CHAPTER 1

Foundations for Economic Growth

THE LONGEST PEACETIME EXPANSION in the Nation's history began in 1982. Throughout the expansion, inflation remained relatively low and stable compared with the 1970s. By the end of the 1980s, the unemployment rate had fallen to levels not experienced since the early 1970s. As is normal in times of robust economic progress, growth varied from year to year during the expansion. After a rapid recovery from late 1982 through 1985, growth slowed temporarily in 1986, gained considerable strength in 1987 and 1988, and turned sluggish in 1989 and 1990.

The first year of the 1990s served as a reminder that even a healthy economy faces the risk of short-term setbacks from external shocks and other disturbances. In August Iraq outraged the world by invading and occupying Kuwait. In the weeks that followed, oil prices rose sharply on the world market, and uncertainty about the timing of the resolution of the Persian Gulf crisis caused business and consumer confidence to plummet. These developments were a substantial shock to an economy that had already slowed for several reasons, including worldwide increases in interest rates, tightened credit conditions, and the lingering effects of a monetary policy that had begun to tighten in 1988 in a successful attempt to prevent an increase in inflation. In the fourth quarter of 1990 U.S. output, as measured by real (inflation-adjusted) gross national product (GNP), turned down, and it became clear that the economy had entered a recession.

The Administration's economic policies are designed both to mitigate the current downturn and to strengthen the foundations for a solid recovery and a return to sustained economic growth. The dominant factor in the success and failure of nations, long-term growth is the fundamental source of improvements in living standards. By responding systematically and prudently to ongoing developments, the Administration's economic policies reduce uncertainty and maintain the credibility so important to long-run growth and to the ability to respond to shocks that may occur in the future.

The global wave of market-oriented reform—most visible in Eastern Europe—shows that the world has learned from America that reliance on free markets is the key to sustainable long-term growth

and prosperity. In the U.S. economy, free markets fuel and direct the process of economic growth. Market forces in the financial sector channel savings into growth-enhancing investment opportunities; these forces both reward and encourage entrepreneurship—the economy's sparkplug.

The flexibility of the market-based U.S. economy both increases its resilience in the face of disturbances and enhances its ability to make the most of new opportunities. That, in turn increases the incentives for productive innovation. As the global economy becomes more integrated and the pace of technological and economic change quickens, flexibility grows ever more important.

The proper role of government is not to supplant or suppress the private market forces that drive the process of economic growth, but to create an environment within which rapid growth can occur. Because regulation inevitably reduces flexibility, its role in the economy must be limited. Barriers to saving, investing, working, and innovating must be reduced.

RECENT DEVELOPMENTS AND PROSPECTS

The downturn in the U.S. economy in the latter part of 1990 does not signal any decline in its long-run underlying health or basic vitality. As stated in last year's *Report*, economic expansions end because of external shocks, imbalances in demand, or policy mistakes. The oil price shock of 1990 makes clear that the economy is episodically buffeted by external shocks. If sound fiscal, monetary, regulatory, and trade policies are maintained, however, such shocks will have smaller effects on the economy, downturns will be shallower and shorter, and expansions will be longer. In fact, with such policies now in place, the current downturn is expected to be shorter and milder than the average post-World War II recession.

DEVELOPMENTS IN 1990

The oil price shock, the sudden drop in consumer and business confidence, and the uncertainty about when the Persian Gulf crisis would end were undoubtedly the key factors in the downturn in late 1990. Oil prices more than doubled between July and October, before declining toward the end of the year and again in early 1991 after the outbreak of hostilities in the Gulf. Consumer and business confidence may have been reduced by the superficial similarity of this oil price shock to those of the 1970s, when unemployment and inflation soared.

The oil price shock hit an economy that was already growing slowly. A worldwide rise in long-term interest rates early in the year—partly due to anticipated increases in the demand for capital in Eastern Europe and to concerns about accelerating inflation—

put upward pressure on borrowing rates in the United States and slowed the growth of consumer and business spending. This rise occurred when long-term interest rates were already high, in part because of large Federal budget deficits and the prospect that they might continue indefinitely.

The Federal Reserve had initiated a more restrictive monetary policy in the spring of 1988 to ward off an increase in the underlying inflation rate. The lagged effects of this policy also slowed the economy in 1989 and 1990, as higher interest rates discouraged spending. This tightening successfully contained inflationary pressures, and left monetary policy with much more latitude—compared with the inflationary policies of the 1970s—to ameliorate the adverse effects of the oil price shock.

Tighter credit markets reduced the availability of loans to some creditworthy borrowers, and this also contributed to the slowdown. Banks and other financial institutions tightened lending standards for a number of reasons: A slowing economy increased the risks of lending to businesses. The value of collateral on residential and commercial real estate loans fell with declining real estate values. Overly zealous bank examiners discouraged some banks from making new loans. And the need to increase the ratio of capital to loan assets to meet minimum capital requirements forced some banks to curtail loan growth. Stricter lending standards for commercial and residential loans slowed business investment and housing construction.

There were several favorable economic developments in 1990. The underlying inflation rate was contained. After a temporary increase in the first quarter, the growth rate of the GNP fixed-weighted price index, the broadest measure of economy-wide inflation, declined later in the year, as did the rate of change in the employment cost index—a measure of wage pressures in private labor markets. Compared with 1988, when inflationary pressures were becoming evident and the Federal Reserve began to take actions to contain them, the employment cost measure of wage inflation grew more slowly during 1990, rather than more rapidly as many had feared.

The continued decline in the trade deficit was also good news. Including trade in both goods and services, the trade deficit has declined from $144 billion in 1987 to $77 billion in 1990. U.S. firms remained competitive in world markets, exports reached a new record, and the United States remained the world's leading exporter. Labor productivity in manufacturing continued its recent strong growth. And, although growth fell for the overall economy, some regions experienced relatively strong employment gains.

THE OUTLOOK

The Administration projects that real economic growth will be 0.9 percent over the four quarters of 1991, with the downturn continuing through the first quarter and a recovery beginning near the middle of the year. Inflation is expected to remain under control, declining substantially from the temporarily high levels reached as a result of the oil price shock. Continued progress in gradually lowering the underlying rate of inflation is also expected. Interest rates are projected to be lower on average in 1991 than in 1990, reflecting slower growth in credit demand during the downturn, as well as lower inflation rates.

The current downturn is expected to be short and shallow for several reasons. Most firms have kept inventories low relative to sales, reducing the need for a sharp cut in production to work off excess inventories. Such inventory corrections accounted for much of the decline in output in earlier postwar recessions. Moreover, net exports are projected to improve, both because the Nation's major trading partners are expected on average to experience stronger growth than the United States, and because the decline in the value of the dollar since 1989 has lowered the price of U.S exports on world markets. Oil prices remain a source of uncertainty in the outlook, but they have declined substantially since their peak in October, particularly since the start of Operation Desert Storm. Finally, both fiscal and monetary policies are well positioned to mitigate the downturn. There is a downside risk that the tightness in credit markets evident in 1990 will continue into 1991, a consideration that poses special challenges for monetary policy.

Assuming adoption of the Administration's growth initiatives—including a lower tax rate on long-term capital gains, tax incentives to reduce barriers to household saving, reforms to strengthen the financial sector, and increased investment in children, education, infrastructure, space, and high technology, all within the context of lower structural budget deficits—the long-term outlook is excellent. Growth is expected to strengthen in 1992, with the economy in a relatively high-growth recovery through 1993 before returning to a solid, sustainable expansion. With sound economic policies in place, there is no fundamental obstacle to an expansion in the 1990s at least as long and strong as the record expansion of the 1980s.

BUILDING ON STRENGTH

In designing policies to cushion the current downturn and enhance long-run U.S. economic performance, it is critical to remember that the Nation already has the largest and most productive economy in the world. The historic changes that began in Eastern

Europe in 1989 represent, in part, the triumph of the basic principles upon which the American economy has been built. The flexibility and adaptability of free markets have given America both the highest living standard of any major economy and the means to ensure the Nation's continued prosperity.

With less than 5 percent of the world's population, the United States produces about 25 percent of the world's total output (measured by GNP). The U.S. economy is more than twice as large as the next largest economy, that of Japan. The average standard of living of Americans—as measured by GNP per capita—is above that in other major industrialized countries. U.S. productivity is also higher than in those other nations; as measured by GNP per worker in 1989, productivity in West Germany and Japan was only about three-fourths of that in the United States.

Economic growth in a flexible market economy involves change as well as expansion; the waxing and waning of individual industries and sectors is natural and healthy. In the United States, as in most other industrialized nations, changes in demand, productivity, and demographics have produced a long-term shift in employment from goods-producing to service-producing sectors. Dramatic advances in productivity have kept manufacturing's share of total real output roughly constant throughout the postwar period, even though its share of total employment has declined.

America is unsurpassed in basic research and has by far the world's largest share of contributions to scientific literature. U.S. firms have a distinct edge in many knowledge-intensive products, and the United States continues to produce larger volumes of many high-technology products than any other nation.

Recent increases in foreign investment in the United States reflect both the size and health of the American economy and the trend toward greater global economic integration. Those who are concerned about this investment neglect the lessons of history. Fears of foreign investment were widespread in Europe in the 1950s and 1960s, when the issue was *American* investment overseas. However, as Europeans have since learned, foreign investment that helps to build plants and equip workers can increase productivity and raise standards of living. Foreign investment in the United States is a sign of America's strength and a vote of confidence in its economic future.

POLICIES FOR RENEWED GROWTH

Fiscal policy—the Federal Government's taxation, expenditure, and borrowing policies—and monetary policy—decisions directly affecting the money supply and interest rates—can have powerful effects on the economy in both the short run and the long run. The

government's policy toward the financial sector—the regulation and supervision of banks and other financial institutions—significantly affects both the short-run stability of the economy and its long-run ability to channel savings efficiently into productive investments.

When unemployment increases or inflation seems to be accelerating, fiscal and monetary policies can alleviate the economy's immediate problems. But a sequence of short-sighted discretionary reactions can produce poorer performance on average than adherence to well-designed credible, systematic policies. Businesses and households are forward-looking, and expectations about future economic conditions and macroeconomic policies affect their decisions. Frequent discretionary changes in policy impede long-term planning and thus undermine the economy's performance.

Signals about the goals and approach that will guide monetary and fiscal decisions must be clear and credible. Credibility provides the latitude to respond to short-run developments without altering the public's expectations that policy will continue to be stable and systematic. But credibility, like respect, must be earned; monetary and fiscal actions must be consistent with stated long-run goals and policies.

Accurate and timely economic data reduce uncertainty and enhance the soundness both of private sector decisionmaking and of macroeconomic policy analysis and implementation. The Administration is thus committed to continuing improvements to the Nation's statistical infrastructure.

FISCAL POLICY

During an economic downturn, government expenditures—such as unemployment compensation—increase, and tax receipts fall relative to what they otherwise would be. Although they temporarily increase the budget deficit, these changes in taxes and expenditures work as "automatic stabilizers" to reduce declines in income and spending and thus to hasten recovery. They are systematic and fast-working, unlike discretionary changes in fiscal policy, which require legislative actions, may take too long to enact, and are difficult to reverse.

To sustain robust economic growth, the United States must maintain a high rate of investment in new capital and new technology. That, in turn, requires an adequate flow of national saving. The substantial Federal budget deficits of recent years have decreased the national saving rate. Sound, growth-oriented fiscal policy thus requires that the Federal budget deficit be reduced.

The Omnibus Budget Reconciliation Act of 1990 contains the largest and most comprehensive deficit reduction package in U.S. history. It is designed to reduce the Federal deficit by a total of nearly one-half trillion dollars over the next 5 years, relative to

what it would otherwise be, with the reduction in the deficit phased so as to minimize adverse short-term effects on the economy. The resulting higher level of national saving will fuel economic growth and contribute to U.S. prosperity for years to come. In addition, the new budget law achieves two key fiscal policy objectives.

First, it contains credible enforcement mechanisms, using caps on spending and pay-as-you-go rules, to prevent new legislation from increasing the budget deficit. The caps put into effect the concept of a "flexible freeze": Within each discretionary spending category, any spending increases must be offset by spending cuts to stay within the cap. Across-the-board spending cuts are required whenever the caps or rules are violated.

Second, new systematic procedures enhance the ability of the automatic stabilizers to cushion downturns in the short run. Under the new law, deficit targets are adjusted for changes in economic conditions, as reflected in the Administration's forecast. That permits the automatic stabilizers to work more effectively. In contrast, the previous law had no procedure for adjusting the deficit targets without suspending the entire enforcement mechanism.

Another important element of the Administration's fiscal policy is a commitment to a tax system with low marginal tax rates and the lowest possible barriers to economic growth. The Administration has proposed a reduction in the tax rate on long-term capital gains. A capital gains tax cut would affect real estate and other asset values favorably, thereby alleviating capital and balance sheet problems in both financial and nonfinancial corporations. It would reduce the existing bias against financing through equity rather than through debt. It would also increase long-term economic growth by stimulating saving, lowering the cost of capital, and encouraging investment. And it would encourage entrepreneurship so essential for the creation of new jobs and the commercialization of new ideas.

To further stimulate private saving, the Administration has proposed Family Savings Accounts. Contributions to these accounts would not be tax-deductible, but withdrawals of earnings and contributions after 7 years would not be taxed. The Administration also proposes to ease requirements for withdrawals from Individual Retirement Accounts for people buying a home for the first time. That would make these accounts more attractive to young people and thereby increase private saving.

MONETARY AND FINANCIAL SECTOR POLICY

Monetary policy also has an important role to play in mitigating the current downturn and providing for strong growth and a gradual reduction in inflation. Because of the past and potential future changes in the structure of the economy, monetary policymakers must necessarily consider a number of indicators—including

output, general price indexes, interest rates, exchange rates, futures prices, money, and credit—in judging the direction of the economy and the impact of monetary policy. But, barring changes in the relationship between money and income, an important characteristic of a credible and systematic monetary policy is a commitment to sustain the rate of growth of money and credit during a downturn. Such a commitment would automatically bring about a reduction in interest rates and soften the downturn. It is important to recognize, however, that a decline in interest rates during a downturn may not be a sign of monetary easing, especially if the growth of money and credit has slowed.

It is vital to maintain a credible commitment to long-run goals and policies when responding to temporary disturbances. The relatively low and stable inflation rates that prevailed before the 1990 oil price shock permit the Federal Reserve to cushion the downturn without leading businesses and households to expect higher future rates of inflation.

Tight credit conditions may create special challenges for monetary policy in the year ahead. The reduction by the Federal Reserve in banks' reserve requirements implemented toward the end of 1990 was aimed at alleviating these conditions and will help to moderate the downturn. In encouraging sound banking practices, the Federal Reserve and other bank regulators should not pursue overly stringent regulations that unnecessarily restrict creditworthy borrowers. Historical experience and research show that sustained money growth can go a long way toward offsetting other sources of credit market tightness.

The Administration's proposal for comprehensive banking reform will reduce unnecessary and antiquated restrictions on the banking industry and thereby help to ease tight credit conditions. Healthier banks are essential if the financial system is to provide adequate supplies of credit during economic downturns as well as in periods of expansion. Lifting restrictions on interstate banking activities and on the ability of banks to combine with commercial and other financial firms will enhance banks' ability to attract capital and thus reduce the risk of a contraction in lending.

POLICIES TO SUPPORT GROWTH

Efforts to protect special interests by resisting the economy's natural evolution are often futile, generally sap the economy's vitality, and always reduce its flexibility and ability to benefit from change. Instead, growth must be supported by policies that increase the role of market forces, while ensuring that opportunities are enhanced for all Americans and that the Nation's environment is protected.

ENCOURAGING INVESTMENT AND IMPROVING EDUCATION

Continued growth in productivity and living standards requires investment in new buildings and equipment, advances in technology, and improvements in the skills of U.S. workers. All these must be encouraged if America is to leave its children a legacy of global economic leadership.

Investment in plant, equipment, and commercial technologies is the task of the private sector. Because market forces guide investment funds to their most productive uses, the government can generally only slow economic growth by second-guessing private investment decisions. Government's primary task is to create conditions under which high levels of productive investment, guided by market forces, can fuel rapid growth. The multiyear deficit reduction program enacted in 1990 is an important step in this direction. Reducing the tax rate on long-term capital gains and enacting the Administration's proposals to increase private saving would also significantly reduce barriers to robust long-term economic growth.

In addition, of course, governments at all levels must recognize their shared responsibility to provide an efficient U.S. transportation infrastructure, which is necessary for sustained economic growth. Legislation passed in 1990 will make it easier for airports to finance needed capacity expansions. The Administration will seek both increases in Federal funding for highways and a restructuring of highway programs that will give the States greater flexibility, while ensuring that the 150,000 miles of roads in the National Highway System will be maintained, rehabilitated, and expanded.

The Federal Government has an important role to play in the process of technological change. Some research projects offer the potential of large benefits to the economy as a whole but do not offer much prospect of profit to any private firm that might undertake them. The knowledge generated by these projects would be valuable, but no firm could prevent others from capturing most of that value. Such "spillovers" are important in the case of basic research, the results of which cannot generally be directly incorporated into a marketable product or process. The Administration has proposed substantial increases in Federal support for basic research, and the President has announced his intention to double the budget of the National Science Foundation.

Some areas of applied research promise advances in generic, precompetitive technologies that would also have large spillovers. The Administration will seek increased support for such research and will make the results of government-supported research more readily available to the private sector for speedier commercialization. Adoption of the Administration's proposed reform of the antitrust

law governing joint ventures would increase the ability of the private sector to take advantage of research opportunities with industry-specific benefits. Finally, the Administration will again seek to make the research and experimentation tax credit permanent to enhance incentives for private-sector investment in new technology.

Education is the key to increasing the skills of the U.S. labor force. If America's children continue to learn less in school than their counterparts abroad, America's workers will not long continue to earn more. The United States already spends more per pupil in elementary and secondary education than all its major competitors, but it does not receive an adequate educational return on this investment.

The Administration will continue its strong support of the fundamental reform necessary to achieve excellence in U.S. elementary and secondary education. The key to successful reform is to harness the power of market forces: Schools should be able to compete for students. Parents and students must be afforded more choice among schools, and unnecessary barriers to entry into the teaching profession must be swept away.

The Administration will introduce a new Educational Excellence Act, which will stimulate fundamental reform and restructure the Nation's education system by promoting educational choice and alternative certification for teachers and principals. And, to help ensure that all students enter school ready to learn, the Administration has significantly expanded the Head Start program. The President will continue his close work with the Nation's Governors to advance the vital cause of educational excellence.

The Immigration Act of 1990, the first major reform of legal immigration in 25 years, will enhance the quality of the American labor force. This legislation will significantly increase the level of skill-based immigration and reaffirm the Administration's commitment to family reunification as a central tenet of U.S. immigration policy.

STRENGTHENING MARKET FORCES

Free, competitive markets for goods and resources maintain high U.S. living standards and both guide and stimulate the process of economic growth. The long-run performance of the economy is thus enhanced by policies that extend the scope of market forces and maintain market flexibility.

The Administration remains committed to an energy policy that relies on the flexibility and power of market forces to ensure that all the Nation's resources are efficiently utilized. In the aftermath of Iraq's invasion of Kuwait, some called for increased regulation of energy markets. But these policies would increase the economic

burden of the oil price shock, bring back the gasoline lines of the 1970s, and make the economy less flexible and efficient. They are firmly opposed by the Administration. The Nation's Strategic Petroleum Reserve was tested in October and November, and an internationally coordinated program to make government-controlled stocks available to the marketplace began with the outbreak of hostilities in the Persian Gulf.

The National Energy Strategy, which was under development well before the onset of the Gulf crisis, continues the successful policy of reliance on market forces. It recognizes that in an increasingly integrated global economy, U.S. energy security cannot be separated from that of the Nation's friends, allies, and trading partners; all countries are affected by sharp, unanticipated price changes in world energy markets. It reflects the need to foster economic growth through the availability of ample supplies of reasonably priced energy. Implementation of the National Energy Strategy would enhance energy security by increasing the diversity of energy supplies, removing barriers to competition in energy markets, encouraging economical conservation, and increasing Federal support for energy-related research with potentially significant spillover benefits.

Strong economic growth requires a financial sector that is sound, efficient, and innovative. Banks in the United States still operate under a regulatory system that dates from the 1930s. That system attempts to keep banks healthy and the deposit insurance system sound by limiting competition, but it is simply no longer workable. U.S. banks face increasing competition from other institutions and markets around the world. The long-term vitality of U.S. banks depends on their ability to compete effectively. The Administration's proposal to reform financial sector regulation would make banks financially healthier and better able to compete, while ensuring the soundness of the deposit insurance system.

An important planting flexibility provision of farm legislation enacted in 1990 makes market incentives a more important determinant of farm production decisions. This provision will save about $7 billion in Federal spending over the next 5 years.

GIVING POWER AND OPPORTUNITY TO INDIVIDUALS

Without a healthy, growing economy, poverty in the United States cannot be reduced. But growth alone is not enough. It should be supplemented by policies designed to give power and opportunity to individuals—to give them both the incentive and the means to participate fully in the economy.

In 1990, after a 3-year debate, the Congress passed child care legislation consistent with the President's objectives of limiting governmental interference with parents' decisions, not discriminating

against working families who care for their own children, and targeting assistance to those most in need. The 1990 budget act provides an increase of about $18 billion in assistance to low-wage workers with children over the next 5 years by expanding the Earned Income Tax Credit.

The Administration's Homeownership and Opportunity for People Everywhere (HOPE) initiative was also signed into law in 1990. This initiative will enable low-income families to become homeowners and give them a greater stake in their communities. Increased tenant ownership and control of public housing would further help to build the bonds of community in distressed neighborhoods. And the Administration's enterprise zone proposal would encourage entrepreneurship, investment, and job creation in urban and rural pockets of poverty.

The landmark Americans with Disabilities Act is the most important extension of civil rights protection in two decades. It will permit many disabled Americans to participate fully in the Nation's economic mainstream and to contribute to and benefit directly from America's growth and prosperity.

Medicaid coverage was expanded in 1990 to improve prenatal care and child health in low-income families and to reduce infant mortality. The Administration's new infant mortality, preventive care, and nutrition initiatives would make significant contributions to the health of low-income Americans.

LIMITING REGULATION AND MAKING IT WORK

When markets can work well, regulation can only reduce flexibility and slow growth. Even when markets work poorly, the inevitable imperfections of regulation often make its use costly and inefficient. Regulation should be employed only when its benefits clearly exceed its costs. Regulatory targets should be chosen by careful cost-benefit analysis, and the methods of regulation should minimize the costs and disruptions of reaching those targets. Cost-minimization requires that incentives be carefully structured and that firms and workers be allowed maximum flexibility to meet well-designed performance standards. In particular, economic growth and environmental protection can be compatible, but only if environmental regulation does not impose unnecessary costs on the economy.

After the President's leadership had broken a logjam that had long blocked congressional action, the first comprehensive amendments to the Clean Air Act in more than a decade were signed into law in 1990. This legislation incorporated a flexible and innovative market-based system that will secure a substantial and permanent reduction in the sulphur dioxide emissions that cause acid rain. The reduction will be achieved at an estimated cost 20 percent

lower than the cost of traditional, less flexible command-and-control regulation. The Administration is committed to implementing all provisions of this legislation so as to minimize unnecessary burdens on American workers and firms.

U.S. LEADERSHIP IN THE GLOBAL ECONOMY

The principle that market forces, not government planners, are the best source of lasting prosperity is as valid in global markets as it is within individual economies. The Administration accordingly remains strongly committed to removing barriers to trade and investment in all nations, to opposing pressures for protectionism and government management of trade, to supporting market-oriented reform around the world, and to pursuing macroeconomic policies conducive to strong noninflationary growth in the United States and the world economy.

INTERNATIONAL TRADE LIBERALIZATION

Since the end of World War II, the United States has led the world toward a system of free trade and open markets. As a consequence of this policy and of natural economic forces, America's economic prospects have become closely linked with those of other countries. Increased global economic integration has expanded markets for U.S. exports, encouraged innovation, and expanded the choices available to American consumers. World trade, which has grown more than 1½ times as fast as world income since the early 1960s, has improved the living standards of all Americans. In recent years exports have made an important contribution to U.S. economic growth.

Policies that target particular industries for protection from international competition, whether by means of tariffs or quotas, or through the newer device of managed trade, impose costs on the economy as a whole. Such policies limit consumer choice, raise domestic prices, reduce competition, impair the flexibility and competitiveness of the U.S. economy, and invite retaliation against U.S. exports. This Administration will continue to resist protectionist pressures and to work to open markets here and abroad.

Sustained strong worldwide growth in the 1990s will depend on continued progress toward a free and open multilateral trading regime. Completing the Uruguay Round of multilateral trade negotiations, under the auspices of the General Agreement on Tariffs and Trade (GATT), remains the top trade priority of the Administration. In the Uruguay Round the United States has sought a significant agreement that reduces or eliminates tariffs in all nations in several broad sectors of manufacturing and that phases out other barriers to trade in textiles and agriculture. A key aim of the

negotiations is to strengthen and modernize GATT rules and to extend them to new areas such as services, investment, and intellectual property.

In 1990 the Administration undertook several other market-opening initiatives that will both spur growth in this hemisphere and support the wave of market-oriented reform sweeping Latin America. A U.S.-Mexico free-trade agreement was endorsed by the Presidents of both countries. The Enterprise for the Americas Initiative aims to expand trade through free-trade agreements, to encourage liberalization of investment regimes in order to increase capital formation in the region, and to reduce official debt of countries pursuing strong economic reform programs. Additional measures to reduce trade barriers were also undertaken to help support cooperation on anti-narcotics efforts with Andean countries. As the benefits of these programs to the United States and its trading partners in the hemisphere become apparent, a clear signal of the gains from freer trade and sound economic policies will be sent around the world.

The Administration also initiated and completed a first round of bilateral market liberalization talks with Japan called the Structural Impediments Initiative. The aim of these talks is to open markets and reduce structural barriers to trade and balance of payments adjustment in both the United States and Japan.

INTERNATIONAL MACROECONOMIC ISSUES

The increased integration of the world economy has significant implications for macroeconomic policies. Both monetary and fiscal policies in the United States have fundamental effects on exchange rates and trade flows. These policies also affect the economic performance of other economies, although to a lesser extent than the U.S. economy itself.

American economic leadership requires that U.S. macroeconomic policy maintain an environment conducive to strong noninflationary growth. That will benefit the U.S. economy and contribute to economic growth and stability abroad. A sustainable trade balance and relatively stable exchange rates are part of such a policy environment.

Coordination of macroeconomic policies across countries can help governments increase sustainable growth worldwide. The regular economic meetings of heads of state, finance ministers and other officials of the G-7 nations (United States, Germany, Japan, United Kingdom, France, Canada, and Italy) provide a framework within which economic issues of mutual concern can be discussed. This evolving process of cooperation has achieved some important successes. During the recent expansion, economic growth was strong and inflation rates among countries tended to converge to

lower levels. In the last several years, trade imbalances have declined significantly. International macroeconomic policy coordination continues to be essential as the world economy reacts to the effects of the oil price shock and changing credit conditions.

SUPPORT FOR ECONOMIES IN TRANSITION

The emerging democracies of Eastern Europe, many nations in Latin America, and other countries around the world have learned from America's example. As nations adopt democracy, their new leaders turn away from central planning and government control of economic activity and toward reliance on flexible market forces. The economic collapse of communism has made it clear that free people working in free markets are best able to create high and rising living standards.

American support for democracy and free markets throughout the world provided a major impetus to what the President has called the "Revolution of 1989" in Eastern Europe. In 1990 many governments in this region deepened their historic efforts to rebuild their failed economies. Many nations in Latin America increased their reliance on market forces and opened their economies to international trade.

The United States continued to provide extensive technical and financial assistance to the emerging democracies of Eastern Europe, and the President was instrumental in establishing the group of 24 Western governments that has already committed about $20 billion in assistance to Eastern Europe. The United States was also instrumental in encouraging the World Bank and the International Monetary Fund to increase lending in this region. And U.S. initiatives aimed at reducing barriers to trade and investment provided powerful support for the forces of reform in Latin America.

CONCLUSION

Writing on the eve of the American Revolution, Adam Smith was the first to make clear the power of flexible, competitive markets to raise living standards and the costs of misguided interference with market forces. As the United States prepares for a new century, Smith's principles remain central to sound economic policymaking.

Policies that remove barriers to market forces and thus increase the economy's flexibility can encourage investment, innovation, entrepreneurship, and growth. Credible and systematic macroeconomic policies can keep the current downturn mild and brief, add strength to the recovery, and provide the foundation for a sustained expansion in the 1990s. The Administration's proposed

growth incentives and its proposals for education and financial sector reform and for giving power and opportunity to individuals, along with its other major initiatives, can significantly contribute to the economy's long-term health and vitality.

In 1991, as always, the United States confronts both economic challenges and exciting opportunities. The U.S. economy remains the largest and most productive in the world, and its flexibility and resilience give America the ability to meet its challenges and make the most of its opportunities. But the Nation cannot take economic growth for granted. Unless sound policies are followed, there is no guarantee that American living standards will continue to rise substantially from one generation to the next or that the United States will remain the world's leading economy. The Nation must choose between sound policies that will promote long-term growth and policies that will reduce economic flexibility, stunt incentives, and place its economic future at risk.