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Statement by

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before the

Subcommittee on International Economic Policy

of the

Foreign Relations Committee

United States Senate

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Mr. Chairman, members of this Subcommittee, I am pleased to participate in your important hearings on the vital international economic issues that confront the United States today. My statement this morning identifies an agenda of issues facing the world economy as we enter the 1980s that deserve our attention so that we may begin to develop specific solutions to them.

We Face Common Problems, Have Common Interests

In an increasingly interdependent world economy, all countries are affected by favorable and unfavorable developments originating in other countries. The world economy faces a number of economic problems and concerns common to, and affecting, nearly all countries -- rampant rates of inflation, the reduced availability and increasing relative cost of raw materials, particularly energy, and sluggish investment. Moreover, gaps in standards of living between the citizens of industrial and developing countries persist and even may be widening. In meeting the challenge of dealing with these problems that affect the welfare of most individuals, all countries have a stake in maintaining a well-functioning international economic system in which goods, services, and capital move freely to satisfy economic needs and wants. In finding solutions to these problem areas, it is essential that the United States -- the world's most important economy -- provide creative leadership.

We cannot delay our exploration of ways to strengthen the performance of the world economy. Given the medium-term nature of many of today's underlying economic problems and the planning and implementation lags associated with major policy initiatives, efforts must be taken soon to affect the outcome in the 1980s.

Economies Becoming More Open and More Dependent on Each Other

In recent decades, international trade has been expanding more rapidly than the growth of GNP, and exports and imports constitute an increasing share of most countries' output and expenditure (Chart 1). On the whole, we all have benefited from greater international specialization, with the availability of lower-priced imports helping to contain inflationary pressures by strengthening the forces of competition and spurring productivity.

As economies have become more open, however, they also have become more susceptible to external developments affecting the supply and prices of the goods that they import. Over time, the major economies have become increasingly dependent on imported raw materials. Even the United States, which once was more self-sufficient in many raw materials than other countries, has increased its reliance on imports of these commodities (Chart 2). By 1978, net imports accounted for more than half the U.S. use of 20 important metals and other minerals. If the United States and other economies are not to suffer from a secular, steep rise of raw material prices, the pace of the absorption of the world's resources needs to be balanced by the development of new sources of supply.

Developments in recent years affecting the price and supply of energy have been especially troublesome for the United States and other economies. Industrial and developing countries still are coping with the problems resulting from the 1973-74 oil shock. The latest OPEC price increases are setting back the limited progress oil-importing countries have made in recent years in containing inflation and in resuming economic expansion. The latest OPEC price increases, moreover, weaken the stability of the international payments system and, in particular, aggravate the financing problems facing the non-oil developing economies.

Despite the United States' vast internal sources of energy, our energy consumption is outdistancing our domestic energy production. As a result, whereas net U.S. oil imports in the early 1950s accounted for less than a tenth of U.S. consumption, these imports now approach nearly one half (Chart 3). Moreover, the United States has relied increasingly on oil produced by Middle Eastern and North African oil producers, so that more than 50 per cent of U.S. oil imports last year were derived from these sources compared with less than 30 per cent in the 1963-73 decade. The adverse consequences for the non-OPEC countries resulting from such an event as the disruption of Iranian oil production reinforce the urgency for the United States and other oil-importing countries to reduce their dependence on imported oil and the need for these countries to conserve energy, to expand alternative energy supplies now available, and to develop new sources of energy.

New Challenges, New Opportunities

The expansion of production capacities for commodities that periodically have been in short supply could be aided by improving the process of transferring technology from industrial countries to less-industrialized economies. Broadening the opportunities for the transfer of technology in manufacturing also will help promote the economic development of the developing countries. The role of technology transfers would be enhanced by the maintenance in less industrialized countries of an economic climate that attracts foreign investment and by reaching agreement on a code of conduct relating to the transfer of proprietary technology and industrial property rights. The U.N. Conference on Science and Technology for Development that is scheduled to convene in August in Vienna provides

an opportunity to bring the resources and skills of science and technology better to bear in advancing the growth of developing countries, with mutual benefit to the world economy. It is important that the United States play an active role at this Conference and that the Conference succeed in reducing those barriers that impede the smooth transfer of technology across borders.

A new challenge to the world trading system is being posed by the emergence of newly industrializing countries as competitive exporters of manufactured products. This development is a logical consequence of a greater transfer of technology and the successful efforts by developing countries to develop their economies. To allow their citizens to benefit from the low cost of these goods, the more industrialized nations must be prepared to permit imports from these emerging countries. Firms and workers displaced by these imports should not be required to assume the full adjustment burdens resulting from this development. Appropriate measures by governments in industrial countries will be necessary in order to facilitate the shift of their productive resources into export industries where these countries enjoy a comparative advantage. The emerging economies, in turn, must be encouraged to open their markets to the high-technology goods produced in industrial countries.

The world-wide economic downturn during 1974-75 precipitated protectionist demands throughout the industrial world. The Tokyo Round of Multilateral Trade Negotiations was important not only because the world economy will benefit from the trade liberalization it provides. but, perhaps more crucially, because these negotiations countered the emerging tendencies towards protectionist actions. We must continue to be alert, however, to the need to place the interests of the general consuming public ahead of

those few special interests that perennially seek protection from the rigors of international competition.

Impressive Expansion of International Capital Markets

The expansion of international capital transactions, and particularly the growth of international bank lending, has been one of the impressive developments in international finance in the past decade (Chart 4). International capital markets have channelled sizable accumulations of savings in some countries to other countries that could utilize these funds effectively. In recent years, the Euro-currency and Euro-bond markets have played an especially important role in recycling massive surpluses of the oil-exporting countries. Industrial, developing, and Communist economies all have been active participants in these markets.

Despite the generally smooth functioning and rapid growth of the Euro-currency market in recent years, the less-regulated nature of this market periodically has been a source of concern among policy-making authorities. The operations of this market have raised questions about the market's impact on the efficacy of domestic monetary policy, about the competitiveness of Euro-currency banks vis-à-vis national banking systems, about the role of this market in facilitating exchange-market speculation, and about the soundness of the banking practices followed by banks involved in the Euro-currency market. In recent years, central bank and Treasury officials, both here and abroad, have focused attention on these and related aspects of the Euro-currency market. The objective of these deliberations has been to ensure that this market performs its important financial intermediary functions without at the same time weakening the structure of national banking systems or market confidence in the international financial system.

Several aspects of the rapid expansion of multinational banking deserve close examination. There is a need to improve the ability of bank supervisory authorities to evaluate bank lending on a consolidated basis. For some countries, more comprehensive statistical reports and more thorough supervisory procedures are needed to ensure that the consolidated operations of banks meet standards of prudence. Supervisory authorities in a number of countries are making progress in this area -- a development that will benefit all. In addition, there is a need for improved evaluation of country risk. It is important to both borrowers and lenders that international bank credit be extended on a scale and be used in a manner that ensures that funds are employed effectively and that borrowers are able to service their debts. Finally, there is a need to evaluate whether the growth of Euro-banking should be controlled. In this regard, a range of techniques, including the possibility of imposing reserve requirements on the liabilities of banks in the Euro-market, deserves to be explored.

Achieving Sustainable, Non-Inflationary Growth

In a world economy that has become more open, inflation and recession in major countries have serious effects on other countries. The attainment of sustained, non-inflationary growth by industrial countries not only would yield direct benefits to these countries, but also would strengthen the world economy in various ways. First, it would reduce the pressures in these countries to adopt protectionist trade policies. In addition, the expansion of import demand by industrial countries in an environment of non-inflationary growth would be one of the best ways to contribute effectively and lastingly to the growth of their trading partners in the developing world.

High rates of inflation have plagued most industrial countries during the past decade (Chart 5). Many developing countries have experienced even higher rates of inflation than those recorded in industrial countries. Rates of inflation in some developing countries in excess of 30 per cent per year are not uncommon, and several of the larger developing countries in Latin America even have experienced triple-digit inflation. While external influences such as high prices for OPEC oil no doubt have contributed to worldwide inflation, in most instances these external influences only intensify an inflation that basically is homegrown and fed by high wage demands, business pricing practices, government regulation and spending policies, and excessively expansionary monetary policies.

The costs of high rates of inflation are well known. They have resulted in arbitrary shifts in the distribution of income and wealth. High inflation rates also have weakened the investment climate, which, in turn, has intensified cost pressures and contributed to sluggish economic growth. Finally, high and divergent inflation rates among countries have been a principal factor in generating instability in foreign exchange markets.

The inflation problem has developed over a long period and has become imbedded in the structure of most economies. It, therefore, would be unrealistic to expect to eradicate it in a short time, and the disruption to the economies and societies of trying to do so would be enormous. This makes it even more important for economic policymakers in the period ahead to persist in maintaining sound fiscal and monetary policies that will prevent further inflationary momentum to develop and to seek to lower the inflation rates somewhat each year. In addition, governments must avoid, where possible, adopting other policies and regulations that have price-raising effects.

Capital formation has an essential role to play in achieving and maintaining steady, non-inflationary growth in industrial economies. Investment spending performs two functions in the process of promoting non-inflationary growth. First, it is an important component of aggregate demand. Second, investment spending creates productive capacity, providing the means to employ a growing labor force and increase the output of the economy. By increasing the ratio of capital to employed labor, the productivity of labor can be raised. Also, higher investment spending typically is associated with an increase in the flow of innovation and brings the average industrial plant closer to the state of "best practice" technology, further raising the average level of productivity. Higher productivity is an important variable curbing or offsetting inflationary pressures. It is through productivity growth, of course, that real incomes can rise in the long run.

A marked feature of the current economic recovery in industrial economies has been the lower rate of productivity increases in this expansion compared with earlier recoveries. This, in part, reflects the weakness of fixed investment expenditures. For a number of industrial countries -- e.g., the United States, Japan, Germany and Canada -- investment as a percentage of GNP has been lower on average in the past five years, at a time of relatively slow economic growth, than in the earlier period of higher GNP growth (Chart 6). A variety of factors has contributed to the weakness of investment spending in recent years -- low levels of capital utilization, the effects of the oil shock, weak profits, and uncertainty generated by high inflation rates.

Governments can best foster increased private investment spending by providing an economic climate that is conducive to business enterprise.

Government officials in many industrial countries are giving increasing recognition to the need to provide more scope for market forces to operate and to encourage private initiative.

Appropriate government policies can stimulate private investment spending. Cost-effective incentives -- such as liberalization of depreciation allowances -- and the elimination of various disincentives-- such as unnecessary and burdensome regulations -- would go far to encourage private investment. In addition, maintenance of sound monetary and fiscal policies that succeed in curbing inflation, stimulate personal savings, and reduce the pace of government spending, will provide an environment that will be conducive to an expansion of private investment spending. Finally, appropriate government support to intensify the efforts by the private sector in enlarging the role of research and the development of improved technology is likely to have substantial pay-offs in additional investment and higher productivity.

The Evolving Monetary System

The changes in the international monetary system in recent years have been substantial -- managed floating has replaced the adjustable peg system, the status of the dollar as an international asset has undergone changes, and the role of the International Monetary Fund in guiding the international monetary system has been enlarged.

The amended Articles of Agreement of the IMF that were put into place last year provide a framework for the evolution of the international monetary system in the period ahead. We must be prepared to examine objectively our attitude towards various proposals designed to strengthen the functioning of the international monetary system.

Despite expressions of doubt in recent years about the future role of the dollar as an international currency, the dollar continues to play a prominent role in private and official transactions. About 80 per cent of all official foreign exchange reserves are held in dollars, a comparable fraction of private financial assets and liabilities is denominated in dollars, and it is estimated that about half of world trade is denominated in dollars. Proposals to reduce the official role of the dollar in the international monetary system, therefore, could have important implications for the operation of the system. The United States did not elect that the dollar assume a key role in the international monetary system. That role developed as a result of an evolutionary process that now may be changing. Proposals to reduce the international role of the dollar and to expand that of the SDR -- such as establishing a substitution account in the IMF -- should be evaluated in the context of the longer-term development of the international monetary system. We must ensure that any plan to reduce the dollar's role will not restrict the freedom of the United States to pursue appropriate domestic economic objectives, that it will facilitate the maintenance of an open system of world trade and capital movements, and that it will contribute to more, rather than less, international monetary stability.

It is in our mutual interest to achieve an economic environment that avoids excessively large swings in exchange rates. World trade and finance respond more effectively to signals that are not erratic. Where exchange-rate adjustment on the basis of fundamentals is necessary, such adjustment should take place in an orderly fashion. Article IV of the amended Articles of Agreement of the IMF provides new procedures for international surveillance over countries' exchange-rate policies and the

adjustment of external imbalances. We need to explore how to make more effective use of these procedures.

The recent strengthening of the value of the U.S. dollar on foreign exchange markets reflects the market's favorable reassessment of underlying trends of U.S. and foreign economic performance and policy, as well as the effects of the November 1 measures to support the dollar. Market participants now recognize the willingness of the United States and its major trading partners to engage, if required, in substantial intervention. The November 1 measures have provided the United States a necessary breathing spell during which its monetary, fiscal and wage-price policies can take hold in dealing with the fundamental economic and financial factors that most influence a country's exchange rate -- international current-account developments, relative inflation rates, and relative rates of real economic growth.

In the final analysis, one cannot decree greater stability of exchange rates. Such stability will require a narrowing of inflation-rate differentials at a lower level of inflation, as well as the achievement of rates of economic growth and structural adjustments in national economies that are consistent with a sustainable pattern of international payments.

Need for U.S. Leadership and Continued International Cooperation

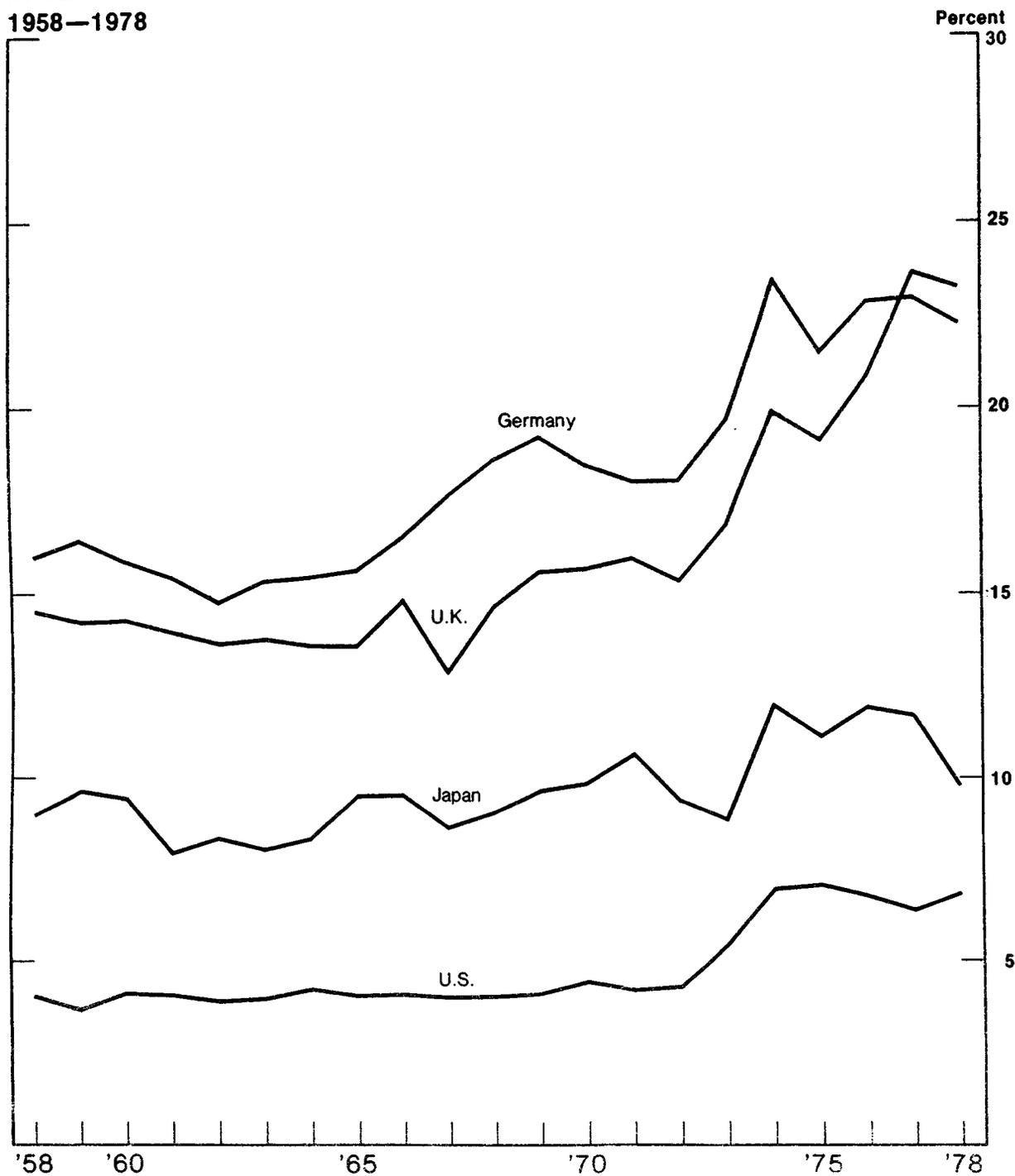
The United States should play an active and constructive role in international deliberations on the issues that I have raised this morning. If the United States is to maintain its leadership role, it must set a good example -- by addressing and solving its urgent internal economic problems, especially those related to inflation and energy, and by demonstrating its support for the international financial institutions.

The economic summits held each year since 1975 have provided a forum for strengthening the process of international consultation and

cooperation. Continued cooperative efforts -- such as next month's summit meeting in Tokyo -- will be required to deal with worldwide economic problems. In an increasingly interdependent world economy, policymakers need to consider the effects of their actions on others when formulating national policies. A frank exchange of views and policy intentions could contribute to better-informed policy formulation in each country and set the stage for sharing of possible solutions to common problems.

Chart 1

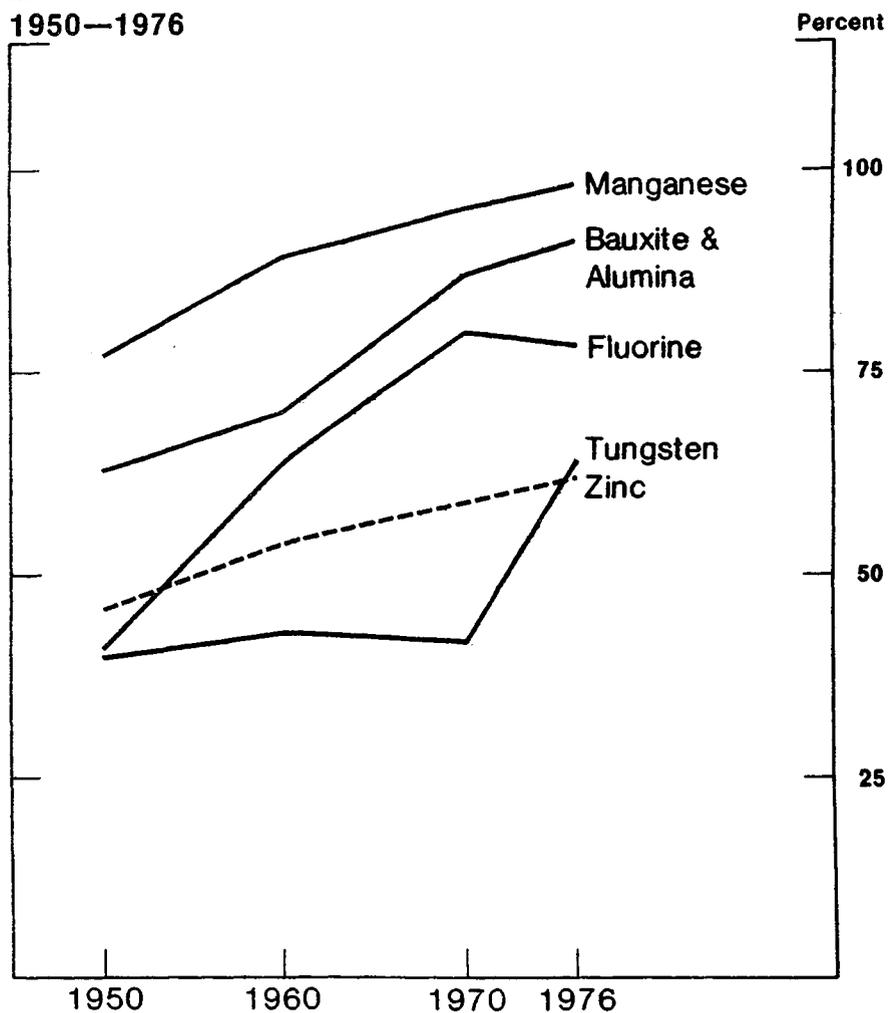
**EXPORTS AS A PERCENTAGE OF GNP
IN SELECTED INDUSTRIAL COUNTRIES
1958—1978**



Source: IMF, *International Financial Statistics and Direction of Trade*

Chart 2

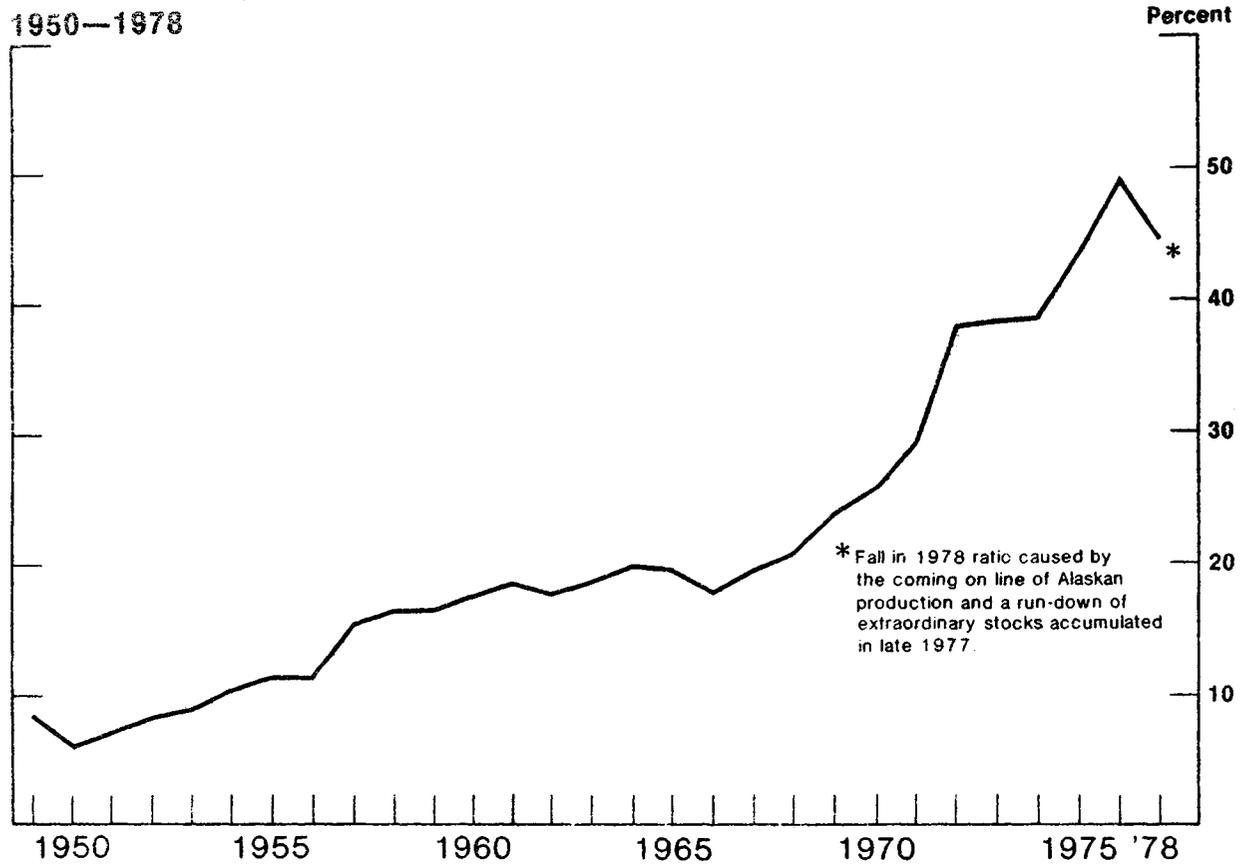
**U.S. IMPORTS OF SELECTED METALS AND OTHER MINERALS AS A PER CENT OF CONSUMPTION
1950—1976**



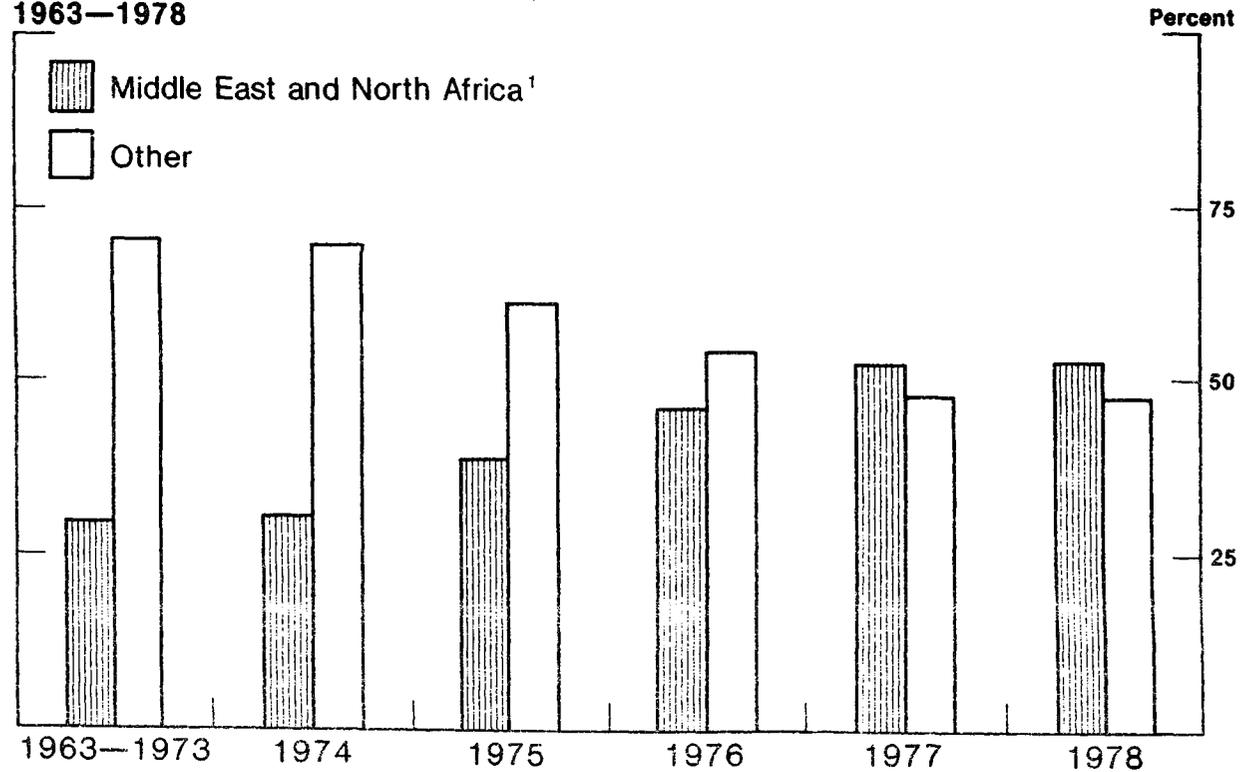
Source: Bureau of Mines, *Mineral Trends and Forecasts*, 1979

U.S. OIL IMPORTS

Net U.S. Oil Imports as a Percentage of Consumption
1950—1978



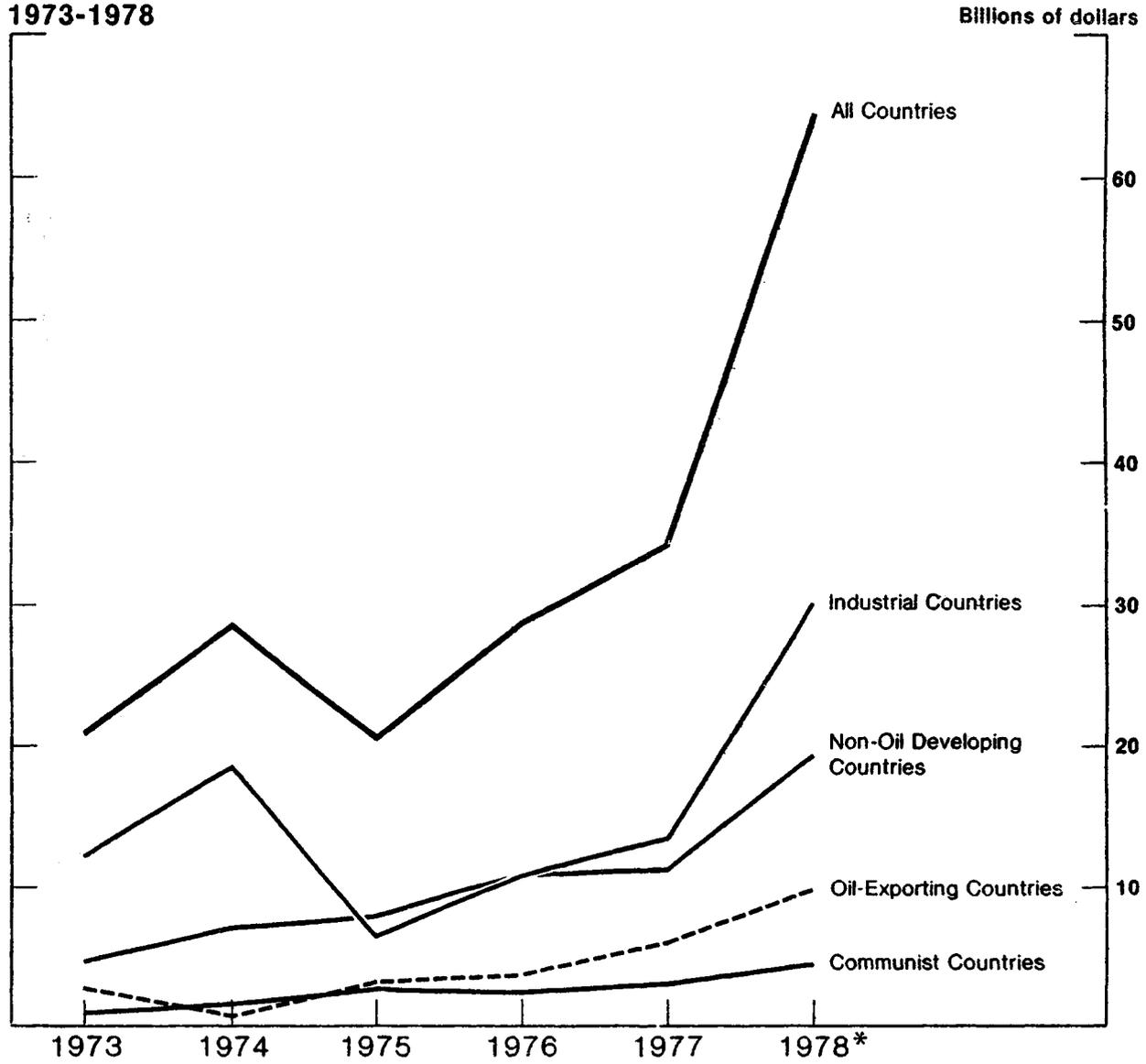
Ultimate Source of U.S. Oil Imports 1963—1978



¹ Members of the Organization of Arab Petroleum Exporting Countries plus Iran
 Source: U.S. Energy Information Administration, "Crude Petroleum, Petroleum Products, and Natural Gas Liquids" and
 "Supply, Demand, and Stocks by P.A.D. Districts," Annual Reports

Chart 4

MEDIUM-TERM EURO-CREDITS COMPLETED DURING THE YEAR 1973-1978

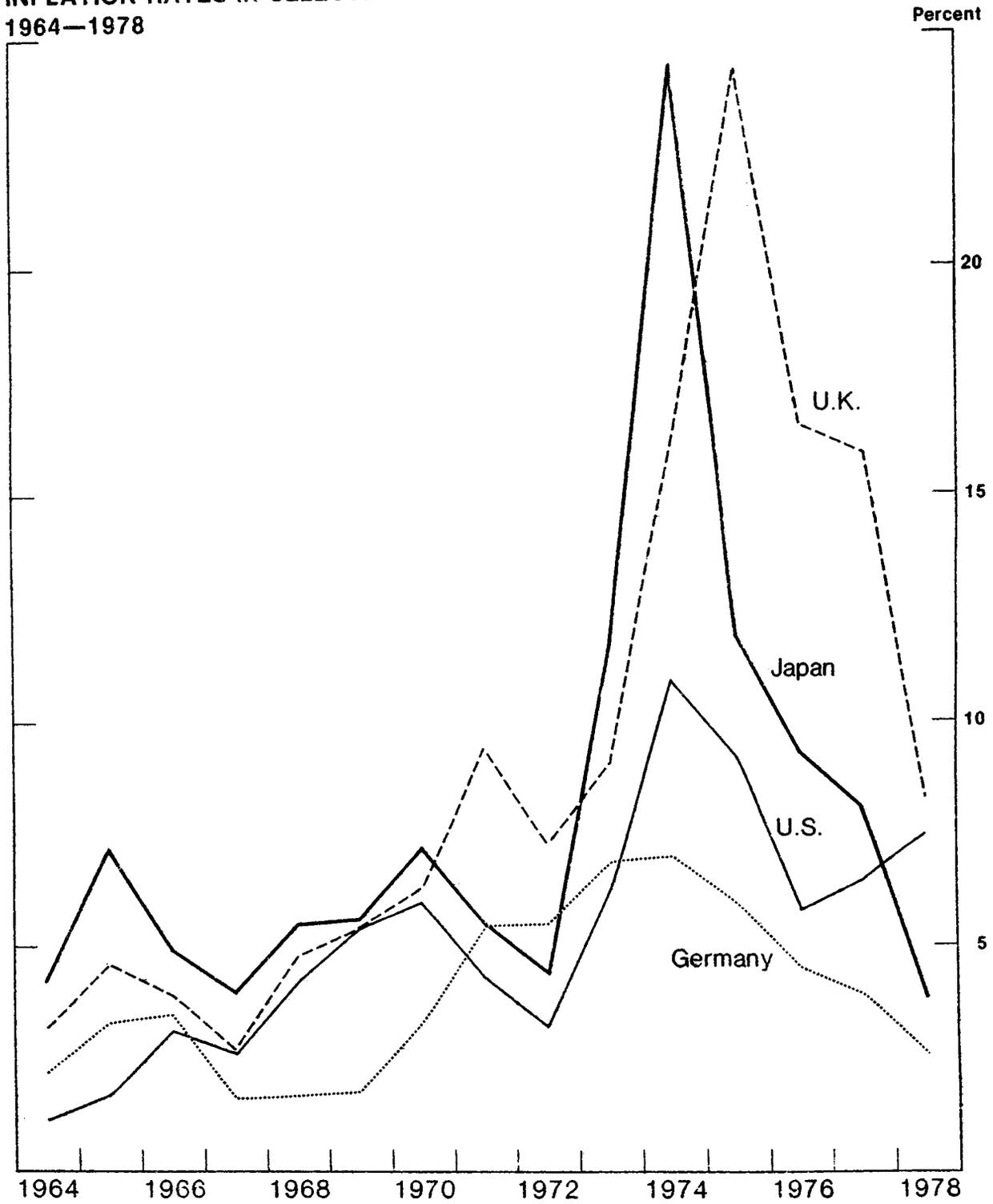


Source: World Bank with adjustments by Federal Reserve Staff.

* Preliminary figures

Chart 5

INFLATION RATES IN SELECTED INDUSTRIAL COUNTRIES 1964—1978

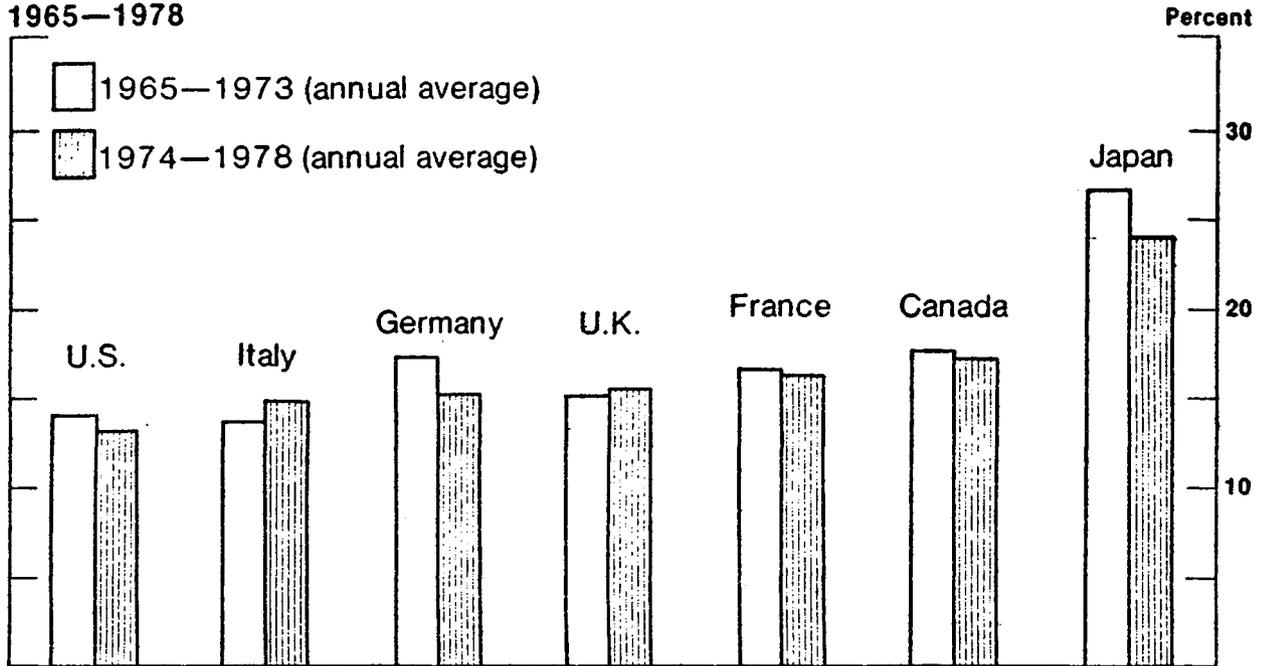


Year over year percentage change in Consumer Prices.
Source: IMF, *International Financial Statistics*

Chart 6

INVESTMENT SHARES OF MAJOR INDUSTRIAL COUNTRIES *

1965—1978



*Nonresidential fixed investment as a share of gross domestic or gross national product in current prices; includes government capital formation. Data for 1978 are partially estimated for Japan, United Kingdom and United States and are not available for Italy. The data for France refer to 1970—73 and 1974—76. Data from national sources, OECD, and staff estimates.