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Remarks by

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During the last few months we have seen some dramatic developments in the international oil market. Spot market prices have plunged since reaching their December peak of nearly $30 per barrel for West Texas intermediate crude oil. Last week, the spot price was less than half the December peak. Contract prices have followed suit, although somewhat less sharply. There is, of course, no certainty about how long oil prices will remain at their present levels, but it is useful, I think, to examine the outlook for the world economy assuming the price of oil remains more-or-less unchanged from current levels for the next year or two.

This examination must be placed in the context of other important developments in the world economy during the past few years. One of these developments that we all find most heartening is the progress that has been made in bringing down price inflation rates in the major industrial countries. The weighted average inflation rate in all the industrial countries as a group is now running at about 3 percent; just a few years ago -- in 1981 -- it was some 9 percent. The U.S. inflation rate is now less than 3 percent. Inflation rates in Germany and Japan are now near zero, with the underlying rates -- abstracting from one-time price level effects caused by the dollar's depreciation and the oil price drop -- also very low.

Another feature of the world economic environment is the strengthening of fiscal positions attained over the past few years in several industrial countries, particularly Japan and Germany. The general government fiscal deficit as a percentage of GNP is on the order of 1 percent in these two key countries; on a "structural" or full employment basis these balances are almost surely in surplus. As is widely recognized, the U.S. fiscal situation is not as strong as that in Japan and Germany, with the actual U.S. deficit on a comparable basis equal to about 3 - 3-1/2 percent of GNP. However, some progress toward fiscal balance has been already registered in the United States, and the trends -- particularly in light of the Gramm-Rudman-Hollings Act -- appear to indicate that further substantial progress can be expected.

Nominal interest rates in the major industrial countries have declined. Between March 1985 and last month, U.S. short-term interest rates fell some 200 basis points; broadly similar declines were recorded in most of the major industrial countries. Long-term interest rates have fallen as well, with the declines -- about 400 basis points in some cases -- in U.S. rates being particularly dramatic. These declines seem to reflect economic fundamentals like lower inflation and inflation expectations and a perception of a change in U.S. fiscal trends rather than overly expansionary monetary policies.

Another positive development, of course, is the ongoing recovery in world economic activity. The U.S. recovery, now in its fourth year, seems set to continue for the foreseeable future. Europe appears to have embarked on renewed economic growth, although in some countries the pace of expected activity still may not be sufficient to lower their exceptionally high unemployment rates. In Japan, policymakers are taking some steps to encourage domestic sources of economic strength to replace the diminishing external stimulus expected as a result of the yen's appreciation.

All is not rosy, however. The fiscal and external imbalances in the U.S. economy, although on improving trends, are still large. The

United States' new position as a net international debtor will make it more difficult to achieve current account balance or surplus since the services account has been weakened by the accumulated effects of past foreign investment in the United States. The U.S. current account deficit is not the only disturbing external imbalance in the industrial world, however. Of particular concern are the substantial and growing current account surpluses being recorded by Japan and Germany. Another concern is the high unemployment rates prevailing in many of the industrial countries, especially Germany. The final problem facing the international community that I want to highlight is the debt-servicing difficulties of many key developing countries.

The first oil price shock

It is useful to look back at the first oil price shock of the early 1970s. At that time, after the first big increase in oil prices, questions were raised about the import capacity of major oil producers and the ability of the international financial system to intermediate large flows of savings from oil producers to ultimate investors. As a matter of fact, the system worked better than the pessimists expected, although not without a world recession, a marked slowing of subsequent industrial country growth, and perhaps too much reliance on bank intermediation of capital flows to developing countries. After a while, oil exporters showed a remarkable ability to consume imports. Oil producers' savings were channeled to industrial countries and, mostly indirectly, to developing countries in order to finance investment and consumption. Moreover, one of the apparent after-effects of the oil shock -- the slowing of industrial country growth even after the initial recession -- probably also reflected other structural problems as much as the new, much higher, world oil prices. Another crucial element in the reaction of the world economy to the shock was the supply and demand response -- delayed in some countries by price controls on petroleum and petroleum products -- to the new relative price of oil. Eventually, as a result of the new market prices, new sources of oil were discovered and developed all over the globe and conservation efforts over time economized on the use of petroleum products.

Today we are faced with the opposite of the situation that we faced in the early 1970s -- a major decline in the price of oil. The questions that must be answered are equally challenging. In particular, what can we expect from the international "recycling" process in response to the decline in oil prices? Will everything just "work in reverse" as an econometric model might suggest? That is,

-- Will industrial country domestic demand replace oil-producer import demand?

-- Will industrial country saving replace oil-producer financial flows?

-- Will oil-producing countries adjust smoothly to their new, lower, standard of living?

-- Will developing countries, particularly those that have been dependent on oil as their principal source of export revenues, reorient their export efforts?

Even if these questions can be answered confidently, or at least bravely, in the affirmative, there remains the question of the transition period involved. That is,

-- How long will the transition period be?

-- What are the economic, social, and political costs involved?

-- What are the responsibilities of policymakers in this process?

Near-term outlook

I would like now to sketch out in broad terms the contours of the world economic outlook in light of the oil price decline. For the United States, the longer-term impact of the drop in oil prices on economic growth and inflation should be favorable, although there will be -- indeed we are already seeing -- important short-term adverse effects on the U.S. oil industry and related activities. The correction in the dollar exchange rate that began last year can be expected to lead to a reduction in the U.S. current account deficit; the oil price developments, by reducing the oil import bill, will accelerate this improvement. As I have mentioned, significant progress is being made in the fiscal area. Reflecting the improved fiscal position as well as better price performance and subdued inflation expectations, U.S. interest rates have eased, thereby reinforcing the positive effect the oil market developments are likely to exert on U.S. economic activity. Also working to boost economic activity will be the stronger business profits that can be expected in most of U.S. industry after a decline in the price of a major input like energy.

Turning to the other industrial countries as a group, and abstracting from the exceptional circumstances of major oil exporters like the United Kingdom, one can expect more-or-less the same kind of scenario as I have just described for the United States, with the differential impact dependent on the degree of importance of net oil imports for a particular country. There is, however, one noteworthy difference between the U.S. and non-U.S. cases. The ups and downs of the dollar alter the effective price of oil in foreign countries even when the dollar price of oil is constant. Thus, the dollar's climb tended to strengthen oil prices in Japan and Europe up through February of last year, when the dollar hit its peak. Since then, the effective oil price in, for example, yen has been falling. Since December the decline has been exceedingly sharp.

With regard to external balances, the drop in oil prices will lead to stronger net exports and current accounts than would have been expected otherwise for most industrial countries. These expected gains will be offset somewhat by oil producers' cutbacks in their demands for industrial country exports. A countervailing pressure on the current account position in many industrial countries, particularly Japan, is the appreciation of exchange rates against the dollar, which, if sustained, will tend to reduce their current account surpluses while strengthening the U.S. current account position. I should point out here that there is no particular virtue in running persistent current account surpluses; belief to the contrary is just a legacy of mercantilism.

Even when the dust is settled and these various developments have worked themselves out, current accounts in the major industrial countries are likely still to be markedly uneven and unsustainable for the next few years. The U.S. current account deficit, although apparently in the process of narrowing, is still expected to be quite large both this year and next. The mirror image of the U.S. deficit is the large and unsustainable Japanese and German surpluses, totaling some $65 billion last year and expected to increase by perhaps $30 billion this year. The international recycling of the financial flows and aggregate demand shifts caused by the oil price decline must take place in this context of a fundamental disequilibrium in the global balance of payments pattern.

Turning briefly to the situation facing the developing countries, the decline in oil prices has a differential impact depending on whether a country is a net oil exporter. The benefits of the oil price decline are diffuse, while the costs to oil-exporting developing countries are large and immediate, especially if a country has few international reserves and a limited international borrowing capacity. Several of the key heavily indebted countries will be hurt badly by the oil price drop, if it persists. Mexico, Venezuela, Ecuador, and Nigeria will be particularly hard hit. On the other hand, there are big "winners," although there are fewer such winners than one might expect because of the development of energy resources, including alternative energy sources, in recent years. Some of the major beneficiaries of lower oil prices are Brazil, Korea, the Philippines, Taiwan, and Yugoslavia.

Regardless of a country's status as an oil exporter or as a debtor, all developing countries stand eventually to gain from two factors related to the oil price movements. The expected increased growth in industrial countries can be expected to boost developing country exports, and lower U.S. dollar interest rates will ease developing countries' debt-service burdens.

Recycling

In general terms, policymakers have two main responsibilities in the recycling process. First, the fiscal and monetary authorities in the industrial countries should be mindful of the need to replace the world macroeconomic stimulus lost by the prospective reductions in demand emanating from the oil-producing countries. Second, policymakers should try to ensure that the resulting new pattern of international capital flows ends up financing worthwhile investment opportunities. As a practical matter, this means that market mechanisms should be relied upon as the primary means of intermediating international capital flows.

In the United States, given the substantial fiscal and external imbalances, care must be taken as to how to maintain aggregate demand sufficient for non-inflationary growth. For the world economy's long-term health, emphasis must be on continuing to reduce the structural fiscal deficit, which remains much too high, while maintaining a responsible monetary policy that does not regenerate inflation expectations. At the same time, private sector demand can be expected to be bolstered by the oil price decline. Moreover, there are policy steps that can be taken to encourage private investment and productivity by making the economy more efficient through such measures as altering the tax code in order to foster more reliance on market allocation of resources. Continued progress in keeping wage increases in line with changes in productivity and the demand for labor will also be helpful.

The recent declines in U.S. interest rates have eased the debt-servicing burdens of the indebted developing countries. An important responsibility of the U.S. economy, indeed all economies, is to maintain open and growing markets for other countries' exports of goods and services. This, of course, is particularly important for the heavily indebted developing countries. In order to service their debts they must be able to sell their exports, and growth in exports is the best way of reducing these countries' debt burdens over time. I personally hope, and expect, the United States to pursue a strong posture against trade protectionism -- including so-called "voluntary" import quotas.

Japan and Germany do not face the constraints that we have in the United States. Their fiscal positions leave room for more economic stimulus; on a structural basis, their fiscal balances are probably in surplus. Also, each is registering a strong and increasing current account surplus, and there is virtually no inflation in either country. Moreover, in Germany at least, there appears to be a great deal of labor market slack. Clearly there is scope for macroeconomic expansion in both Japan and Germany. Increasing domestic demand -- including expansionary fiscal policy measures -- in these two key industrial countries in order to correct their external imbalances as well as to maintain world demand would seem to be useful. Such measures would represent not so much a change in Japanese and German long-term economic policy strategy, but rather an alteration of the timing of policy steps already envisioned. For example, the recently released Maekawa Report, endorsed by Prime Minister Nakasone, details ways in which Japan can reduce its dependence on export-led growth. The measures include stimulating domestic demand and opening the economy to imports. All I am advocating is that these and similar moves be accelerated in light of recent oil market developments, and that increases in Japanese imports include products of developing countries as well as those of industrial countries. In Germany, the second stage of the long planned tax cut, now scheduled for 1988, could be brought forward.

Given their current account surpluses, Japan and Germany by definition have to export capital. How can the Japanese and German governments ensure that their countries' considerable capital exports go ultimately to worthwhile investments throughout the world, not just U.S. government securities? In this regard, closing the U.S. fiscal deficit is important in order to help redirect these capital flows. The authorities could also encourage increased purchases of such alternative securities as World Bank bonds, but the scope for actual governmental direction of the capital outflows is, as it should be, limited.

In general, the industrial countries should be prepared to support the International Monetary Fund, the World Bank, and the other multilateral development banks in their efforts to aid the process of economic adjustment to the new, lower, world oil price. As I mentioned before, it is imperative that the industrial countries maintain open markets for goods, services, and capital flows. Countries hard hit by the oil price developments must be able to increase their sales of non-oil exports. In addition, financial intermediaries in the industrial countries must continue to channel funds between surplus and deficit countries in a sound and responsible manner, taking a longer-term view of profitability.

As for the developing countries -- both oil exporters and oil importers -- the Plan for Sustained Growth put forward last October by

U.S. Treasury Secretary Baker remains valid. Policy emphasis in these countries must continue to be on the structural and macroeconomic adjustments that will establish the conditions necessary for sustainable growth. This approach obviously has been made easier for some countries by the drop in oil prices, while for some other countries it has been made more difficult. Oil exporters with sufficient international reserves and access to credit can take a longer adjustment period. Those with very limited reserves or credit must adjust more quickly, although international capital flows that finance suitable adjustment programs can ease the transition.

Recycling will be as important with oil prices in sharp decline as it was when oil prices were sharply rising. Aggregate demand must be recycled in order to maintain world economic activity. Equally important, capital flows must be recycled in order to support worthwhile investment projects worldwide, to cushion declines in levels of consumption (where appropriate), and to support suitable developing country adjustment efforts directly and through multilateral institutions.

The correction of the current account imbalances in the industrial countries is an essential part of this recycling process. Large current account surpluses or deficits can be manageable, and even useful, as temporary buffers. However, they seldom make sense economically as a long-term policy.

The challenges presented to the world economy by the break in oil prices are difficult, but I think they can be met successfully. The outcome depends on responsible policies in the industrial countries.

The aggregate demand measures that I have outlined would help the individual industrial countries as well as the international economy. Open markets for goods, services, and capital benefit the entire world community. Adjustment in the developing countries, where necessary, is again constructive for both the individual countries involved as well as the global economy. I am hopeful that policymakers will have the vision to meet these challenges constructively.