THE INTERNATIONAL ECONOMIC AND MONETARY SITUATION
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I. Introduction

A. The three main international economic issues as I see them involve the currency system, protectionism and other impediments to world trade flows, and LDC debt.

B. These are all, of course, interrelated but I think each one has it own unique dynamics and importance.

II. Changes in the **foreign exchange system** are a source of concern and confusion.

A. First, with regard to the considerable currency realignment we've had, confusion arises from the fact that our foreign trade deficit has not diminished to the extent many anticipated when the dollar began to fall a year and a half ago.

1. One reason is that currency realignments affect trade flows with a lag, though many people expected more of a response by this time.

2. This unexpected delay can be explained in part by the increasingly prominent roles played by the Asian nations of Taiwan, South Korea, and Hong Kong, which together accounted for $24 billion—or 16 percent—of our $149 billion deficit in 1985 and by the fact that against their currencies the dollar has changed very little, whereas since February 1985 it depreciated some 40 percent against the yen and by almost as much versus the Deutschemark, the traditional benchmarks.

3. Similarly, the U.S. dollar has actually appreciated slightly against the Canadian dollar. Our trade deficit of $22 billion with Canada in 1985 was roughly 15 percent of the total.

4. Thus while we might hope for some improvement vis-a-vis Japan, which accounted for about one-third of our 1985 deficit, and Germany with about 8 percent, it is unclear how much improvement we can expect, especially in the near term.

a. Certainly the latest U.S. merchandise trade numbers are not encouraging.

b. On the other hand, the situation with Taiwan could improve somewhat.

(1) Their enormous foreign exchange reserves of $32 billion garnered from continuing trade surpluses continue to exert

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downward pressure on the dollar relative to the taibi ("Tie-bee").

(2) Anecdotal evidence suggests that prices of Taiwanese manufactured goods may rise as well, since factories are flooded with orders as Japanese firms, pressed by greater production costs at home, compete with other foreign purchasers for factory output.

B. A second currency-related issue concerns the entire system and especially whether we should stick with floating rates or return to a fixed-rate system.

1. To some the large trade and current account deficits have raised the specter of an uncontrolled "free fall," a prospect that I consider unlikely but certainly a cause for concern.

2. Nor do I view present developments—or recent volatility of exchange rates—as reasons for returning to a gold standard or to the type of fixed exchange system employed until the breakdown of the Bretton Woods arrangement in the early 1970's.

3. Experience, as well as economic theory, has taught us that free markets, or even relatively free markets, adjust better to shocks than bureaucracies do.

4. Nonetheless, I find merit in proposals to intervene when necessary to keep exchange rates within fairly wide "target zones" so that they do not become grossly misaligned.

III. The second major issue has to do with **trade flows**.

A. World trade patterns show some serious imbalances, with large U.S. deficits matched by excessive surpluses in other countries.

1. One solution is for Europe and Japan to stimulate their domestic economies toward the end of providing better markets for goods from other countries and thus maintaining or strengthening worldwide growth.

2. Despite the decline of the dollar, sluggish demand in those two areas has frustrated growth of U.S. exports to them.

3. It is noteworthy that the last two cuts in central bank discount rates have been made unilaterally by the United States, a departure from the unified actions taken earlier in the year.

4. Even should such stimulative measures be taken, however, it is unlikely that our relationship with Japan in particular will change dramatically.

a. An island nation short on natural resources, Japan is dependent on imports of oil and raw materials.

(1) These it buys from the LDC's, running a trade deficit with those countries in so doing.

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(2) In order to maintain the surplus necessary to pay for these bilateral deficits with LDCs, Japan exports manufactured goods to advanced economies especially.

b. There are also financial flows that parallel the trade flows and these cannot be corrected simply by currency changes but involve underlying policy, particularly fiscal policy.

(1) Japan has a surplus of savings

(a) With a population over half that of the United States crammed into an area about the size of Montana, and a largely mountainous area at that, Japan lacks the physical space to support the type of consumer economy based on expansive suburban dwelling we enjoy in this country.

(b) Cultural and demographic patterns there make it necessary for individuals to save for their retirement creating a high demand for savings instruments.

(2) Meanwhile, the U.S. has been increasingly in need of savings to meet its investment and financing needs because U.S. consumers have a lower rate of savings and deficit spending by the federal government in the 1980s has increased our financing needs enormously.

(3) As a result, in the past few years, nominal interest rates on Japanese bonds have been consistently lower than yields in the U.S. Recently, the gap between yields on U.S. treasuries and Japanese government bonds has been about 2 percentage points. Not surprisingly, the better yield, good security and enormous liquidity of U.S. treasuries have attracted the concerted attention of Japanese institutional investors.

(4) The resulting capital flow from Japan to the United States is the counterpart of a significant portion of the U.S. trade deficit with that country.

(5) Thus a change in America's savings habits and a reduction in our large government deficit as well as a currency realignment will be needed to improve our trade balance and even then there are limits to the amount of improvement we can hope to achieve given that country's need for imported raw materials.

B. **Protectionism.** Concerns over the trade deficit have led to emotional calls for new tariffs to protect American industries from what is viewed as unfair competition.

1. It is thought by some that the cause of our imbalance in trade lies in protective measures abroad which stifle U.S. exports and in subsidies used by foreign governments to lower prices of goods produced in their factories.

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2. Certain industries, it is true, suffer directly from protective measures abroad, our agriculture being a case in point.

3. The hard reality remains, however, that by erecting trade barriers aimed at shoring up particular industries, one engages in an inevitable spiral of retaliatory measures from countries whose export trade is hurt by the original rise in duties. In the long run, consumers across the board bear the cost in higher prices for the initial effort to protect.

4. In response to the call for protection, we would be better served as a nation to adopt measures designed to improve productivity of domestic industries and ease the strains of adjustment away from industries in which an advanced economy like ours is losing its comparative advantage to developing nations whose cost structures are lower.

   a. In fact, we have been moving in that direction for some time:

      (1) overall manufacturing has remained a fairly constant 43 percent of GNP, but fewer workers are needed in the process.

      (2) In this way we are becoming in effect more productive.

   b. At the same time, the service sector is growing as the economy makes its transition from activities that were most efficient for our labor force to perform previously to those which make the most sense in the current environment.

   c. In a market economy, such change is a recurrent pattern and not something we should face with trepidation.

   d. The services we perform are of value as exports, especially the scientific and technical expertise at which we continue to excel.

   e. What we can ask of our trading partners is that they protect our rights to intellectual properties through increased vigilance over copyright and patent infringement. This would allow a significant share of what we now "export" without reward to be compensated.

5. Another hopeful sign on the trade front is the new round of GATT

   a. Although nonmarket economies pose special challenges to the very essence of GATT's free trade principles, I look with enthusiasm on the efforts of nonmarket economies like China and the U.S.S.R. to be included in these talks.

      (1) China will participate in this round as an observer but is seeking full membership status in the future, and the Soviets are examining the prospects of joining the treaty group.

      (2) The broadening of GATT should lay the groundwork for advancing trade on a global basis.

   b. More importantly, the agenda for this meeting should include:

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(1) the subjects of services and intellectual properties mentioned a moment ago

(2) the widespread subsidization of agriculture that is contributing to worldwide surpluses and depressed farm prices

(3) the future of several countries currently enjoying the status of LDC but which no longer require special exemptions in light of their recent development.

IV. **LDC debt**—for some countries remaining in the "Less Developed" category, the question of their inordinate external debt must be addressed as one of the major international economic issues.

A. In my opinion, no crisis looms

1. In the case of Mexico, which carries the most serious debt problem, recent strategies advanced by the IMF and internal efforts to restructure the economy suggest that other countries in similar straits should be able to make accommodations.

2. While low oil prices continue to hurt Mexico, other LDC's with debt burdens—Brazil, for example—benefit from lower energy costs coupled with current low rates of interest.

B. However, these countries need to grow in order to absorb the American exports that could raise their productive capacity and satisfy consumer needs.

1. 25 percent of world trade involves the LDC's—a portion without which the global economy would contract to the detriment of all.

2. Indeed, the loss of large shares of Latin American markets due to inability of citizens there to purchase our goods has hurt our trade balance in a way that is often unreported due to concentration on Asian and European competitors.

V. Conclusion. Constant vigilance is as much the price of a free market as it is of a democracy.

A. Vigilance, rather than regulation, should maintain balance in the currency system and allow the market, the best arbiter we know, to continue setting exchange rates.

B. Policy actions on LDC debt have already returned a measure of stability to what had been a near crisis, and I expect our attention to the situation to remain taut.

C. Finally, the international market calls for vigilance against the sentiment of protectionism that would inevitably erode the relatively open commerce which has raised standards of living around the globe during the post World War II era.

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