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Statement by

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I am glad to have this opportunity of discussing international economic problems and their domestic repercussions before this distinguished subcommittee.

If a broad-brushed picture of the international economic scene in recent years is drawn, several major features stand out. The international economy has been upset by a number of severe disturbances. Foremost among the recent disturbances have been the oil embargo and the jump in the international price of oil. More broadly, the international prices of commodities have moved dramatically, rising particularly rapidly during late 1972 and early 1973. The rises in the price of oil and other commodities have contributed to the worldwide inflation which is currently raging, but inflation can by no means be exclusively attributed to the commodity sector. In recent years, aggregate demand in many countries has become overheated; too many have tried to do too much too quickly.

But if disturbances and change have been major unsettling features of the international economy in recent years, its resilience has offered some reassurance. In spite of the disturbances, there have been solid gains in the volume of trade and other transactions among countries. For the United States, for example, exports of goods and services have increased more rapidly than total GNP, rising from 5.9 per cent of GNP one decade ago to 7.8 per cent of GNP during the past year. Looking at goods only, foreign markets have become even more important to U.S. producers, since exports of goods last year amounted to more than 10 per cent of our domestic goods production, compared to 8.2 per cent in 1964. These gains in international trade reflect elements of strength in the international economy -- the reductions in tariffs which have been painstakingly negotiated in recent decades, the highly developed and continuously improving system of transportation and communication, and the rapid growth in world production.

While the over-all level of international transactions has expanded rapidly, the trade balance of the United States has moved unevenly in recent years, sliding into deficit in 1971 and 1972, and then temporarily recovering to a small surplus in 1973 as agricultural exports boomed and as the effects of the devaluations of the dollar began to have their effect. Elements of strength continue to benefit U.S. export trade, but they have been overwhelmed by increases in the price of oil, with the result that our trade balance is now back in deficit. During the second quarter, the deficit amounted to $6.8 billion at an annual rate (seasonally adjusted). During that quarter fuel imports were running at an annual rate $20 billion above last year.

It seems unlikely that the trade balance will improve very much, if at all, over the next 12 months. Much depends on the size of the harvests here and abroad and on the price of oil. In

1973, following upon poor crops abroad, our agricultural exports rose to 25 per cent of our total merchandise exports, compared to a figure of 19 per cent in 1972. In 1974, this percentage is likely to decrease.

The degree of exchange rate flexibility which has developed in recent years has contributed to the ability of the international economy to withstand shocks. Indeed, it is difficult to see how the disturbances of the past few years could have been absorbed as smoothly as they in fact were if exchange rates had been pegged and rigidly defended. As a result of the negotiations recently conducted by the Committee of 20 of the International Monetary Fund, the evolving system of exchange rate flexibility can be put on a more systematic basis. A major feature of the reform effort has been a set of guidelines for floating, which define what countries should and should not do in the way of intervening in foreign exchange markets. The development of guidelines for intervention should limit potential conflicts among nations over exchange rates and limit swings in rates, and this tends to ease some of the concern that we may feel with respect to the system of floating rates.

But while exchange rate flexibility has increased the shock resistance of the international economy, it has produced problems of its own, such as the speculative losses that have affected some financial institutions in recent months. Market swings have been unnecessarily wide, and have from time to time permitted declines in the value of the dollar which have contributed to inflationary pressures. In any event, exchange flexibility can at best make only a marginal contribution to the very real longer run difficulties engendered by the increase in the price of oil. The difficulties with which I specifically want to deal in this testimony are balance-of-payments problems, financial strains, and domestic repercussions.

When the oil-exporting countries receive their huge additional payments, they basically have two ways of using their great windfall. They can import additional goods; or they can acquire assets in the oil-importing countries. Insofar as they do the former, a course of action which is limited by their absorptive capacity, the total current account deficits of the oil-importing countries are reduced. Of course, this partial solution of their balance-of-payments problem cannot be considered a painless outcome for the oil-importing countries, since they will of necessity then have to give up the resources needed for the production of their additional exports to the oil producers, with a consequent reduction in their living standards. Insofar as the oil exporters take the second option -- acquiring assets, and in a broad sense, investing in the oil-importing countries -- they are automatically recycling the oil receipts to the oil importers as a group. In general, money not used for imports must be deposited or invested somewhere, and wherever it goes, it is available to the oil-importing countries.

But the automatic recycling occurs only with respect to the oil-importing countries as a group. For individual countries and institutions serious problems may nevertheless arise. First, the oil-exporting countries may want to hold their funds in only a limited number of large banks. A great increase in deposits, for instance, could strain the capital positions of these banks. A desire for high liquidity on the part of the oil-exporting countries, causing them to hold their funds in the form of short-term deposits, would strain the banks' liquidity positions. Second, some countries may suffer severe financing difficulties if their ability to finance imports by drawing on reserves or by borrowing them falls short of needs.

Both problems can be mitigated to the extent that the oil exporters are prepared to make appropriate financial arrangements. To the extent that the oil-exporting countries decide to hold some of their assets in forms other than bank deposits, the problems of the financial institutions will be lessened. If, further, oil exporters were willing to acquire assets in the importing countries in approximate proportion to the need of the importing countries to pay for oil, the danger that some countries may not get enough recycling would be obviated. We are beginning to see encouraging developments along these two lines. As of this time, however, one cannot expect that the problems of financial institutions and of balances of payments will be fully met by developments such as these.

The normal workings of the market will ease some of the problems growing out of the vast payments to the oil producers. If the OPEC countries, like other recipients of windfalls, initially hold most of their new wealth in liquid bank balances, they will compel banks to tighten up the conditions on which they will accept these funds. This would give the Organization of Petroleum Exporting Countries (OPEC) an incentive to look for other investments, either of a debt or equity nature. If a country receives less recycling than needed to meet its current account deficit, it may be able to borrow from countries that receive more than they require. The market has a major role to play in redistributing funds according to need. This applies both to the Eurodollar market, and to the national capital markets of countries. The ability of capital markets to fulfill their function as intermediaries between countries with plentiful and relatively scarce supplies of capital has been enhanced by recent moves towards freer capital markets.

Situations may develop that the market cannot handle, however. Such situations will be more frequent if the price of oil remains at anything like the present level. For instance, where credit risks are perceived by private financial intermediaries as excessive, facilities in addition to those that the market can supply may be required. Some international steps are now being taken to make financing available to needy countries, most notably through the IMF oil facility. The financial facilities of the European Economic Community have been drawn upon by Italy. As strains on the international financial system are to a large degree attributable to the actions of the OPEC countries, it is urgently desirable that they contribute to the easing of the situation by lowering the price of oil, and by making funds available increasingly for official financing arrangements.

Potential strains on the international financial system can be reduced if steps are taken to keep some fair balance among the current account positions of the oil-importing countries. As a group, the oil-importing countries will run large current account deficits into the foreseeable future -- unless the oil problems are reduced by a major price rollback. How these deficits should best be distributed has been a matter of concern, both within international organizations such as the Organization for Economic Cooperation and Development (OECD) and within national governments.

It must be borne in mind that the oil deficits are occurring in addition to deficits and surpluses that particular countries were already experiencing as a consequence of domestic policies and other factors. Where good policy calls for elimination of these deficits, every effort should now be made to eliminate them. But a country cannot eliminate its oil deficit without increasing the deficit of some other country, since the surplus of the oil-exporting countries, for reasons already stated, cannot be eliminated in the short run. Individual countries might, of course, nevertheless attempt to eliminate their oil deficits. But such attempts, if pursued too vigorously, could lead to general contraction -- since the standard ways to eliminate a deficit are to restrain aggregate demand, restrict imports and other payments, and possibly depress exchange rates. The danger, so to speak, is that the oil-importing countries may be lured into a game of musical chairs with their combined deficit. The deficit will remain, but the game itself can become mutually destructive.

But while mutually contradictory attempts to eliminate current account deficits represent a danger, there is no fully satisfactory basis for agreeing on how the deficits should be distributed. It is frequently suggested that countries should attempt to balance their current account receipts and expenditures exclusive of the deficits attributable to the increase in the price of oil. Alternatively, it has been suggested that countries adjust their trade balances in such manner that each oil-importing country accepts a deficit proportionate to its GNP. Neither of these criteria provides an adequate guide, if only because some countries may be unable to borrow enough in the market, and then would have to cut down their deficit unless they receive aid.

It is appropriate that countries that face both large current account deficits and strongly inflationary domestic conditions should take firm steps to control domestic demand. Each country, of course, should frame its policy in full awareness of the fact that, collectively, large current account deficits cannot be avoided by the oil-importing countries. But the prospective oil deficits do not mean that countries should ignore the prudent fiscal and monetary policies needed to put their domestic house in order.

In summarizing this review of the financial repercussions of the high price of oil, I would say this. We have good markets and institutions, and public policy makers are not without guides as to what to do in the face of this situation. But one cannot at this time be sure that the situation will in fact be manageable, unless there is a substantial reduction in the price of oil.

I now turn to the second group of problems set out earlier, relating to domestic repercussions of international events. Among the oil-importing countries, by far the greatest problems are encountered by the less developed countries (LDC's). Facing an uncertain future at best, a number of them have been put in a grim position by the increases in the price of oil -- upon which depend their transportation, their nascent industries, and their supplies of fertilizer. Indeed, unless the price of oil is reduced, or unless the LDC's receive large flows of capital or aid from the OPEC or OECD countries, the outlook for some of them is very difficult indeed. The adverse effects of high oil prices on the supply and cost of fertilizers and therefore on the price of food is particularly troublesome.

For the economically developed countries, increases in the price of oil also have important domestic implications. Representing a strong autonomous increase in costs, they have exacerbated the already grave inflationary problems of the United States and other countries. The increases in the price of oil have frequently been compared to a large excise tax paid to foreigners, having both an effect of pushing up prices, but also tending to drain real disposable income from the economy, thereby increasing the dangers of weakness in economic activity. This source of softness of demand has, however, tended to be offset by new demands for capital investment.

Several aspects of the changes in the international economy have contributed to the need for additional capital, of which the need to develop substitute sources of energy is only one. Another is the fact that, as the current accounts of the United States and other oil-importing countries show large deficits, there will be an accumulation of liabilities to the oil-exporting nations. In order to ease the future problems of debt repayment, we should encourage the growth of our capital stock and productive capacity.

Fortunately, one of the effects of the higher price of imported oil is to create an opportunity for increased investment in each oil-importing country's economy. As already mentioned, the increase in the price of imported oil, like an excise tax, removes purchasing power from the domestic economy. The resources thus released can advantageously be channeled into investment. Such an increase in investment could come about, for instance, if the oil-exporting countries recycle the funds to the importing countries and acquire assets there.

Neverthless, until the present inflation has been brought under control, increases in investment must be accompanied by determined restraint on aggregate demand. It is here that restraint in the government budget has a crucial role to play. Cutting of government expenditures and a reduction in the volume of government financing will have desirable direct effects in restraining inflationary forces. Furthermore, given the over-all monetary restraint applied by the Federal Reserve, more fiscal discipline will mean less government borrowing and hence lower interest both here and abroad. The relaxation of pressures on institutions which finance the housing industry would be especially beneficial. Indeed, a strong case for budgetary restraint can be made on the grounds that, in present circumstances, government expenditures are directly competitive with home construction.

In our domestic fight against inflation, we must not expect quick success; perseverance has become the key note. If we are to be successful in our anti-inflationary fight -- and it is imperative that we achieve success -- then we must be determined to fight inflationary pressures over an extended period. And, just as the international prevalence of excess demand in recent years has meant that national inflationary problems have tended to reinforce one another, so, on the other side, the unwinding of inflation will be less difficult for each country if there is an international determination to exercise restraint.

The problems of inflation as well as those of international finance and balances of payments would be greatly eased by a decline in the price of oil. There are reasons for expecting such a decline, not only on the grounds of a current excess of supply over demand, but on the grounds of the long-term economic self interest of the oil-exporting countries who undoubtedly will want to protect their markets. But a decline to the prices of past years cannot be expected.

Efforts to cope with inflation are needed almost everywhere. In the OECD countries, inflation currently rages at rates which range between 7 per cent and 23 per cent. Inflation has reached a stage in which fears are being expressed openly about the survival of democratic institutions. Germany, which took anti-inflationary action earlier in the cycle, has been rewarded by the lowest rate of inflation among the major industrial countries. German restrictive actions in the past year have kept domestic demand approximately flat in real terms, with the expansion of German economic activity being completely accounted for by the buoyancy of its exports. In many countries, the combination of a rapid rate of inflation accompanied by softness on the real side of the economy have added to current difficulties. In the United Kingdom, real GNP in 1974 is not expected to be above that in 1973. In Japan, a 25 per cent rate of inflation during the first quarter of this year was accompanied by a fall of 5 per cent in real GNP -- both developments being due in significant part to Japan's heavy dependence on imported oil.

Given these conditions and policies, the outlook seems to be for a period of at best moderate growth abroad, as it is at home. I do not, however, see policies that are deliberately designed to restrain inflation leading to a serious decline in the world economy, as prophets of gloom sometimes predict, anymore than I see a crisis of the world's financial system ahead. We must not deceive ourselves about the fact that we face severe difficulties. We shall be sailing in uncharted waters part of the time. But our institutions are strong, the right policies are at hand, and given the will, I feel confident that the way will be found.