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Testimony by

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Committee on Banking, Housing, and Urban Affairs

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I welcome the opportunity to appear before you today to review some aspects of the world economic situation. In particular, you asked me to concentrate on exchange market developments and international debt. These issues are in turn related to the overall functioning of the world economy. Indeed, I would argue that the problems of economic growth, balance of payments adjustment, protectionism, and international debt are so intertwined today that a failure to deal constructively with any one of them would risk failure across the board.

#### Instability in Exchange Rates

So far in this decade we have experienced tremendous swings in the value of the dollar. Measured in terms of a multilateral-trade-weighted average against the currencies of the other G-10 countries, the dollar's value rose about 80 percent from 1980 to the first quarter of 1985. It has since retraced most of that rise and is now at a level only about 10 percent above its average in 1980 when our current account was close to balance.

Large swings in exchange rates among industrialized countries over periods of several years were also characteristic of most of the 1970s. However, if anything, the fluctuations have appeared to become greater, rather than less, as the period of floating rates has been extended.

In themselves, such wide swings in exchange rates are troublesome. When exchange rates among nations fluctuate much more widely than relative changes in domestic prices, productivity

and other basic economic variables, economic units producing internationally tradeable goods receive misleading price "signals" over time. Investment decisions may be distorted, and individual firms and workers can be whipsawed by fluctuations in price competitiveness internationally. For the economy generally, deflationary or inflationary impulses may complicate the task of economic management and affect the stability of financial markets.

However, it does little good merely to rail against excessive fluctuations in exchange rates without being prepared to do something about them. And that "something," in the end, involves appropriate national economic policies and reasonable consistency and complementarity among the policies and performance of major nations. In fact, national policies during much of the 1980s have, in important respects, diverged in ways that put pressure on exchange rates and distorted trade positions, even though inflation rates have tended to converge at much lower levels.

For one thing, the U.S. federal budget deficit was high and rising as budget deficits in other countries were being reduced. For several years, growth in the United States was substantially stronger than elsewhere and our interest rates were relatively high. Although U.S. growth overall has since slackened, expanded consumption has depressed further our chronically low personal savings rate.

As a result, there have been strong incentives for a flow of capital from abroad into the United States. For a time, that flow pushed up the dollar, and that strength was probably amplified by more speculative forces. The result of the strong dollar and our relatively rapid growth in domestic demand was a sharp deterioration in our international competitive position and in our trade and current accounts.

The rising trade deficit, lower interest rates, and slower growth have all worked in the direction of reducing dollar exchange rates over the past two years. Relative to the Japanese yen and the German mark, the dollar is at, or close to, all time lows.

No doubt a sizable realignment of currency values has been a necessary part of the process of restoring better balance to our trade and current accounts. Moreover, I believe sustained economic growth and financial stability in the United States over the next few years is importantly dependent on improvements in our trade balance. But I do not believe we can be successful in that effort if we fail to recognize the importance of factors other than exchange rates in redressing our trade balance. There are clear dangers in relying too much on exchange rates alone.

The hard fact is that we have been spending more at home than we have been producing -- about 3-1/2 per cent more last year. The decline in the dollar has provided incentives for more exports and for less imports. But if we are to

improve our trade balance, and do so with a minimum of inflationary pressures, we will also have to slow the growth of spending at home, particularly for consumption. We want to maintain investment. However, we will have to achieve a better balance between that investment and domestic savings if we are to be in a position to dispense with foreign capital. In terms of laying the groundwork for future growth, progress in making these adjustments seems to me more important than achieving a particular rate of growth overall this year.

The constructive way to work in the needed direction would be to reduce our budget deficit, year by year, paving the way for improvements in our trade accounts. In contrast, looking toward depreciation of the dollar alone to improve our trade balance would clearly pose substantial risks of renewed inflationary momentum and undermine confidence in future financial stability -- developments that could jeopardize prospects for sustained economic expansion. You are well aware that some warning signs of just such developments have appeared in recent weeks.

I know of no reliable way of judging now whether several years ahead the dollar vis-a-vis other currencies will ultimately need to be higher or lower, consistent with restoration of a sustainable trade position. Too much depends upon other important factors and policies affecting relative growth and competitive performance here and abroad. What we do know is that a substantial exchange rate adjustment has already been made. That adjustment should be large enough, in a

context of a growing world economy and fiscal restraint in the United States, to support the widespread expectations of a narrowing in the real trade deficit in the period ahead. There are indications that the volume of our exports is now growing substantially, and some slowdown in the growth, or even a decline, in the volume of imports seems possible this year. In real terms, the deficit in our trade narrowed in the fourth quarter of last year.

Whether and how soon improvement in the real trade balance this year will be accompanied by a reduced trade deficit in dollar terms -- the data published each month -- is more problematical. The trouble is higher dollar prices of imports as the dollar depreciates -- the well-known J-curve effect -- might offset improvement in the volume of net exports for some time. That phenomenon itself points to one of the dangers of looking to depreciation of the dollar alone to deal with the trade problem: it generates inflationary pressures and could actually prolong "J-curve" effects, perhaps, raising more doubts about our ability to finance our current account deficit.

Prospects for achieving solid and steady improvement in our external trade -- and doing so in a context of sustained world growth -- is critically dependent upon the strength of markets abroad, and on whether they are open to us. Unfortunately, the evidence on that score is not entirely favorable.

Specifically, growth of real GNP in foreign G-10 countries on average slowed to about 2-1/4 percent last year (fourth quarter

to fourth quarter), almost 1/2 percent less than in 1985. To be sure, much of that slowdown reflected reduced export growth rather than reduced domestic demand. But clearly, domestic expansion in those countries was not enough to offset the effects of the trade adjustment. And the clear danger now in most other industrialized countries is that growth may be slowing further.

In that kind of situation, further sizable depreciation of the dollar could well be counterproductive. It will take time and other policy changes both here and abroad to achieve the shift in resources necessary to achieve better international balance. Excessive volatility in exchange rates could jeopardize instead of speed the process by further impairing prospects for investment and growth in the surplus countries.

That I believe is the sense of the understandings reached among the leading industrial countries in Paris in February looking toward greater stability of exchange rates around current levels. Those understandings have been reflected in active intervention in the exchange markets in recent weeks. But intervention, taken alone, is of course a limited tool.

Confidence in the current exchange rate levels will in the end depend upon perceptions that more fundamental policies than intervention will in fact be brought to bear. I have emphasized the need for complementary changes in fiscal policies in the United States, Germany, and Japan. The conduct of monetary policy, here and abroad, will be relevant as well. The performance of the dollar in the

exchange market might become a factor bearing on our provision of reserves; I should think our central banking colleagues abroad may wish to take account of such circumstances as well.

In sum, we plainly do want and need improvement in our trade balance. There are some encouraging signs in that respect. But there are also practical limits as to how fast the necessary massive shift in resources can be accomplished if the momentum of world expansion is to be maintained. Undercutting investment and growth abroad at a time when growth prospects are already relatively weak is neither in their interest nor ours. Undercutting our own prospects for price and financial stability by a weak dollar is equally unattractive.

What we need now, instead of more depreciation, is action here and abroad to carry through on those other measures needed to support growth and adjustment -- specifically action to reduce the budget deficit here, and to provide stimulus abroad. We need time for those actions, and the earlier depreciation, to work their effects. And we need the patience to see it through, without embarking on self-destructive protectionist policies.

#### The World Debt Situation -- Progress and Problems

Patience is difficult enough for rich countries like the United States; for the heavily indebted countries of the developing world, the plea wears thin without supportable prospects for greater economic growth and stability. In that



connection, I do not share the sense of some that radical new approaches to the debt problem are necessary or practicable -- indeed, writing down and forgiving debts that can reasonably be serviced would risk undermining growth and stability in the borrowing countries. But I also believe that we would be blind to fail to recognize shortcomings in implementing present approaches.

Specifically, there is clearly a danger that adequate financing arrangements are not being negotiated and put in place in a timely way. Borrowing countries that have demonstrated their intent and ability to carry out effective economic programs need to be able to proceed with confidence that necessary funds will in fact be available to support those programs.

More broadly, sluggish growth in the industrialized world has affected the export markets of the heavily indebted countries, slowing their return to full economic and financial health. For awhile, in 1983 and 1984, as the United States led world recovery, markets of the borrowing countries expanded at a rapid pace. Then the growth rate for industrialized countries dropped to 3 percent in 1985 and to less than 2-1/2 percent last year. As things stand, prospects are no better -- and perhaps worse -- in 1987. Taking the whole period since 1982, Europe and Japan have increased their imports very little from Latin America. Plainly, it is in our collective interest, as well as that of the indebted countries, to do better.

Meanwhile, my sense is that there has been too little appreciation of how much progress the heavily indebted countries themselves have made toward laying the groundwork for renewed and more sustainable growth. To take one key measure of adjustment, the combined current account deficit of the so-called Baker-15 countries declined from the \$50 billion range in 1981-82 to essentially zero in 1984-85. The aggregate deficit widened again by about \$10 billion in 1986, but that almost entirely reflected the decline in oil and other commodity prices. Even under those circumstances, the deficits have collectively been within the amounts envisaged when Secretary Baker outlined the "Program for Sustained Growth" in Korea in 1985. At the same time, capital flight in most borrowing countries has tended to slow; it has even reversed in some.

Reflecting those factors, growth in the external debt of the most heavily indebted countries has slowed sharply, averaging less than 3-1/2 percent a year in dollar terms since 1982. With reasonable rates of economic expansion both in the borrowing countries and in the world at large, that rate of increase in external debt should be manageable and consistent both with declining debt burdens for borrowers relative to GDP or exports and with reduced exposures of lenders relative to their capital and assets.

I realize neither world growth nor growth by borrowing countries has recovered to "pre-crisis" levels. Nonetheless, along with the progress in external adjustment, many of the major

borrowing countries have also experienced significant recovery in economic activity. A few -- Brazil, Chile, Colombia, and Morocco -- have achieved a substantial pickup in economic growth, averaging more than 4 percent per year during the past three years. For the 15 heavily indebted countries as a group, real GNP has grown by some 8.8 percent since 1983.

Measured against the performance of the 1970s, when foreign finance was so freely available, or against prospective needs, the improvement in economic activity, employment, and living standards has not been satisfactory. But a full measure of success by those criteria was hardly possible in so short a period of time. Plainly, the earlier amounts of lending from abroad are simply not available today. Instead, some fundamental economic adjustments have been required to build a more solid foundation for sustained growth.

Naturally, the degree of success in making those adjustments has varied from country to country. In difficult economic and political circumstances, punctuated by natural disasters and external shocks, some setbacks have been inevitable. But what is so striking overall is the amount of progress that has been achieved.

In country after country, fiscal deficits are under better control than at the beginning of the decade. Chronically overvalued exchange rates have been brought into more realistic competitive alignments, enabling their industries to compete more effectively in world markets.

At the same time, the exchange rate and fiscal changes have helped create conditions in which the borrowing countries could be more open to international competition -- quantitative import restrictions, licensing requirements, and tariffs have, on balance, been reduced. Other efforts are underway to limit the role of the state in the economic system by cutting back on subsidies, credit allocation, and in some instances public ownership of industry.

One area that has been squeezed that reflects adversely on future prospects is investment. That points up the need for some margin of fresh funds from abroad to support growth. The provision of such funds from both public and private sources has been, of course, one of the basic elements of the "Baker Plan."

Both the IMF and the World Bank have played important roles in that respect. In particular, the World Bank over the past year, complementing the efforts of the Fund, has embarked on an ambitious program to define and to support financially structural changes that would provide a basis for debtor countries to resume more vigorous economic growth. This has entailed an intensive process of consultation with each of the largest indebted countries to develop policy approaches that are both strategically important for improving economic efficiency and politically feasible.

During the past two years, the most significant structural changes adopted by the major indebted countries have been in the area of trade policy. Nigeria, Mexico, Chile, Colombia, and

Ecuador have each taken steps to liberalize their import restrictions -- and at the same time, have been able to achieve impressive growth rates for their non-traditional exports. In other instances, huge credit subsidies to agriculture or other sectors have been reduced while other measures have been taken to enhance the efficiency of those sectors.

Overall, disbursements by the World Bank and the regional development banks to the "Baker 15" increased to \$7-1/2 billion in 1986, almost 40 percent above the rate of 1983-85. Disbursements should increase further this year to the levels envisaged by the "Baker Plan." These institutions will certainly provide a substantially larger proportion of new funds flowing to Mexico and other heavily indebted countries than in earlier years.

Both governmental and private lenders have restructured outstanding debts of the borrowers, and interest rates on many bank credits have been negotiated downward. More importantly, world interest rates have declined in both nominal and real terms. As a result, the burden of external interest payments has been falling despite some increases in debt.

From the perspective of the commercial bank lenders, progress has been more striking. Exposure to the heavily indebted countries relative to their capital bases has declined sharply. For all U.S. banks, the ratios of such loans to capital have by now declined by close to 50 percent. Relative exposure

of foreign banks has probably declined even more since 1982, as a result of the depreciation of the dollar.

That progress is welcome in terms of the implications of reduced financial pressure on lenders and borrowers alike. However, there is another side to the coin. The heavily indebted countries need to be able to count on receiving in a timely way those funds reasonably necessary to support well-conceived economic programs -- and in particular necessary levels of domestic investment. Available data suggest net new commercial bank lending virtually ceased in 1985 and 1986, and certainly was below amounts assumed in the approach outlined by Secretary Baker.

Part of the difficulty has been the length of time required to negotiate and syndicate the large new Mexican loan -- the gestation period is now approaching nine months. Underlying the delay in that instance and others has been evident differences in viewpoint and emphasis among banks -- those with large exposures as against those with limited exposures, those in one country as against those in others, those with continuing interests in international lending and those who want to withdraw.

While differences in approach and priority are natural, and have been present from the start, what is disturbing to many bankers and borrowers alike is the increasing difficulty in arriving at a consensus, and once reached, implementing that consensus effectively and speedily. What has been lacking is the sense of urgency and willingness to cooperate in the

larger general interest that was so evident in 1982 and 1983. The irony is that it is precisely a failure to arrive more expeditiously at mutually satisfactory financing agreements that may be the greatest threat to the success of the overall effort. In some instances, doubts about financing undermine the resolve to carry out needed economic reforms. And an environment of successive financing crises can hardly be in the interests of the banking community itself.

Fortunately, a sense of renewed effort and commitment seems to be emerging. Restructuring agreements were recently completed with Venezuela and the Philippines and financing arrangements with Chile modified, in each case, after months of discussions. Initiatives are underway among U.S. regional banks, looking toward the development of innovative approaches to broaden the choices of banks in structuring their participation in new financing programs. Discussions among banks at an international level should help deal with points of friction.

In all these discussions, the issue of "free riders" will need to be dealt with effectively; the cohesion of the entire effort will be undermined to the extent some creditors "opt out" of participation in new credits or restructurings while continuing to receive interest and principal payments.

The success of all this renewed effort is being tested in important negotiations with Argentina. That country is among those making substantial progress in recent years toward greater domestic stability and restoring growth, despite its heavy

dependence on severely depressed world grain markets. Argentina has been working closely with the IMF for several years, and the World Bank is prepared to provide additional financing to support sectoral reforms. But it is also clear that restructuring of outstanding loans and some margin of new credit will be necessary to support growth and to maintain continuity in debt service. Early agreement on those matters seems to me obviously in the interests of Argentina and lenders alike, providing a base for greater confidence that their objectives -- some common and some different -- can be reached.

The largest developing country debtor -- Brazil -- is obviously in a difficult position today. After a period of strong domestic growth and large trade surpluses, strong inflationary forces again developed, the external position deteriorated, and the momentum of expansion has been interrupted. In the circumstances, with international reserves rapidly falling, the government suspended servicing medium and longer-term bank debt.

Given its enormous human and material resources, Brazil clearly has the potential for becoming one of the world's leading economic powers; its competitive strength, vitality, and adaptability have been demonstrated again and again in recent years. At the same time, as for any country, realization of that potential over an extended period will clearly be dependent upon both consistent and effective economic policies at home and strong and harmonious trade and financial relationships with other countries.



As a practical matter, the necessary regularization of external payments by Brazil will take concerted effort. The key prerequisite is clearly in the hands of Brazilian authorities -- shaping an economic program that commands the support and confidence of Brazilians themselves and the world community. Given that base, both Brazil and its creditors, official and private, seem to me to have the strongest kind of incentive to work together to develop external financing arrangements consistent with strong and sustained growth.

### Conclusion

In more general terms, that is of course the challenge for all the heavily indebted countries and their creditors. It seems to me a challenge that will continue best to be approached case-by-case, taking account of the different circumstances and problems of each country. But there are, of course, common needs that run through all the particulars.

First, a successful approach needs to be premised on the requirements for growth. That is not simply a matter of providing external financing, critical as that may be at the margin. It is first of all a matter of the intelligent design of effective domestic programs.

Second, sustained economic growth, and the growing imports and exports that are an indispensable part of that process, is importantly dependent on access to world financial markets. Continuity in debt service and negotiated settlements are critically important in maintaining those relationships.

Finally, success in the common effort will depend upon growing and open markets in the industrialized world. That responsibility plainly lies mainly with the United States and its principal trading partners.

It is an effort that, in my judgment, needs to be reinforced by appropriate fiscal and other policies here and abroad. It is an effort that would be placed at risk by excessive instability in exchange rates. And it is an effort that would be undermined entirely by a retreat into protectionism.

I trust that we will have the collective will and wisdom to take those steps that are necessary and to reject those that could only be counterproductive. Too much is at stake to do otherwise.

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