

**The United States in the World Economy**  
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Good afternoon! I am pleased that this economic outlook conference is concluding with a focus on the United States' position in the world economy. This testifies to how important the international sector has become to the overall performance of the American economy. Rather than focus on current international problems or the near-term outlook, I have the enviable task of speculating about what I think the United States' position in the world economy should be in the long run and suggesting some steps that we need to take to get there. To do so, I'll first try to put the current importance of the international sector into perspective. Then I'll review the factors that contributed to the rising importance of international trade. By way of conclusion I will touch on some of the forces that threaten to delay further progress toward attaining the benefits that come with greater international economic integration and suggest certain measures that seem necessary if we are to enjoy the ultimate benefits that closer international ties can bring.

**Current Importance of International Sector to U.S. Economy**

It has become apparent during recent years that the world is becoming much more integrated economically. The current importance of international trade and investment to the U.S. economy did not develop overnight, as it were. Nor is it limited to the manufacturing and farm sectors even though the most obvious evidence of increasing global economic integration is found in enlarged trade flows of manufactured goods and other tangible commodities among all nations, developing as well as advanced economies. Americans no longer import technically advanced camera and optical equipment only from such advanced economies as Germany and Japan. Consumer electronics and even cars produced in such recently developing countries as Hong Kong,

Korea, and Yugoslavia are now competing with manufacturers in industrialized nations. Moreover, many of the parts for domestically produced cars and other products are being made in countries such as Mexico and Brazil, then shipped to the United States for final assembly. At the same time American farmers have come to rely heavily on foreign markets as a source of growth, and domestic manufacturers have learned how they could expand their profits by concentrating more on exports, not only to Europe but to the less developed countries of the world.

As vivid as these illustrations are in the minds of many Americans, they are not the only or the most important dimensions of the global economic integration we have reached. Services such as international travel, hospital management, and computerized data processing are an increasingly important component of international trade. In addition to trade in goods and services, a third dimension is the growing role of international finance. Commercial banks in the United States have lent heavily to borrowers abroad, and banks from many other countries have set up offices in the United States. More recently, foreigners have helped to make up the shortfall between America's domestic pool of savings and our investment and financing needs, which have been greatly expanded in recent years by huge federal budget deficits. In 1984, for example, the equivalent of one-fourth of our total needs for investment and deficit financing were met by external sources.

### **Why Has the International Sector Become So Important?**

Thus, whether measured in terms of tradable goods, services, or finance, the world's economies have become more interrelated. There are a number of reasons underlying this important trend. Cheaper transportation and communication have certainly played a part. Advances in telephones, computers, and air transportation have fostered more international activity by businesses as well as more foreign travel by

people from all income brackets. Since the 1970s the partial dismantling of exchange controls, together with changes in banking regulations in particular countries, has helped propel a substantial increase in international capital flows. Another key reason for the growing importance of international trade has been the concerted international effort, particularly by the world's advanced economies, to promote free trade by reducing tariff barriers in an orderly and systematic fashion through such mechanisms as the General Agreement on Tariffs and Trade, better known as GATT.

The reason Americans have been pushing for relaxation of tariff and trade barriers and greater economic cooperation among nations is that we learned the advantages of such integration in the earlier stages of our economic development. During the late nineteenth and early twentieth centuries, our nation, aided by the expansion of the railroads, the spread of the telegraph, and reforms of the banking system, evolved from a collection of semi-independent local or regional markets into a unified national economy. The integration of the American economy brought many benefits. Larger markets made it feasible for companies to take advantage of economies of scale. Mass production techniques in turn helped manufacturers produce more goods for a lower unit cost. With the advent of national markets American consumers enjoyed not only lower prices but also a greater diversity of goods. Businesses found new opportunities for sales, not only of existing products but for other goods whose production would not have been profitable in a regional market. The availability of more specialized products and services certainly contributed to America's rising living standards.

Later on, when the Great Depression of the 1930s hit, the United States and other advanced economies learned the costs of a breakdown in these relationships. The Depression taught us and our European colleagues that actions impeding trade and financial flows could be very costly, leading to much lower output, high unemployment,

and a worldwide depression of extended duration. After World War II, particularly during the 1950s and 1960s, the nations of Western Europe moved toward greater integration through the vehicle of the Common Market. At the same time, most advanced economies attempted to enhance worldwide prosperity through GATT, the International Monetary Fund, the World Bank, and other international agreements and organizations. Such institutions were designed to promote freer trade, smooth balance-of-payments problems, and foster economic development in the world's poorest nations. These concerted efforts were motivated by the desire to attain the benefits of greater economic integration among the nations of the world and to avoid the devastating consequences of beggar-thy-neighbor policies.

#### **Potential Roadblocks to Further Progress and Why They Have Been Erected**

The process of attaining these benefits--a wider array of products, lower prices, expanded business opportunities, economies of scale, the advantages of specialization, and higher average living standards--is still going on. However, since the 1970s the path of progress has become somewhat rougher than in the earlier postwar period. In the last decade, for example, many countries, including the United States, began to break from the spirit of free trade by erecting so-called nontariff barriers, providing subsidies to favored industries, and entering into special agreements with individual countries or groups. More recently, protectionist sentiments have become even stronger in the United States.

Several factors--each related to problems the United States faces in the international sector--account for the slowdown in American willingness to progress toward greater economic integration. The first and probably most basic reason derives from the dislocations that typically occur during the transition process. As less developed countries began to achieve the goal of economic development that both

industrialized nations and LDCs have long sought, it was inevitable that the comparative advantage of some industries, particularly those in the lowest wage category, would shift away from the United States and other advanced economies to LDCs. As some firms and workers are confronted with new and much tougher competition from abroad, they find themselves hard-pressed to adapt. It is only human nature to attempt to alleviate this stress in the most painless way, that is, by eliminating the competition, rather than by making the difficult but necessary changes to compete more effectively. This structural factor is not really new, nor is the recourse to protectionism as a measure to alleviate transitional pains. The American textile industry has been protected by quotas for over twenty years now.

However, since 1980 several other developments have exacerbated the situation faced by certain sectors of the American economy. Perhaps the most significant of these was the sharp appreciation in the value of the U.S. dollar over the last five years. The dollar rose some 90 percent, on a trade-weighted basis, from its trough in 1980 to its most recent peak in early 1985. The dollar strengthened in part because of positive aspects of the U.S. economy during this period. These included lower inflation, stronger economic growth than in Europe, and, in general, a better investment climate. However, the dollar's sharp rise in foreign exchange markets was induced primarily by higher real interest rates available here; these high real rates are associated with the very large federal budget deficits we have been incurring in recent years. The government's massive financing needs, along with the expectation that these would continue into the foreseeable future, put upward pressure on interest rates, thereby attracting foreign investors to dollar-denominated assets and, in the process, driving up the foreign-exchange value of the dollar.

As the dollar rose, American consumers and businesses came to rely more and more on less expensive imports. At the same time, U.S. farmers and manufacturers found it increasingly difficult to market their products abroad. By 1985, the third year of expansion, GNP growth slowed dramatically because of this imbalance between the international and domestic sectors of the economy. Moreover, the brunt of this deceleration has been concentrated on a few sectors, most notably agriculture and manufacturing, while services and construction have continued to advance.

Slow economic growth and stubbornly high unemployment abroad have also dampened the expansion of U.S. exports to Europe. At the same time European businesses have become more aggressive in their efforts to export to the United States, in part because their home markets have been so weak. It is true that until recently Japanese growth has been relatively robust. However, this expansion has been driven largely by exports. Domestic demand in Japan is comparatively weak. As a result it has been more difficult for American producers to sell to the Japanese.

Another development contributing to America's current problems in the international sector is related to the very large burden of debt owed by developing countries to commercial banks here. The ongoing solutions to the LDC debt crisis have brought greater stability to the international financial system. These measures entailed rescheduling of debt, increased LDC exports to service their debts and pay for essential imports, tighter fiscal policies, and other measures designed to reduce inflation. However, an indirect result of these measures has been a substantial slowdown in U.S. exports to the developing countries. That deceleration is more important than many people realize because the LDCs had been an important growth market for U.S. exporters.

A final factor often blamed for America's current trade difficulties is unfair trade practices by other countries, especially Japan. This factor is probably less important, however. Many countries including the United States, members of the European Economic Community, as well as Japan employ subsidies, quotas, and product restrictions and regulations which can act as nontariff barriers. Formal limitations on the number of Japanese cars imported into the United States, long safety-related delays in the introduction of pharmaceuticals, and price supports for farm products such as tobacco indicate that the United States' record in this area is far from perfect.

Even if Japan eliminated all such barriers, it is still likely that it would run a trade surplus with the United States because of structural features of the two economies and the composition of their trade patterns. Japanese imports consist largely of raw materials, such as oil, purchased primarily from developing countries. Its exports are mostly manufactured products directed largely toward U.S. markets. Conversely, the United States exports farm products and manufactured goods, largely to Europe and many LDCs. Thus, the U.S. trade balance with Japan tends to be in deficit because of the composition of this bilateral trade flow. Another related factor is the high Japanese savings rate. Since Japanese households consume proportionately less, their demand for imports is relatively smaller. At the same time, the large domestic pool of savings forces portfolio managers there to look abroad for investment opportunities. Furthermore, Japanese fiscal policy has been tighter in recent years than in the United States. Japan's smaller budget deficits augment capital outflows that arise from Japan's high savings rate. Since U.S. savings are relatively lower and our investment and financing needs higher, capital would tend to flow from Japan to the United States, thereby rendering the U.S. current account relationship to Japan one of ongoing deficits.

Thus, trade restrictions imposed by foreign countries are only a minor reason for America's current international trade difficulties and, accordingly, a less serious stumbling block toward greater economic integration. The most important impediments that policy-makers, businesses, and even individuals must address are the transitional problems that accompany any profound economic change, the slow pace of economic expansion in Europe, the debt burden faced by many developing countries that is curtailing their capacity to absorb American exports, and, perhaps most importantly, large U.S. federal budget deficits.

### **Measures to Achieve Further Progress**

Of the various policy options we could employ to deal with these issues, the least effective, in my opinion, is protectionism. Protectionist policies may temporarily mitigate some of the hardships of the transition, but they are likely to retard economic expansion. In fact, they eventually result in slower growth than would be expected in a free trade environment. What's more, they lock certain workers and regions into a lower equilibrium income by postponing their transition from low-wage industries that are most sensitive to import penetration to higher wage industries that are usually in a better position to export. The last point is especially relevant to us here in the Southeast because it implies that average income levels in this region will remain below the U.S. norm if we follow the course of protectionism.

To achieve both goals of correcting current imbalances and achieving higher long-run growth and prosperity, the United States must adopt public policies and private sector practices that get us back on the road to greater international trade and economic integration. Certain developments should also make the process somewhat easier, and some useful measures have already been initiated that could help deal with problems in the medium-term. First, the dollar has fallen over 20 percent on a trade-weighted basis

since its peak in February 1985. The effects of the dollar's decline should begin to become manifest in trade flows this year. In addition, recent initiatives supported by Federal Reserve Chairman Volcker and Treasury Secretary Baker could help improve the LDC debt situation. Essentially, this initiative calls for commercial banks to increase their lending to the most heavily indebted LDCs so that these nations can make necessary investments that will help them achieve faster growth, retire their debt, and eventually absorb more U.S. exports. This initiative also calls for European and Japanese governments to generate greater domestic demand by adopting more stimulative fiscal policies. If our colleagues in the advanced economies agree to these proposals, they could help our international situation not only directly by consuming more U.S. goods but also indirectly by taking a greater share of LDC exports, whose absorption has fallen largely to the United States in recent years. Another policy already in place is the Gramm-Rudman amendment, which holds the promise of deficit reduction between now and 1990. This Congressional action to address one of the major factors underlying our current trade difficulties is a clear step in the right direction. However, at this point it is only a promise to reduce future deficits. As voters, we must keep our representatives in Washington aware of our strong desire to see deficit reduction carried out.

I support all these recent initiatives--the G-5 accord, new lending to LDCs, an increased role for other advanced economies in propelling world economic growth, and Congressional action on the deficit. However, even if these initiatives succeed, we still face problems associated with the long-term transition of our economy. In this sphere, public policy makers must be careful to avoid quick-fix remedies that could make the situation worse in the long run. We must eschew protectionist measures and instead formulate domestic policies that will help workers move into growth industries. Such policies may require greater investment in education and training and thus increased government expenditures at the very time when we are trying to reduce the gap between

spending and revenues. However, such human capital investment will, I'm sure, pay off in lasting benefits not only to the workers involved but to the nation as a whole.

The private sector must also take on additional responsibilities. In particular, American businesses need to put more emphasis on exports. To do so will necessitate a longer-term perspective than many companies now utilize. Establishing international trade relations can be a lengthy process, and fluctuations in foreign political as well as economic conditions can threaten these relationships in the short run. However, this task is not out of the reach of American corporations, including our many small businesses. Europeans have long known the importance of foreign markets and learned the attitudes that are necessary to sell abroad successfully.

Finally, the puzzle of slow productivity growth in the United States must be solved in order to ensure continued increases in American living standards. We have made some progress thus far in the 1980s thanks to increased investment by American businesses and, ironically, to the intensified pressures from foreign competitors. Cheap imports spurred American workers to relax their wage demands and encouraged U.S. managers to make necessary changes in production techniques. As the lagged effects of the dollar's decline begin to be felt and if some investment incentives are eliminated in our efforts to reduce the federal budget deficit, we must all work to maintain productivity advances as a top national priority.

### **Conclusion**

I began my remarks this afternoon by reviewing the U.S. position in the world economy--how it has evolved in recent decades and where it seems to be headed. As we've seen, the American economy is already firmly linked to a global marketplace. Since World War II, we, along with many other nations, have been moving toward more

international trade and increased economic cooperation. We launched ourselves on this course because of the many advantages of a more integrated world economy. However, this trend means that the international sector has come to play a much larger role in the American economy than it has in most of this century. This importance became painfully apparent last year when, despite the vast size and strength of our domestic markets, imbalances in the international sector led to much slower growth.

Right now we seem to have been driven off our course toward greater international economic integration. Some are suggesting that we take a new tack, one that I'm afraid could ultimately reverse many of the gains we've achieved over the last 30 years. I believe we must recommit ourselves to this international policy goal and formulate measures that will help us through the medium-term problems we face—workers displaced by foreign imports, reduced exports due to heavy LDC debt burdens and slow growth in other industrialized nations, and, to a lesser extent, unfair trade practices that restrict the expansion of international trade. Certain developments and initiatives that I've reviewed this afternoon should facilitate this process. I believe the U.S. economy will be strengthened considerably over the longer term if we give our full support to these proposals, particularly to Congress' long-delayed response to the issue of unacceptably large federal budget deficits. However, we must also do what we can as individuals in business, in the media, and in the public sector to promote other measures, such as greater emphasis on productivity and on exports, that will advance America's position in the world economy. The benefits of increased international cooperation are within our grasp; we need only the wisdom and perseverance to attain them.