CHAPTER 4

The World Economy—Managing Interdependence

FROM THE EARLY 1950s THROUGH THE LATE 1960s, growing economic interdependence provided the major impetus toward sustained, rapid growth in the world economy. Just 10 years ago, in his last *Economic Report,* President Johnson wrote:

> In the past two decades, enormous progress has been made in building a closely knit international economy. Remarkable growth in the volume of international commerce has gone hand in hand with sustained world prosperity; each has contributed to the other. At times, deep and obvious strains in the international monetary system have imperiled this progress, but these financial difficulties have been weathered without a serious setback in economic growth or world trade.

Much has changed throughout the last decade. In some areas the momentum of the 1960s has continued: an ever-growing share of world production is devoted to international trade. Financial markets have become more integrated internationally and have adapted to the task of recycling unprecedented flows of funds from surplus to deficit countries. For a few countries of the Third World and the southern tier of Europe, rapid export growth—and particularly the shift in the composition of exports toward manufactured goods—have occasioned rapid rises in income growth and production.

There have also been fundamental changes in the international economic system. The most dramatic change, of course, was the breakdown of the Bretton Woods system of pegged exchange rates, and its replacement by a system of market-determined flexible exchange rates. This change has, by and large, helped the world economy to adjust to the severe problems confronting it in the past 5 years—the rise in oil prices and the poor harvests of 1973–74, the subsequent serious recession, persistently high and divergent rates of inflation in most industrial countries, and the hesitant economic recovery outside the United States.

The evolution of the floating rate regime has given individual countries more elbow room for steering their economies in different directions. The extent of independence, however, is limited and the need for some coordina-

tion of economic policies remains. Indeed, to some extent the major lesson of 1977 and 1978 is that policy divergences produce severe strains: the rapid expansion in the United States relative to other major industrial countries triggered a large and potentially destabilizing depreciation of the dollar during 1978. The rise in U.S. inflation and the depreciation of the dollar led the United States to implement a policy of monetary and fiscal restraint, in coordination with a cooperative action to deal with exchange-market disturbances.

A second major change from the picture 10 years ago—and one which has been appreciated only slowly—is the pronounced decline in growth dynamism of the industrial world. Growth of potential output has been retarded, but growth of actual output has fallen even further. Aggregate demand has been sluggish throughout the industrial world outside of the United States since 1973. Weak investment and cautious consumers generally slowed private demand. Yet the need to reduce inflation and the large external and public deficits made policy makers cautious. As a result, the overall growth in the countries making up the Organization for Economic Cooperation and Development (OECD) slowed to an average of 3.0 percent over the 1973–78 period, compared to 4.9 percent in the preceding decade.

The reasons for the slowdown of potential output are not fully evident. The slowing of investment virtually everywhere has resulted in an aging capital stock. The growth of trade has slowed, and the earlier economic gains from economic integration have not been repeated. In many countries the hidden unemployment in agriculture has largely disappeared, leaving little of the productivity bonus that accompanies a declining primary sector. Clearly the sharp rise in the cost of energy has led to some costly substitution. To a lesser extent, generally higher and more volatile commodity prices may have retarded some productive sectors.

Finally, both actual and potential output growth has probably been restrained because of new views concerning the value of change and economic growth. Occasionally, a new spirit of "preservationism" has created pressures to protect the existing structure of jobs and wages and bolster weak sectors. In part, this spirit is a reaction to acute problems in key industries: excess capacity in steel, shipbuilding, and textiles, for example, burdens many economies. But a more cautious attitude has also increased the difficulties of shifting resources from declining to expanding sectors. Preservationist pressures encourage protectionist trade measures or internal subsidies that could make the world economy even less dynamic and more prone to inflation. The adventurous spirit that once characterized much industrial activity and is vital to rapid structural and economic change may have been suppressed at least temporarily by the uncertainties of the recent past.

Managing interdependence today is a major challenge. We have been through a period in which—in contrast to the robust postwar expansion—growth potential has declined and inflationary pressures have increased. To

some extent these conditions may prevail for a number of years. In the past, numerous structural factors favored rapid expansion and rising productivity: relative commodity and energy prices fell, trade barriers were lowered, new technologies came in quickly, and economies of scale were realized. These favorable factors have been weakened or reversed. The challenge to policy—at home and abroad—is twofold: to steer our economies safely through these more hazardous waters and to create conditions that favor sustained economic growth. Improved international coordination of domestic policies will be essential to accomplish both of these tasks.

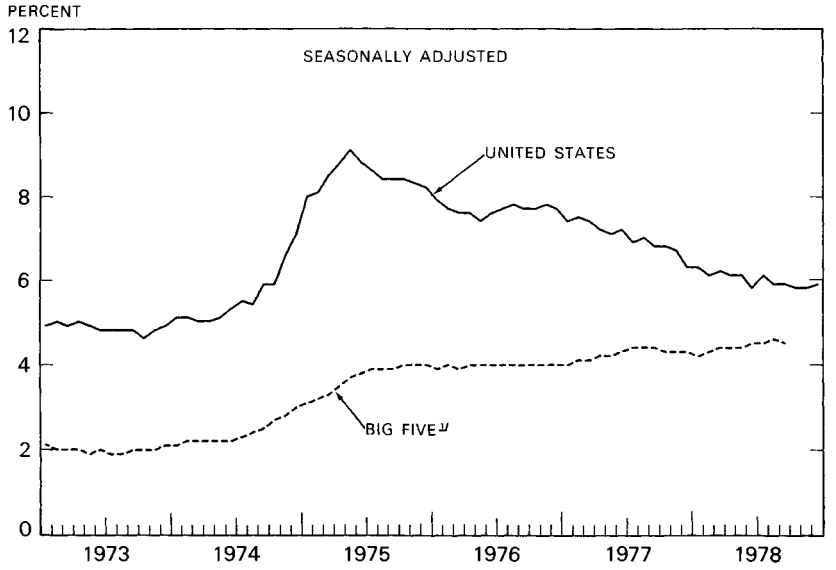
THE GLOBAL ECONOMY: DEVELOPMENTS AND PROSPECTS

In many ways 1978 can be seen as a year of transition for industrial countries. Here in the United States economic growth began to slow after a strong recovery earlier. In the other major industrial countries, where recovery had been hesitant, growth accelerated somewhat, though not enough to reduce excess capacity substantially or to prevent a continued upward drift in unemployment (Chart 9).

The inflation rate accelerated in the United States. In most other industrial countries, inflation rates, which on average exceeded those in the United States during 1974–77, continued to decline. As a result, the rate

Chart 9

Unemployment in the U.S. and Five Major Industrial Countries



[1] JAPAN, GERMANY, FRANCE, UNITED KINGDOM, AND CANADA. DATA ARE GNP-WEIGHTED AVERAGE.
SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.

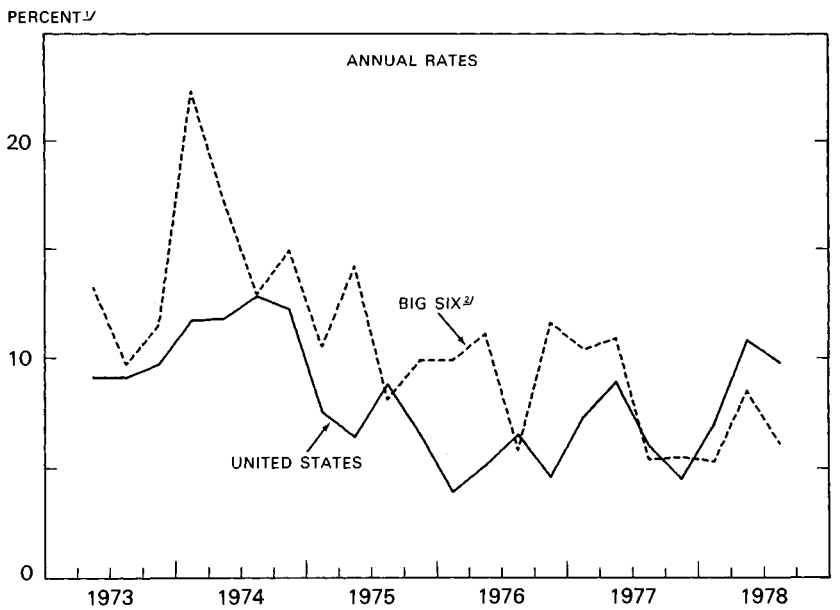
of inflation in the United States in 1978 was higher than the average level for the major foreign countries (Chart 10).

External positions also changed markedly during 1978. For the OECD countries as a group the combined current account deficit declined sharply. The deficit of the United States widened somewhat, but this was more than offset by the large rise in the combined surplus of the other major countries, especially Japan, and a marked decline in the combined deficit of the smaller OECD members. Nevertheless as the year progressed there were increasing indications that the major imbalance between the positions of the United States and Japan was beginning to be reversed. Both the Japanese surplus and the U.S. deficit were smaller in the second half of 1978 than in the first half.

The year 1979 should see some correction in the cyclical divergence that has arisen since the oil crisis. As shown in Table 31, the anticipated slowing of growth in the United States is matched by an expected slight rise of growth abroad. For the first time since 1975, growth abroad is likely to exceed growth in the United States. (It should be noted that the growth rates presented here are year over year, rather than fourth quarter over fourth quarter as generally presented elsewhere in this *Report.*)

Chart 10

Consumer Price Inflation Rate in the U.S. and Six Major Industrial Countries



1/PERCENT CHANGE FROM PRECEDING QUARTER AT ANNUAL RATE.

2/JAPAN, GERMANY, FRANCE, UNITED KINGDOM, CANADA, AND ITALY. DATA BASED ON 1977 GNP/GDP WEIGHTS AND EXCHANGE RATES.

SOURCES: DEPARTMENT OF LABOR AND NATIONAL SOURCES.

TABLE 31.—*Annual growth in real GNP in the United States and other major industrial countries, 1960–79*

[Percent change]

Country	1960–74 average	1975	1976	1977	1978 [1]	1979 [2]
United States	3.6	−1.3	5.7	4.9	3.9	3.3
Big Six [3]	5.8	−.3	5.4	3.3	3.8	3.9

[1] Preliminary.
[2] Forecast.
[3] Japan, Germany, France, United Kingdom, Canada, and Italy; OECD estimates. For 1960–74 average, based on 1970 GNP/GDP weights and exchange rates; for 1975–79 based on 1977 GNP/GDP weights and exchange rates.
Sources: Organization for Economic Cooperation and Development and Council of Economic Advisers.

Inflation rate differentials are also expected to narrow somewhat during 1979, in line with the anticipated slowing of inflation in the United States and a possible increase in inflation in some foreign countries. Trade and current account imbalances are expected to diminish further as a result of the shift in relative growth and of the large exchange rate movements during 1978.

GROWTH AND INFLATION

In the major foreign countries there was a modest rise in the growth of gross national product (GNP) in 1978. Table 32 records the growth rates of GNP during 1977 and 1978 for each of the major foreign countries and the United States. Also included are two columns showing the average annual growth of GNP prior to 1974 as well as the average rate of growth since then.

TABLE 32.—*Annual growth in real GNP in major industrial countries, 1960–78*

[Percent change, except as noted]

Country	1977	1978 [1]	1960–73 average	1974–78 average [1]	GNP shortfall in 1978 (percent) [2]
United States	4.9	3.9	3.9	2.3	8.1
Japan	5.2	5.8	10.5	3.7	37.3
Germany	2.6	3.0	4.8	1.7	16.0
France	3.0	3.0	5.7	2.8	14.7
United Kingdom	1.6	3.0	3.2	1.0	11.5
Canada	2.7	3.5	5.4	3.4	10.2
Italy	1.7	2.0	5.2	1.9	17.1

[1] Preliminary.
[2] Difference between actual GNP and the level that would have been reached if growth since 1973 had equaled its 1960–73 trend rate, expressed as a percent of actual GNP.

Sources: Organization for Economic Cooperation and Development and Council of Economic Advisers.

The final column shows the percentage difference between the actual GNP in 1978 and the level of GNP that would have existed in 1978 if growth had proceeded after 1973 at its 1960–73 trend rate. The gap recorded in the last column is not meant to indicate the precise difference between actual and potential output. Few deny that potential output growth has slowed everywhere in recent years, and in some cases sharply, although considerable uncertainty remains about the current underlying trend for potential output. What the gap does indicate is that, for whatever reasons, the major indus-

trial countries outside the United States have witnessed a dramatic reduction in growth since the oil crisis.

Evidence that at least part of the slower growth is due to a slowdown in potential growth is shown in Table 33. Each of the large industrial countries has shown significantly lower productivity growth in the last 5 years compared to the earlier period. Clearly, part of the poor productivity performance is due to low utilization rates. Even after correcting for utilization

TABLE 33.—*Annual growth in GNP per employed worker in major industrial countries, 1964–78*

[Percent change]

Country	Average	
	1964–73	1974–78[1]
United States	1.8	0.1
Japan	8.9	3.2
Germany	4.7	3.0
France	4.5	3.0
United Kingdom	3.2	.8
Canada	2.4	.6
Italy	5.4	1.1

[1] Estimate.

Source: Organization for Economic Cooperation and Development.

and recognizing analytical shortcomings in the productivity measure, however, some slowdown is evident. The largest absolute decrease occurred in Japan, where growth in GNP per worker slowed from 8.9 to 3.4 percent annually.

Whatever the new rates of potential growth may be, the actual GNP growth outside the United States was apparently not above the underlying potential growth in 1977 and 1978. In the fifth year after the onset of recession, recovery toward a fuller utilization of potential among countries outside the United States continues to be extremely hesitant and incomplete.

To some extent the slowing of potential growth and the weakness of actual growth relative to potential since 1975 are tied together. In Japan, for instance, the sharp fall in potential growth reduced capital requirements and hence reduced required investment as a share of output. Because this fall was not matched by a decline in the personal saving rate, a problem of excess saving emerged. This imbalance was absorbed partly by the rise in the external surpluses and government budget deficits and partly by the decline in income and production relative to potential output. In Japan, as in other countries, low rates of actual investment constitute a major reason for the hesitant recovery of demand. At the same time, as mentioned earlier, sluggish investment has led to a marked aging in the capital stock and has further checked the growth of potential output by limiting productivity increases.

The principal factors constraining more expansionary policies during the current recovery have been persistently high rates of inflation in most countries and the resulting judgment that relatively cautious fiscal and monetary

policies were needed. Even in those countries making notable progress in reducing inflation by 1977—particularly Germany and Japan—fear of renewing inflation continued to dampen enthusiasm for more expansionary fiscal and monetary policies.

In 1978 constraints on policies eased somewhat outside the United States as rates of inflation declined almost everywhere (Table 34). For the United Kingdom and Italy, where the rates had been highest, the decline was impressive. As a result of relaxed constraint, fiscal policies also tended to

TABLE 34.—*Changes in consumer prices in major industrial countries, 1976–78*

[Percent [1]]

Country	1976	1977	1978 [2]
United States	5.8	6.5	7.6
Japan	9.3	8.0	3.9
Germany	4.6	3.9	2.7
France	9.6	9.5	9.2
United Kingdom	16.6	15.8	8.3
Canada	7.5	8.0	9.0
Italy	16.8	17.0	12.2

[1] Changes measured from year average to year average.
[2] Estimate.

Sources: Department of Labor, Board of Governors of the Federal Reserve System, and Council of Economic Advisers.

become significantly more expansionary in the major foreign countries: according to OECD estimates, the direct impact of fiscal policy shifts in 1978 amounted to over one-half of 1 percent of GNP for the major foreign countries, excluding Japan, and to over 2 percent for Japan.

The 1978 pattern of changes in growth and inflation rates was heavily influenced by the marked decline of the dollar and the consequent appreciation of most other major currencies. In countries where exchange rates appreciated, it is broadly true that GNP growth lagged behind the growth of domestic demand and that inflation rates declined. In this environment fiscal policy became more expansionary during the course of the year. These shifts in fiscal policy were both necessary and appropriate. They were necessary because extra stimulus was required to offset the negative effect on GNP of the adverse shift in real net exports. And they were appropriate because the reduction in inflation due to currency appreciation gave policy makers breathing room to shift toward more expansionary policies. Moreover in Germany, and even more in Japan, a reduction in the current account surplus required a shift in policy to make sure that shifts in export and import volume would eventually become large enough to offset the effects of the currency appreciation on terms of trade.

For the United States the opposite set of circumstances prevailed. A weak external sector, accelerating inflation, rapidly declining unemployment, and a depreciating currency made it necessary to shift toward a more restrictive fiscal and monetary policy. Indeed, this shift occurred during the year.

The need to realign and coordinate economic policies, both in the United States and abroad, so as to promote external adjustment and reduce diver-

278-216 O - 79 - 10

gences in economic performance across countries was increasingly recognized during 1978. In the course of meetings that culminated in the Economic Summit at Bonn in July 1978, a significant degree of coordination was realized. At the Bonn meeting the leaders of the seven largest industrial countries discussed the major goals and problems in the world economy, and a Concerted Action Program was devised in which each country made appropriate specific commitments.

The Bonn Summit marked a turning point, particularly for the United States. The United States noted that curbing inflation has become the top priority of economic policy. The President therefore pledged to take specified actions to reduce the U.S. inflation rate, obtain a more rapid reduction in our current account deficit, and adopt an energy policy which would, by 1985, cut our imports of petroleum by 2.5 million barrels per day.

In addition, Germany and Japan proposed steps to increase growth and thus reduce external surpluses: Germany to provide additional fiscal stimulus totaling 1 percent of GNP; Japan to achieve a 7 percent growth in real GNP between March 1978 and March 1979. The other participating countries (France, Italy, the United Kingdom, and Canada), whose high rates of inflation provided less scope for specific action, made broadly complementary commitments. At the same time, each country recognized the overriding importance of not allowing sluggish growth, sectoral difficulties, or trade imbalances to serve as pretexts for actions that would undermine the framework of free trade among nations. A joint commitment, covered more fully later in this chapter, was adopted to secure a rapid and successful outcome for the Multilateral Trade Negotiations.

Considerable progress has been made in meeting these commitments. As discussed earlier in this *Report,* the United States has in place a major anti-inflation program and has shifted both fiscal and monetary policies toward restraint. The 1978 National Energy Act, signed at year's end, establishes a comprehensive framework for rationalizing energy policy and reducing oil imports along the lines discussed at Bonn. Germany completed legislation in December 1978 that fully implements its own commitment. Although Japan began in September to carry out a supplementary fiscal program to stimulate growth, it now seems likely to fall well below the 7 percent growth target.

The Concerted Action Program adopted at Bonn marks an important step in international economic cooperation. On a substantive plane, the measures taken helped put the major economies onto more balanced and sustainable paths. More important is the symbolic significance: it is now clearly recognized at home and abroad that, in a world where countries are interdependent, policy choices by one nation directly affect economic performance in others. If some countries grow very slowly, their trading partners will be forced to abandon dynamic export industries; if one country attempts to protect its industries, at the border or by domestic

subsidies, others will have to retrench; if one nation pursues extremely rapid growth or inflationary policies, the resulting exchange rate depreciation may lead to uncertainties and market disorders. Increasing awareness of these linkages and acceptance of the responsibilities they imply represent the goal of policy coordination exemplified by the Summit.

PROSPECTS

Although the shift toward more rapid growth abroad is a welcome development, the world economy continues to face difficult challenges. GNP growth, while expected to maintain the 1978 rates, will remain low by the standards of the 1960s, and it will be hard to generate enough jobs to reduce unemployment. In some countries more extensive use of specific job programs and special incentives to reduce structural unemployment of young workers must effectively supplement demand management policies if further increases in unemployment are to be avoided.

Most economies also face excess capacity in basic industries such as steel, textiles, and shipbuilding. The consolidation of these sectors by reducing capacity, and the resulting loss of jobs, aggravate labor market problems. Ways must therefore be found to smooth the transfer of workers from declining to expanding sectors. Securing a more rapid rate of job creation is made harder by continued low rates of investment in plant and equipment. While some growth in investment occurred in 1978, the basic circumstances have not changed substantially. Excess capacity remains large and prospects indicate only a moderate growth in demand. In this environment a sharp acceleration of investment during 1979 is not foreseen.

While faster growth would greatly benefit most foreign economies, inflation rates in all but a few OECD countries remain too high for governments to pursue policies that are significantly more expansionary. Even relatively restrictive macroeconomic policies will bring only a gradual decline in inflation. In some countries inflation may accelerate again as the favorable effects of exchange rate appreciation and commodity price declines wear off.

Thus, despite some easing of constraints on policy in countries outside the United States, the economic environment presents difficulties. Few easy solutions are available; and according to an increasing number of observers, it will take a continued effort to bring about conditions more favorable to sustained economic growth.

CURRENT ACCOUNT DEVELOPMENTS AND PROSPECTS

In 1978 there were marked changes in global payments positions (Table 35). First, the large current account surplus of the countries making up the Organization of Petroleum Exporting Countries (OPEC) diminished sharply and unexpectedly from about $32 billion in 1977 to an estimated $11 billion in 1978.

TABLE 35.—*World current account balance,*[1] *1975–78*
[Billions of dollars]

Country	1975	1976	1977	1978 [2]
OECD countries	0.3	−19.0	−27.5	0.5
United States	18.4	4.3	−15.3	−17.0
Big Six [3] and Switzerland	−3.8	−3.7	13.5	33.5
Other OECD	−14.3	−19.4	−25.7	−16.0
OPEC countries	27.3	37.0	31.5	11.0
Non-oil developing countries	−38.5	−26.0	−24.0	−34.0
Other [4]	10.9	8.0	20.0	22.5

[1] OECD basis.
[2] Estimate.
[3] Japan, Germany, France, United Kingdom, Canada, and Italy.
[4] Reflects errors and asymmetries, as well as balances with omitted country groups.

Sources: Organization for Economic Cooperation and Development and Council of Economic Advisers.

This remarkable decline resulted from volume and price effects in about equal measure. The volume of OPEC oil exports actually fell somewhat in 1978, a consequence of the slackened pace of growth in energy demand in the industrial countries and the rapid 1978 expansion of other sources of oil. North Sea, Alaskan, and increased Mexican production, accounted together for a rise in production of 1.2 million barrels per day, or roughly 4 percent of total OPEC production.

At the same time, the volume of imports into OPEC countries continued to grow at a significant though slowing rate, a result of the momentum of ongoing development plans in a number of OPEC countries. Price movements have also been important in reducing the OPEC surplus. The dollar price of oil remained roughly constant, while import prices rose.

Second, in the so-called non-oil developing countries (that is, the poorer countries outside of OPEC and the OECD) the combined deficit expanded considerably last year. The terms of trade, which had been generally favorable in 1977, turned against such countries in late 1977 and early 1978. Late last year, however, the terms of trade again strengthened appreciably. Borrowing conditions for most of these developing countries remained favorable, and many of them borrowed substantial amounts to service outstanding debt, maintain the growth of their imports, and increase their gross reserves for the third consecutive year.

The most striking change in 1978, however, was the disappearance of the OECD deficit. The aggregate deficit of the OECD countries, $28 billion in 1977, gave way to a small surplus in 1978. This turnaround was the second largest recorded year-to-year change in the OECD external position; it was exceeded only by the large shift from surplus to deficit which followed the OPEC price rise. It was surprising that the decline passed virtually unnoticed and had little effect on developments during the year compared to those occurring in the 1974–75 period.

The OECD can be usefully divided into three groups. The first comprises countries in surplus; the second contains small countries, chiefly in deficit;

and the United States is the third. Starting with the surplus countries, one should note that the largest part of the decline in the OECD deficit is accounted for by the rise in the combined surpluses of Japan, Germany, France, Italy, and Switzerland. These countries, along with the United Kingdom, experienced strong gains in their terms of trade—that is, the prices received for exports rose more rapidly than prices paid for imports, principally because of appreciation in their exchange rates.

A gain in the terms of trade affects the favored country in two ways. First, it increases income and thus tends to have a stimulating effect on aggregate demand similar to that of a tax cut. Second, after some time, however, the higher export prices tend to depress the volume of exports, while the lower import prices tend to raise the volume of imports, thereby reducing aggregate demand. Table 36 records the movement in current account balances for each of the countries named above, except Switzerland, and shows the relative size of the two different effects in 1978: the ratio between the gain in terms of trade and domestic demand, and the ratio between the change in the volume of net exports and GNP.

TABLE 36.—*Current account balances for selected major industrial countries, 1976–78*

Country	Current account balance [1]			Gain in terms of trade as percent of domestic demand, 1978 [2 3]	Change in volume of net exports as percent of real GNP, 1978 [2]
	1976	1977	1978 [2]		
	Billions of dollars			Percent	
Japan	3.7	10.9	20.0	1.9	−0.3
Germany	3.8	3.7	6.0	.6	−.3
France	−6.1	−3.3	2.0	.8	.3
United Kingdom	−2.0	.5	−.5	1.2	−1.0
Italy	−2.8	2.3	5.5	.4	.8

[1] OECD basis.
[2] Estimate.
[3] The gain in terms of trade is the percent change in export prices times 1977 export value minus the percent change in import prices times 1977 import value.

Sources: Organization for Economic Cooperation and Development and Council of Economic Advisers.

Even though estimation of gains in terms of trade is subject to a considerable margin of error because of serious measurement difficulties, the results are striking. These five countries experienced very large gains in income from the terms of trade in 1978 and, excepting the United Kingdom, had little or no offset from the declining volume of net exports. The income gains, however, do not appear to have been matched by a corresponding rise in the growth of real output, especially when allowance is also made for the expansionary shifts in fiscal policy. A possible explanation for this relatively weak multiplier effect is that, because these income gains were perceived to be transitory, they were largely absorbed in increased household and corporate saving, rather than in increased expenditures.

The second group of OECD countries, comprising the smaller nations, in the aggregate reduced their deficits in 1978 by about $10 billion. This

reduction was especially welcome in view of the very large deficits these countries had run from 1974 to 1978, when their net indebtedness grew by close to $80 billion. Indeed, external positions had become unsustainable for a number of countries in this group and severe retrenchment was necessary. Stabilization programs were developed in connection with upper credit-tranche drawings from the International Monetary Fund for Portugal and Turkey. Governments in the Scandinavian countries acted to forestall further accumulation of debt that might well have become a source of difficulty in a few years. For still others, the extent of improvement in their current account was limited by adverse shifts in the terms of trade stemming from the fall in a number of raw materials prices. For the group as a whole, the decline in current account deficits can be explained almost entirely by the reduction in import volumes relative to export volumes.

The United States stands alone in the third category. Throughout the postwar period the growth of U.S. imports tended to be greater in relation to domestic growth than the growth of exports in relation to growth abroad. Until 1975 a rough balance between import and export growth was maintained by the fact that growth abroad tended to exceed U.S. growth. From 1975 through 1978, however, growth in the United States surpassed the average growth abroad. As a result, the current account of the United States shifted sharply. In 1977, a year in which U.S. economic growth exceeded that of its trading partners by about 1½ percentage points, the U.S. current account shifted by almost $20 billion, from a surplus of $4.3 billion to a deficit of $15.3 billion. Roughly three-fourths of this shift is accounted for by the more rapid growth of merchandise import volumes compared to export volumes. The remainder of this shift reflected changes in the terms of trade and in the composition of trade, only partly offset by gains in service transactions.

On the basis of preliminary estimates the current account shifted toward deficit in 1978 by a further $1.7 billion. There was, however, substantial improvement from the first half of the year to the second, when growth in export volume picked up and import growth began to moderate. Despite the depreciation of the dollar during this period, the expected adverse shift in the terms of trade was restrained to a significant degree by the constancy of the price of oil imports and by the general increase in the prices of manufactured goods relative to the prices of primary commodities.

The shifts that occurred in 1978 in current account positions among the countries of OPEC, the non-oil developing countries, and the OECD countries are not likely to be reversed in 1979. The large oil price increase announced by OPEC last December will seriously complicate the task of economic management in the industrial and non-oil developing countries. This price increase is not expected to result in a substantial widening of the OPEC surplus from 1978 levels, however, since imports by OPEC will also continue to rise. It can be said that the industrial countries are now paying the "OPEC oil tax" largely in current goods and services rather than

I O Us. As a result, the so-called recycling problem has become much less troublesome—though the surpluses of a few individual OPEC countries will continue for years to come. More generally, the traditional pattern of resource flows between countries, in which the major industrial countries are net capital exporters to the developing countries and to other poorer countries within the OECD, appears to have been firmly reestablished.

Barring a substantial run-up in commodity prices, the deficits of the non-oil developing countries are likely to rise somewhat in 1979. Such a rise in deficits would appear to be consistent with the strong liquidity positions of many countries in this group, the ability of a growing number of countries to borrow successfully on international financial markets at lower interest spreads and longer maturities, and the apparent willingness of banks to increase their lending to developing countries despite a few isolated debt rescheduling problems during 1978.

Among industrial countries of the OECD, a more balanced distribution of surpluses and deficits is likely to emerge in 1979. The U.S. current account deficit is expected to decline considerably from the levels at the end of 1978, dropping to about an annual rate of $2–$8 billion by the end of 1979. This reduction will result from two conditions: first, the effects of slower U.S. economic growth on imports; and second, a steady and vigorous growth in exports as markets continue to adjust to the improved price competitiveness of American goods and services that resulted from last year's depreciation of the dollar.

Some decline, too, is anticipated in the surpluses of Japan and Germany. Expectations for the decline of the Japanese surplus are grounded primarily in the anticipation of a further fall in the volume of Japanese exports. Import volumes rose only moderately in 1978 after allowance for large accounting transactions made under the emergency import program. They are unlikely to accelerate strongly this year, despite the appreciation of the yen, because of the relatively closed structure of many Japanese import markets. This one-sidedness in adjustment by Japan is likely to intensify the difficulty of reducing the Japanese surplus to a sustainable level over a longer period. The need for a sustained reduction of barriers in Japanese import markets is well recognized by Japanese officials, and extensive discussion between Japan and the United States during 1978 has laid the groundwork for progress toward this end.

INTERNATIONAL FINANCIAL DEVELOPMENTS

For the international financial markets 1978 was a year of unusual instability. Serious questions were raised at home and abroad about the functioning of foreign exchange markets, culminating at year-end with the charter of the new European Monetary System and with the dollar support measures of the United States. These developments were responses to increased volatility and to disorderly conditions in the foreign exchange mar-

kets. In the case of the European Monetary System they arose also from concern about the undesirable side effects of a system of floating exchange rates for closely integrated economies and from the need to foster closer economic integration in Europe.

THE OPERATION OF FLEXIBLE EXCHANGE RATES

The developments of 1978 must be seen as a part of the continued evolution of international financial arrangements. It is therefore appropriate to begin this discussion by reviewing the role of floating exchange rates in macroeconomic adjustment over the 1973–78 period.

Floating Rates in Principle

The role of floating exchange rates can best be seen in the need for adjustment among national economies. All countries are continually subjected to shocks that lead both to internal imbalances (excessive or deficient utilization of domestic resources) and to external imbalances (foreign trade or capital flows at unsustainable levels). A system of flexible, market-determined exchange rates (or, in short, "floating" rates) allows more automatic external adjustment than a system of fixed parities, and thus leaves more scope for domestic macroeconomic policies to adapt to the changing requirements for internal balance.

External adjustment occurs as exchange rates move to equilibrate trade and net capital flows. More precisely, for a given change in official holdings, the rate will move to a level that either brings the value of goods and services exported and imported into balance or induces changes in private asset holdings to finance the discrepancy.

The equilibrating mechanism works on both the capital and current accounts. For a country incurring a large current account deficit, the currency depreciates to reduce the current account deficit by increasing the country's price competitiveness. That process, however, takes time. In the interim, currency movements will induce private holders of wealth to accumulate the country's assets to the extent necessary to finance the deficit.

The second feature of an idealized system of floating exchange rates can be seen as a consequence of the first. Because floating rates tend to assure external equilibrium, countries can enjoy greater independence of macroeconomic policies and performance. Under a regime of fixed exchange rates, the extent to which a country's macroeconomic policies could diverge from those of its trading partners was limited in important ways. Divergent policies would lead to trade imbalances, with expansionary countries moving toward deficit and restrictive countries toward surplus. There was no automatic mechanism to generate the needed capital movements to support the imbalances. Indeed, outflows of capital from countries pursuing relatively expansionary policies to countries pursuing restrictive policies sometimes exacerbated disequilibria in overall balance of payments positions. A coun-

try's freedom to engage in independent macroeconomic policies was thus constrained by its capacity to absorb or lose reserves.

Under a floating rate regime, however, wide divergences of macroeconomic policies would, in principle, be possible. For those countries pursuing rapid growth through expansionary macroeconomic policies or those accepting high inflation, the presence of a depreciating currency would allow the balance of payments to remain close to equilibrium.

Critiques of Floating Rates

For more than 5 years the major economies have functioned under a floating rate regime. The new regime has been successful in permitting the industrial economies to absorb shocks that were unprecedented in the postwar period. At the same time, overall economic performance and exchange market behavior have been much less satisfactory than was expected, leading many to wonder whether the exchange rate regime was at least partly responsible for the poor performance.

Critics have argued that floating rates have had four failings: they have not eliminated balance of payments disequilibria; they have not allowed the degree of policy independence that had been anticipated; they have proved inflationary; and they have introduced major new elements of instability and uncertainty to financial markets.

First, floating rates clearly have not eliminated current account surpluses and deficits. These deficits and surpluses have not, in general, fallen from the levels of the late 1960s and early 1970s and, on many occasions, some have been even higher.

Such an observation, however, does not imply a failure of floating rates to perform their adjustment function. The imbalances that have occurred have not usually resulted from floating per se, but from the greater divergence of macroeconomic performances and from the exceptionally large shocks to the international system, such as OPEC price rises and large increases in agricultural and commodity prices. Exchange rate changes have generally responded well to these deficits and surpluses and have helped to move economies back toward external equilibrium, even if not as quickly or as smoothly as originally hoped. A balance of payments equilibrium, moreover, does not necessarily require that the current (or trade) account should be balanced, only that the current or trade account deficit or surplus be willingly financed. In fact, deficits or surpluses on current account may well represent the equilibrating counterpart to structural or "autonomous" capital inflows or outflows.

In contrast, during the final years of the Bretton Woods system, balance of payments disequilibria that resulted at least partly from divergent macroeconomic performances led to several serious and protracted balance of payments crises. Normal trade and investment patterns were disrupted as governments responded to these disequilibrium situations by imposing trade

and capital controls and other emergency measures before they were finally forced to change their exchange rate parities.

A second cause of concern exists because floating has led to less policy independence than had been anticipated. To be sure, countries have been significantly more independent than in prior years, especially in the realm of monetary policies. A good example lies in the ability of Germany, during the early phase of the current expansion, to pursue a relatively restrictive monetary policy, while that of the United States was relatively expansionary.

Although independence has been greater than with fixed rates, it has by no means been complete under floating. There have been obvious limitations to policy flexibility, partly because exchange rate changes cannot insulate national economies from their partners' performance or from international economic shocks. We have learned that in an increasingly interdependent international economic system floating exchange rates do not free countries from the effects of their neighbors' economic policies and performances. Similarly, countries must recognize their responsibility to act in ways that do not inflict excessive adjustment costs on others.

The third major criticism of the floating rate system has been that it contains an inflationary bias. Two lines of argument have been presented to support this view: first, that floating generates inflation because it fails to impose needed discipline on the conduct of fiscal and monetary policies; second, that because of asymmetries and ratchets the increased inflationary pressures associated with depreciation are not matched by commensurate downward price pressures in countries whose exchange rates are appreciating. Thus, it is argued, the net effect of exchange rate changes is inflationary for the world as a whole.

Neither of these arguments is entirely convincing. Regarding the first argument—presumed lack of discipline—it is important to note that even without external pressures there are clearly powerful internal forces which oppose inflation. Recent experience in the United States and some countries of Europe, where large current account deficits and currency depreciations have led to quite restrictive economic policies, indicates the extent to which difficult stabilization policies will be undertaken even in a flexible exchange rate system.

Moreover, a regime of fixed rates allows inflation to spill over the borders. Price rises originating in one country spill over into other countries directly if exchange rates cannot shift. Indeed, to the extent that inflation originating in one country is shared by others when exchange rates are fixed, discipline in the conduct of fiscal and monetary policies may be weaker than under floating rates, where the full inflationary impact of inappropriate policies is felt domestically.

The evidence to support the second argument—that there are asymmetries in the effects of exchange rate changes on inflation—is mixed. While it is true that there exists considerable evidence of increasing downward rigidity in the levels of prices and wages in a number of countries, there is

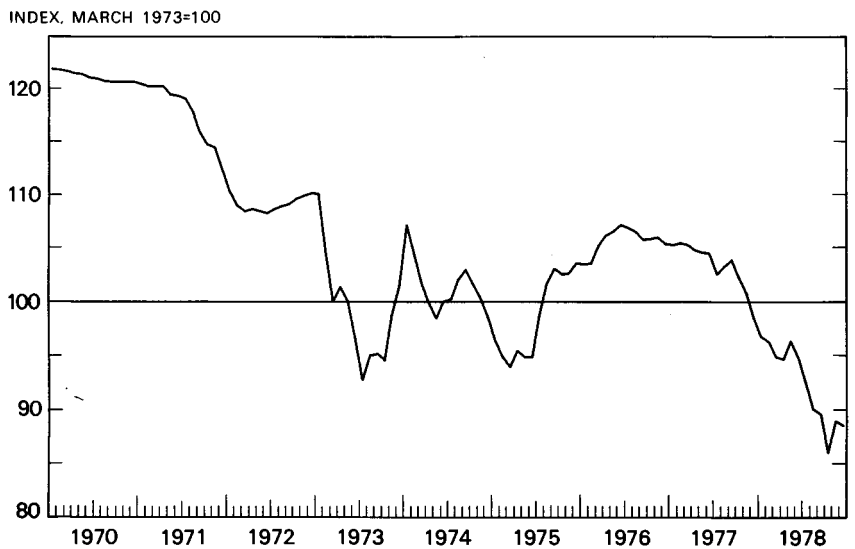
no comparable evidence that rates of inflation are less responsive to currency appreciation than to depreciation.

Finally, factors other than floating exchange rates provide a more compelling explanation for the high and persistent inflation in the industrial countries: slower productivity growth, excessive demand pressures, external shocks such as those created by OPEC, and structural changes and rigidities in domestic labor and product markets.

A final criticism of floating has been that it induces excessive volatility in exchange rate movements. Chart 11 presents the path of the trade-weighted dollar since 1970, using an index of dollar movements against the 10 major currencies, and 1972–76 total multilateral trade shares as weights. In addition to these longer-run swings in rates, it is certainly true that day-to-day movements in exchange rates have been larger in the float than in the preceding Bretton Woods era. It is difficult to determine whether these movements have been excessive. In a fixed rate system such as Bretton Woods, day-to-day variability is sharply reduced by the active intervention of central banks to keep the rate within a narrow range. Furthermore, for as long as the range remains credible, private actions tend to keep the rate within the range whenever transient factors lead to a rate movement to the upper or lower limit. Day-to-day variability is thus largely eliminated. On the other hand, the fixing of exchange rates while economic conditions are changing makes it likely that exchange rates will increasingly

Chart 11

Weighted-Average Exchange Value of the U.S. Dollar



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

diverge from levels that would be consistent with underlying economic factors. Eventually the credibility of the range is challenged by market participants, and potentially disruptive speculative attacks can then occur until rates are forced to new, more appropriate levels.

In a floating rate system, day-to-day variability of exchange rates is inevitable as market participants respond to new information about economic developments that alters their perceptions about appropriate exchange rate patterns. Indeed, these day-to-day movements in principle constitute the means of accomplishing longer-run adjustment of exchange rates to changing economic circumstances. This fundamental role of exchange rate movements raises the question whether the observed short-run variability of exchange rates has been larger than was required to allow the necessary medium-term flexibility. This question is complex and has not been thoroughly addressed. A preliminary examination of recent experience and related studies by the Council of Economic Advisers has uncovered mixed evidence. In some cases, short-run variability over the last 5 years has been broadly commensurate with longer-run changes, while in other cases short-run changes have been less than might be consistent with the longer run. No cases of persistent, excessive volatility were found.

There is a sense in which the floating rate system itself may have led to excessive volatility—through the relaxed constraints on macroeconomic behavior. As noted above, a floating rate system allows greater divergence in macroeconomic experience. Unfortunately, when greater scope for divergent policies and performance is allowed, market uncertainty about appropriate exchange rates is also increased. The uncertainty, in turn, can cause market exchange rates to move in an erratic and disorderly fashion as market participants react, and overreact, to transitory bits of information and rumors.

Greater exchange rate noise and uncertainty are among the costs of a floating rate system. Achievement of greater stability in exchange rate markets is dependent on the closer and more effective coordination of macroeconomic policies among countries and on the continuing efforts of each country to sustain macroeconomic policies that are consistent with internal and external adjustment.

In general, however, the evidence, although not conclusive, does indicate that floating has worked well over the long run, especially considering the magnitude of the shocks to the international financial system. In fact, given these shocks, it is not clear that any system other than generalized floating would have been viable during the period. Exchange rate movements, while large, have broadly responded to economic fundamentals, have facilitated adjustment, and have tended to move the system toward rather than away from greater stability. If exchange rates are at present too volatile for some countries, steps to increase the coordination of macro-

economic policies could be helpful. Recognition of the current level of interdependence through improved coordination across countries may help to bring greater stability to the foreign exchange markets as well as to provide an international environment that is favorable to domestic policy goals.

IMPORTANT 1978 DEVELOPMENTS

The summer and fall of 1977 marked the beginning of a protracted fall in the value of the dollar and an increase in the day-to-day volatility of exchange rates in general. Both of these trends continued through the first 3 quarters of 1978.

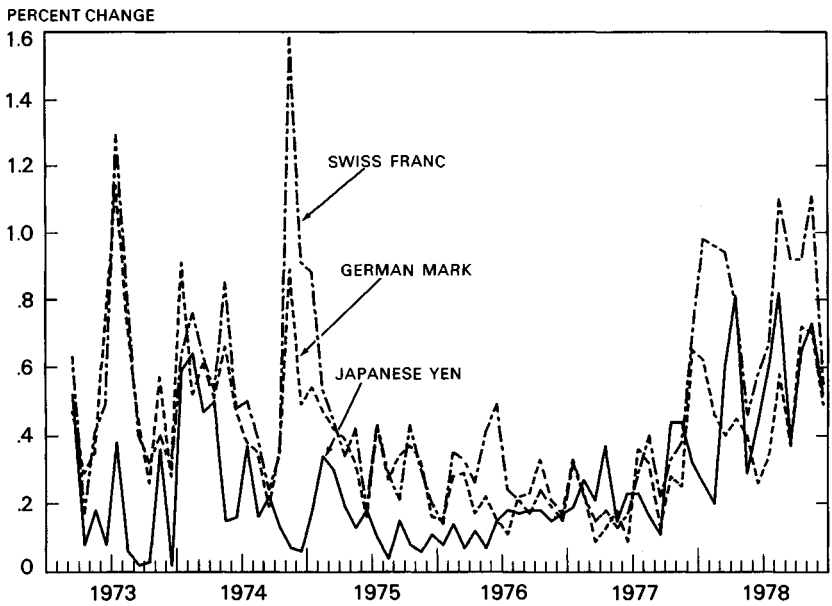
The Variability of Exchange Rates and Depreciation of the Dollar

The extent of exchange rate variability can be seen in the average day-to-day change of major currencies. In general the daily variation in exchange rates decreased between 1973 and 1975, remained comparatively small from 1975 to about the middle of 1977, and then increased markedly in the second half of 1977 and in 1978 (Chart 12).

The decline in variability from 1974 to the 1975–77 period is probably due to a lessening of shocks to the world economy and the gradually growing ability of market participants to work with a regime of floating rates. The

Chart 12

Monthly Average of Daily Exchange Rate Changes



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

source of the sudden increase since late 1977 is less clear. Only to a small extent can it be explained by the fact that the computed variability is somewhat amplified when the level of the exchange rate is moving sharply in one direction rather than fluctuating around a steady trend. A more plausible explanation was the heightened uncertainty about the dollar's future equilibrium level in view of the growing current account deficit, a subsequent acceleration in inflation in the United States, and, for a time, uncertainty about the response of U.S. economic policies to these developments.

The value of the dollar also began to change dramatically in late 1977. Chart 11 shows the trade-weighted value of the dollar against the major currencies for 1970–78. Two distinct periods can be identified during the recent experience. From September 1977 through March 1978 the dollar fell by 8.7 percent on a weighted average basis against other currencies. During this period the markets tended to focus on the rapid widening of the U.S. trade and current account deficits and their expected persistence. Even though a substantial portion of the deficits could be accounted for by the cyclical position of the United States relative to its major trading partners, growth forecasts suggested that this cyclical divergence would not soon be eliminated.

After a brief period of leveling off in April and May 1978, a second dollar decline began in early June and carried through until the end of October. Some part of this renewed decline can be accounted for by the acceleration and persistence of inflation in the United States, which aroused much concern in international financial circles. From a purely technical point of view, this is not a sufficient explanation, however, since the inflation rate in the United States, while substantially higher than that in Germany, Switzerland, and Japan, was not much higher than the average level among all our major trading partners. And the parallel shift in interest rate differentials in favor of the dollar was more than sufficient to offset the change in underlying inflation in the United States. Finally, the dollar's fall came in the face of increasing evidence that the U.S. current account position was improving markedly.

By the end of October, then, there was considerable evidence that the primary reason for the dollar's fall was the uncertainty in foreign exchange markets. Little attention was paid to the anti-inflation message on October 24. Market participants continued to shift out of dollars despite an apparent consensus of market expectations that the dollar was undervalued from a long-run point of view. Almost all market participants commenting in the press or in discussions during the fall of 1978 expected an eventual turnaround of the dollar. Only the timing and the duration of the expected recovery were uncertain. Market participants, however, were highly uncertain about the future course of U.S. macroeconomic policy, and this uncertainty encouraged shifts out of dollars because it made the dollar a riskier, and hence less attractive, asset.

THE NOVEMBER 1 INITIATIVE

On November 1 the Administration and the Federal Reserve implemented a strong dollar support program. Its basis was the judgment that, whereas some of the earlier 1977–78 dollar decline had been necessary to correct the external disequilibrium, the continued decline of the dollar had become disorderly and was not justified by fundamental economic conditions. On the contrary, all the econometric evidence, the government forecasts, and the private forecasts indicated that the U.S. current account deficit was likely to narrow sharply in 1979. Indeed, it had already fallen from the levels reached in the first half of 1978.

The dollar depreciation from September 1977 through the summer of 1978, combined with U.S. economic policies recently put in place—the National Energy Act, a new national export policy, the shift toward more restrictive monetary and fiscal policies, and the other elements of the anti-inflation program—was thought likely to be effective in slowing inflation at home and bringing about a more appropriate external balance. Further dollar depreciation, especially that induced not by fundamental economic factors but by uncertainty about future exchange rates or policies, was therefore unnecessary for adjustment and would have led to a misallocation of resources at home and abroad, possibly even to serious instability in the financial system. Such movements would have added further to U.S. inflationary pressures and thus harmed the prospects for the anti-inflation program. They could also create the kind of instabilities in exchange markets that could threaten economic prospects in other countries.

In the light of these considerations, the United States announced a dollar support package that contained two parts. First, the United States mobilized $30 billion in resources as its share of a joint intervention program with Germany, Japan, and Switzerland. Second, the Federal Reserve tightened domestic monetary policy by raising the discount rate from 8½ to 9½ percent and by imposing a 2 percent supplementary reserve requirement on large time deposits. The Federal funds rate also rose from 9⅜ to 9⅞ percent on November 1.

The $30-billion intervention package comprised several different items: (1) the Treasury's drawings on our International Monetary Fund reserve position of $2 billion and $1 billion in Deutschemarks and yen respectively; (2) the Treasury's sales of a total of $2 billion of special drawing rights to Germany, Japan, and Switzerland; (3) a doubling of the Federal Reserve swap lines with Germany, Japan, and Switzerland—to $6 billion, $5 billion, and $4 billion respectively; and (4) the Treasury's commitment to issue up to $10 billion in foreign currency denominated securities in foreign private markets.

The markets responded favorably to the dollar support policy. By the end of the first week of the program, the trade-weighted dollar was 7.7 percent higher than it had been at its low point at the close of business on October 30. By November 30 it had risen an additional 2.4 percent; and, while some

declines occurred in December and early January—principally with the news of the OPEC price increases and the instabilities in Iran—by the middle of January it was again roughly 7.7 percent above its October low. Thus the foreign exchange markets at the beginning of 1979 were clearly in a different condition from what they were in the summer and fall of 1978. The one-way speculation had largely ended, and economic fundamentals appeared to be much more important market factors than they had been 2 or 3 months before. Market participants, who had been primarily concerned about preventing further foreign exchange losses and uncertain about the specific timing of an expected dollar upturn, were now taking a more healthy wait-and-see attitude about the future course of market fundamentals. The November 1 action, bolstered by the greater certainty that it generated, appears to have achieved its basic purpose. In the period ahead the value of the dollar should depend on sustained progress in the U.S. trade and current accounts and on the success of the new anti-inflation program, rather than on the level of market uncertainty.

While the dollar's decline in the fall of 1978 was an instance of a malfunctioning of exchange markets, the overall history of exchange rates in recent years does not suggest that such malfunctions are chronic. Rather, they are temporary but acute symptoms that are most likely to develop when general macroeconomic conditions are diverging, or in transition, thereby generating greater uncertainty about future economic conditions and policies and an increased dispersion in expectations about future exchange rates. Conversely, as general macroeconomic conditions and policy directions become better established, exchange markets can be expected to perform more smoothly their function of adjusting rate levels to such economic divergences as remain between countries. Such a calming of exchange markets may take time and may require considerable further efforts toward coordinating macroeconomic policies across countries. Excessive market sensitivity, built up during periods of disorderly movement, is likely to induce continued higher than normal variability in rate movements until accumulated evidence of greater underlying stability becomes firmly established.

THE EUROPEAN MONETARY SYSTEM

The members of the European Economic Community reached agreement on a new European Monetary System expected to be implemented in 1979. The development of this system is consistent with the Community's continued efforts to work toward economic and political unification and with its members' concern about the negative effects on economic activity and investment of what they consider increasingly excessive and unnecessary volatility in exchange rates.

In the short run this new agreement amounts to adding France, Ireland, and Italy to the Snake arrangement of the Benelux nations, Denmark, and West Germany, with Norway dropping out. There will be expanded credit arrangements and increased margins around parity changes (up to 6 percent

for new members) as well as greater flexibility for parity changes. The United Kingdom, which initially will participate in only part of the system, may become a full member later in 1979. The European Monetary System is considered by many participants to be an important step toward a full-fledged monetary union of the European Community countries, with fixed exchange rates, a European Currency Unit for use as a numeraire as well as for intra-Community central bank settlements, and a European Monetary Fund with comprehensive credit facilities.

In the early part of its existence, any system of fixed exchange rates must concern itself with the establishment of consistent rate patterns and adjustment mechanisms. Otherwise, whenever rate patterns or fundamental economic conditions appear unsustainable, market participants are likely to test the weakest and strongest currencies. Judging from past efforts, governments can sometimes forestall such attacks by judiciously adjusting central rates when economic conditions warrant such action. The adjustment of central rates, however, cannot be too frequent, for then future changes would tend to become anticipated by the market, and the self-stabilizing property of the system—which is its major benefit—would be dissipated. On the other hand, if rate adjustments become too infrequent, fundamental disequilibria will become so large as to attract massive, and successful, speculative attacks.

To maintain a fixed-margin arrangement, therefore, it is necessary to forestall situations in which central rates cease to be credible and to do this by working actively toward convergence of macroeconomic conditions and policies. For the countries of the European Monetary System, this necessity is clearly recognized. Indeed, to some extent the European Monetary System was regarded as an instrument for achieving precisely this sort of convergence. Its success will depend in the shorter run on its flexibility, the viability of its credit arrangements, and the eventual full-time membership of all Community members, and in the longer run on the convergence of member countries' macroeconomic policies and economic conditions.

THE CHANGING ENVIRONMENT OF WORLD TRADE

Until recently, the postwar period has been one of very high growth of national economies and improved living standards. One of the major sources of this vitality has been the progressive dismantling of trade barriers. Each of the three major industrial regions (North America, Europe, and Japan) has experienced increased trade flows. This increase is due in large part to the vision of those who built the Common Market, progressively opened up the Japanese economy, and sustained the Kennedy Round of multilateral tariff reductions.

During the last decade, however, movement toward increased competition in international markets has flagged. Indeed since 1974 there has been some regression in trade policies. In response, the United States, along with governments of other major industrial countries, has committed itself to pro-

278-216 O - 79 - 11

moting free trade and reducing protectionist pressures around the world. The aims of U.S. trade policy are to enable the United States and other economies to benefit from the most efficient allocation of worldwide resources and to channel U.S. resources into sectors of comparative advantage. In 1978 the major activities of U.S. policy makers in this area involved the Multilateral Trade Negotiations in Geneva, the determination of domestic trade policy, and the development of the President's National Export Policy.

In recent years the growing economic interdependence in the international community, along with an increasing incidence of shocks and resulting adjustment policies, has led to an increasing number of trade problems around the world and consequently to more cases of overt or indirect protection and reaction. These trade problems and increasing protectionist pressures have several causes: the emergence of newly industrialized nations who are competing to gain an increasing proportion of the export market for industrial goods; the development of long-term structural problems in several sectors, resulting from shifts in the pattern of world consumption and production; the appearance of significant current account deficits after the oil price increase in 1973; greater skepticism about the functioning of the international trading system; and, above all, the recession, stagnant domestic markets, and associated high levels of unemployment since 1974. Accordingly, individual nations have taken several measures—including safeguard actions (protecting domestic industry against injury from imports), antidumping proceedings, and actions to offset export subsidies. These policies have been concentrated in certain industrial sectors, particularly textiles, automobiles, steel, and shipbuilding.

THE MULTILATERAL TRADE NEGOTIATIONS

The Administration, in conjunction with its major trading partners and numerous developing nations, is committed to resolving these trade problems through the Tokyo Round of the Multilateral Trade Negotiations. The goals of these multilateral negotiations have been to relax tariff and nontariff barriers to trade, to formulate rules for trade and codes of fair conduct, to develop effective mechanisms for settling disputes, and to allow nations to benefit from specialization without unduly losing control over the growth patterns of their own economies.

By the end of 1978 these goals seemed close to achievement when significant agreement was reached on the reduction of most of the tariff and nontariff barriers to trade. The trade package (still subject to final agreement in early 1979 and to legislative approval later in the year) includes codes on subsidies, government procurement, standards, customs valuation, and licensing. It also includes a package of tariff cuts by the United States, with reciprocal cuts from our trading partners. The U.S. cuts are projected to average about 30 percent. In addition, negotiators agreed to remove several particularly burdensome industrial and agricultural nontariff barriers. And finally, the trade package provides measures to improve the General

Agreement on Tariffs and Trade (GATT) framework for dealing with agricultural trade issues, trade with developing countries, balance of payments measures, export restrictions, and the general management of trade disputes.

Among the most significant areas of agreement for U.S. trade interests are the codes on safeguards, on subsidies and countervailing duties, and on government procurement. The safeguards code ensures that countries will observe international trading rules as set forth in the revised GATT Article XIX when they restrict imports of particular products in order to afford temporary relief to domestic producers from injurious foreign competition. This revised article provides for a broad coverage of trade policies, improved criteria and conditions for taking safeguard action, more openness and due process in domestic safeguard procedures, and better international surveillance. There is also likely to be some scope for selective action when an injury can be ascribed to imports from particular countries. Such selectivity would be subject to consultation and negotiation with the affected countries and to surveillance by a GATT committee of representatives from each of the signatories.

The agreement on subsidies and countervailing duties will limit trade-distorting subsidies, and will enunciate more clearly a country's right to take counteractions against such practices. Export subsidies will be defined more broadly than they have been in the past (for example, they can exist even if the domestic price and export price are the same); they must be imposed and regulated with greater "transparency" (that is, so that they are more visible to the domestic and foreign public); they will be prohibited on primary mineral products and nonprimary products; and their use for agricultural products will require greater discipline. In addition, signatories will agree to consider the impact on their trading partners when using economic subsidies in general. Countermeasures can be imposed if a subsidy causes injury to domestic producers, the impairment of benefits from GATT concessions, or serious prejudice to other signatories (if, for example, it reduces a nation's expected benefits from international agreements). This particular code will be enforced through a tightly controlled process for settling disputes (the recommendations of the international committee must be reported within 120 days of a complaint).

The government procurement code is intended to reduce the scope for discrimination against foreign suppliers when governments purchase articles for their own use. It entails agreement on greater transparency in the bidding and awarding of government contracts for purchases of goods; and, since the elimination of all discrimination is unlikely, it also requires agreement about the official entities that would be covered by the code. The latter problem is particularly difficult since many of the entities which are private in the United States are governmental in many foreign countries. Nevertheless significant reduction of discrimination in government procurement, subject to settlement of disputes by an international panel, should be achieved.

Taken together, the tentative agreements reached in the Tokyo Round of the Multilateral Trade Negotiations represent significant progress in our continuing efforts to reduce barriers to international commerce and to strengthen and expand international trading rules, and they should contribute to an increase in trade and investment around the world. This agreement represents the first time since the 1960s that the international community has reduced the barriers to trade across such a broad spectrum of tariff and nontariff measures. For the United States in particular, the lowering of our own import barriers should help reduce inflationary pressures by increasing the competitiveness of imports and of import-competing products. At the same time, our export capabilities will receive a boost through the lowering of both tariff and nontariff barriers in our major export markets.

U.S. DOMESTIC TRADE POLICY

Despite increasing trade problems and pressures for protectionist trade policies around the world, the Administration remains committed to a free and open trading system. In many highly concentrated domestic industries, foreign competition helps prevent market power from becoming excessive. Nevertheless cases occur from time to time where, under U.S. law, import relief is necessary: where injury exists, where imports are the major cause of injury, and where such temporary actions can contribute to adjustment.

In 1978 the International Trade Commission investigated petitions for import relief by over 30 industries, covering imports valued at over $2 billion. The International Trade Commission recommended increased protection in the form of tariffs or quantitative restrictions on more than $1.3 billion of trade in such goods as stainless steel flatware, high-carbon ferrochrome, CB radios, refined copper, industrial fasteners, and bicycle tires and tubes. Relief was granted in escape clause cases involving approximately $750 million in imports (for example, CB radios, high-carbon ferrochrome, and industrial fasteners). In these cases the Administration decided in favor of import relief because it would aid substantially in the development of more efficient industries, and because the direct benefits of relief were sufficiently high to outweigh the costs to consumers and other sectors of the economy.

THE NATIONAL EXPORT POLICY

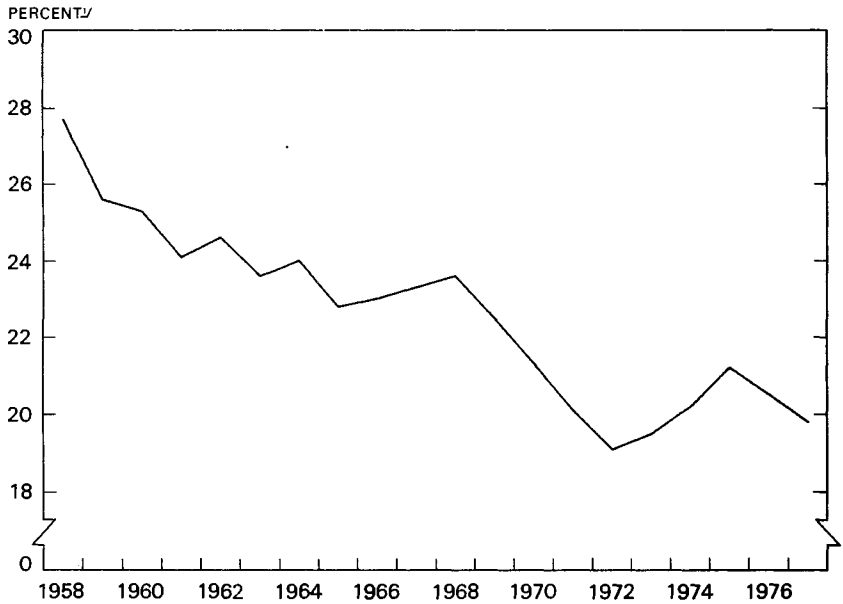
Faced with the large external deficit and the need for action, the Administration felt that increasing U.S. exports could be a valuable way to move toward adjustment. In the light of the weak dollar, the deteriorating position of U.S. manufactured exports, and the low profile accorded export efforts in the United States, the Administration announced the National Export Policy on September 26, 1978. This National Export Policy, in conjunction with the successful conclusion of the Multilateral Trade Negotiations, will ensure a strong export industry and an environment for fair competition from imports for the period ahead.

Before 1976 the largest U.S. trade deficits for a full year were the $5.3-billion deficit in 1974 and the $6.4-billion deficit in 1972. In comparison, the trade deficits in 1976, 1977, and 1978 were $9 billion, $31 billion, and an estimated $35 billion respectively. The U.S. share of total manufactured exports of 15 industrial countries fell from almost 30 percent in the late 1950s to 19.2 percent in 1972. It rose to 21.1 percent in 1975 but has declined steadily since then, falling to 18.9 percent by the first quarter of 1978, the lowest since mid-1972 (Chart 13).

The outlook for 1979 and the early 1980s is much brighter. U.S. exports of manufactured goods have already shown a strong turnaround in 1978. This improvement, and the favorable outlook, derive from several factors. First, some of the trade deficit can be explained by our faster growth compared to that of our major trading partners. As their growth rates abroad increase in relation to ours, in accord with recent trends and commitments made at the Bonn Summit, our exports should increase relative to our imports. Second, the depreciation of the dollar over the last 18 months will provide a continuing spur to exports in the coming years. Third, by reducing inflationary pressures, the Administration's anti-inflation program will improve our international competitiveness, increasing our exports and reducing our imports. Fourth, the successful conclusion of the Multilateral

Chart 13

U.S. Share of Fifteen Industrial Countries' Exports of Manufactured Goods



1/U.S. EXPORTS OF MANUFACTURES AS PERCENT OF TOTAL INDUSTRIAL COUNTRIES' EXPORTS OF MANUFACTURED GOODS.
SOURCE: DEPARTMENT OF COMMERCE.

Trade Negotiations in Geneva will reduce tariff and nontariff barriers in our export markets and should improve our export capabilities.

Finally, the Administration has committed itself to a stronger emphasis on foreign markets for U.S. goods by developing the National Export Policy. This policy includes the following major provisions: an increase in the size and the flexibility of the Eximbank's activities; a commitment from the Small Business Administration to channel up to $100 million of its loan guarantees to small export businesses; an earmarking of $20 million of the Commerce and State Departments' budgets to assist small- and medium-sized businesses in their marketing efforts abroad; an increase in the level of short-term agricultural export credits by almost $1 billion; and a decision to ask the Justice Department to clarify ambiguities about the enforcement of the Foreign Corrupt Practices Act and the international application of our antitrust laws.

Perhaps the most important contribution the Federal Government can make to improving our trade position is to assure a more sensible regulatory environment. Too frequently, obstacles to production or investment have raised domestic costs or encouraged imports. If agencies are required to take into account the effects on trade and other costs of regulations, greater scope can exist for competitive forces, thereby allowing domestic producers to gain a greater share of domestic and foreign markets.