian crisis. In sum, U.S. and European leaders, as well as the leaders of Japan, need to devote more attention to reducing political-security risks in the Middle East and to develop broader contingency plans for responding to major political-security crises.

Part II

U.S.-European Economic Relations

In the economic realm, one often hears that U.S.-European economic relations are becoming less important to the Europeans. Although the relative share of EEC exports destined for the United States has declined during the last decade--from 17 percent in 1970 to 13 percent in 1979--it would be a mistake to conclude that the relative importance of U.S. economic affairs to Europe also has declined. For one thing, service, investment, and financial linkages have grown during that period and the dollar remains the dominant international currency. Perhaps more importantly, the United States and European economies interact in a multilateral framework. Thus economic developments within either Europe or the United States are often transmitted to each other through markets in other countries.

Although the collapse of fixed exchange rates in the early 1970s led many to prematurely declare the death of the postwar international economic system, the fundamentals of that system have survived. Those fundamentals include a shared belief among the major industrialized countries and many semi-industrialized and developing countries that their respective national interests would best be served under a market-oriented, multilateral international economic system based on the principles of open markets, nondiscrimination, and reciprocity. There also has been a general recognition that beggar-thy-neighbor policies would undermine and ultimately bring down the international system. Finally, there has also been a firm belief in the role of discussion and negotiation in suitable fora. During the postwar period, a large number of countries acted on those beliefs and gradually reduced (although did not eliminate) restrictions on the flows of goods, services, capital, and money across national borders. As a consequence, economic flows among countries grew more rapidly, and national economies became more closely linked. Because economies have become more interdependent, economic policy actions taken in one country are more likely to have a greater impact on economic developments in other countries.

With this background in mind, I would like to address your request for specific policy prescriptions for better managing the U.S.-Western European relationship. In doing so, I will focus initially on two domestic areas of U.S. policy which have been at the heart of our economic policy conflicts with Europe and other nations in recent years.

In my judgment, the most serious economic conflicts between the United States and individual countries in Europe, as well as between the United States and other countries, stem from the U.S. mismanagement of domestic fiscal and monetary policies during the past fifteen years. First, excessively expansionary fiscal and monetary policies during most of that period generated higher rates of U.S. inflation which in turn transmitted inflation abroad and undermined the dollar. Secondly, sharp swings in U.S. fiscal and monetary policy led to sharp fluctuations in U.S. economic activity. Although many observers have commented on the gradual decline in the size of the U.S. economy relative to the size of other foreign economies during the postwar period, shifts in the U.S. economy still have a significant impact on economic activity in other countries. Fluctuations in U.S. economic activity not only influence foreign economic developments through markets for goods and services but also through the capital and money markets. Since the latter are linked through exchange markets, shifts in financial flows have contributed to volatile exchange rates.

The European governments have been critical of the high and rising rate of U.S. inflation for more than a decade, but a major political conflict broke out in 1977 when the Carter administration pressured the German government (and also the Japanese government) to pursue more expansionary fiscal and monetary policies. Both governments rejected the pressure because they feared that a more expansionary policy would trigger domestic inflation and ultimately result in higher rates of unemployment. Eventually, the rise in domestic U.S. inflation (and the sharp decline in the dollar) forced the Carter administration to shift to a less expansionary policy in late 1978 and again in late 1979. At the same time, because inflation had been sharply reduced, the German and Japanese governments were able to follow a more stimulative policy after mid-1978. In addition, Japan and Germany are weathering the 1979 oil price increases much better than the United States.

During the past few months the dollar has been relatively strong. However, should it appear to the national and international financial markets that the U.S. government is turning away from its fight against inflation and providing too much stimulus, I have little doubt that the dollar will again decline sharply. In sum, the future prospects of the dollar, and indirectly the future prospects for good U.S. economic relations not only with the nations of Europe, but also Japan and the surplus OPEC producers, will depend on whether or not the U.S. government can reduce the rate of inflation and return the U.S. economy to a more stable growth path. Unless the U.S. economy does stabilize and return to a low rate of inflation, attempts to ameliorate the exchange rate consequences of an unstable dollar through special facilities, for example the SDR substitution account proposal, are likely to prove futile.

U.S.-European Energy Relations

Since the OPEC revolution of 1973, differences regarding energy have probably been the second most significant source of conflict between the United States and the nations of Europe--as well as with a number of other countries. Again, a fundamental cause of the problems are domestic U.S. policies. As is well known, the Europeans have been critical of the failure of the United States to adequately adjust to the changed situation in the international oil markets. Given that most of the European nations had allowed their domestic oil prices to rise with the price of international oil, Europeans have been critical of U.S. price controls which have maintained U.S. oil (and gas) prices below the levels determined by international oil prices. The European nations have believed that at a minimum, the United States should adjust to world oil market prices. Since most of the European nations tax oil consumption at very high levels, there was a strong belief that the United States should take even more vigorous steps to conserve on energy and encourage production. From the European perspective, the greatest opportunities for oil import reduction among the consumer nations existed in the United States since they believed that the United States had considerable "energy waste" that could be squeezed out of consumption and a considerable energy base that could produce more.

Although the Europeans were correct in their assessment that the United States was not doing enough to reduce oil imports, the Europeans did underestimate the degree to which prices had risen and the amount of adjustment that had in fact taken place within the United States. This misunderstanding exacerbated the bitterness the Europeans felt toward U.S. economic policies, especially during the period in 1977 and 1978. Although there has been a slight decline in U.S. oil imports since 1977, and although U.S. oil (but not gas) prices are moving toward the international price level, and although a variety of measures have been enacted to encourage conservation and production of energy, there are a number of domestic steps that could be taken to promote production and conservation within the United States.

The future of U.S.-European energy relations will depend importantly on the ability of the United States to reduce U.S. oil imports from the 1979 level of 8.4 million barrels a day. A further reduction in U.S. oil imports would strengthen the hand of the United States in dealing with the Europeans, not only on energy issues--for example, in efforts to persuade other countries to impose oil import targets in the future--but also would have a favorable effect on overall U.S. economic relations with the European nations.

There is an <u>international</u> energy issue which I would like to briefly address. A consensus appears to be developing for another producer-consumer dialogue. The official text of the Declaration of the Venice Summit states that "We would welcome a constructive dialogue on energy and related issues between energy producers and consumers in order to improve the coherence of these policies." Having been involved in the CIEC negotiations, I am skeptical about the usefulness of global negotiations of that sort. If anything, there are political costs since such negotiations provide a stage for posturing on the part of governments which often take one position in public and another in private.

The United States should not enter such negotiations unless two conditions are met. First, detailed groundwork should be laid with other governments regarding the subjects to be negotiated and the possible outcomes of the negotiations. Secondly, the U.S. government should have a clear-cut idea of what it is willing to give--and demand in such negotiations. With respect to the U.S. positions to be taken, the U.S. Executive Branch and the Congress should work closely before and during such negotiations in ways similar to the planning and cooperation that exists during major trade negotiations.

U.S.-European Trade Relations

The completion of the Tokyo Round of trade negotiations was a major accomplishment of the Carter administration in the context of its economic relations with other countries. The Carter administration has also been reasonably successful in containing domestic protectionist pressures. Looking out over the near term, and given the recession in the United States as well as the slowdown in economic growth in other countries, protectionist pressures are going to intensify. During the next two years, trade conflicts are likely to become the primary source of economic conflict between the United States and other governments, including but certainly not limited to nations of Europe. Thus, I believe that the most significant statement in the Venice Declaration was the shortest: "We are resolved further to strengthen the open world trading system. We will resist pressures for protectionist actions, which can only be self-defeating and aggravate inflation."

International Finance

Another subject which is likely to require greater attention from European and U.S. leaders, again in a multilateral context, involves the recycling of the OPEC surpluses. Immediately following the oil price increases of 1973, there were forecasts that the OPEC surpluses would remain large and pose a threat to the international financial system. The international financial system, including not only private banks but also official institutions proved to be more resilient and adaptive than many had thought possible. In addition, by 1978 the OPEC surpluses had disappeared. Commercial financial institutions, however, continued to play an important role in channeling money from other surplus countries to deficit countries.

The recent rise in oil prices has once again generated uncertainty about the ability of the private financial system to recycle the OPEC surpluses. Although history may repeat itself, there are many who today forecast that the OPEC surpluses will be remain large through the decade of the 1980s. In addition, many of those who were optimistic at the stage of the cycle following the 1973-74 price increases are today much more pessimistic about the ability of the international financial system to recycle this round of OPEC surpluses.

This is a subject requiring extensive analysis in and of itself, but I would like to comment on what I consider to be the central policy issues. These issues involve those industrialized countries whose banks perform international financial intermediation services and the surplus OPEC countries. One issue concerns whether official institutions, including the World Bank as well as the IMF, should play a significantly greater role in the recycling of the oil surpluses. Since a significantly larger role for these institutions would probably require appropriations on the part of the U.S. Congress to underwrite the risks connected with such an increase, (which I doubt the Congress would be willing to support at this stage,) and since a significantly larger role for official financing would embroil those institutions in the political choices that have to be made with respect to which deficit countries should receive the recycled OPEC surplus, I believe it would be a mistake at this time to significantly expand the roles of the official institutions. Instead, the United States, the major European governments, and the governments of Japan and the major OPEC surplus countries, should have contingency plans to enable them to quickly respond if the commercial banking industry encounters serious problems, such as the possibility of a major country default. There are many different kinds of risks confronting the international financial system today, and it is difficult to assess at this time which, if any, of those risks might produce an actual financial crisis. However, if a crisis develops, it is likely to emerge very rapidly. Thus, the major countries need to be prepared to respond quickly. Otherwise, an international financial crisis could have serious repercussions on a large number of deficit countries and result in a wholesale contraction of world economic activity.