

THE INTERNATIONAL ECONOMY: CURRENT CONDITIONS AND FUTURE OUTLOOK
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Good afternoon! As all of you are well aware, the world is increasingly becoming a single marketplace. This shift toward greater economic integration poses certain challenges, but it also offers enormous opportunities for higher living standards for people in all countries. So, I am delighted to have a chance to discuss current international economic conditions and the future outlook. I'll have a few remarks about what this outlook implies for the pulp industry. By way of conclusion, I'd like to raise some important issues facing the world economy. When I've finished, I'll try to answer any questions you might have.

Economic Performance in 1985

As we survey the world economy in 1986, it seems appropriate to begin with the United States because of our leading role as an "engine of growth." U.S. economic growth this year has been marked by imbalances. GNP expanded at a rapid 3.7 percent pace in the first quarter and then slowed to 0.6 percent in the second. Progress toward reducing unemployment was slow especially during the first half, though the unemployment rate did fall to 6.8 percent in August, marking the second month it has been below 7 percent. On a more positive note, inflation proved to be milder than expected. In large part because of declines in oil prices, consumer prices actually fell for several months and, as of July, the CPI was up less than 2 percent from its level a year earlier.

Far more troubling than the uneven economic performance of GNP or the CPI

from quarter to quarter and month to month are the imbalances among sectors of the economy. Consumption remains strong, and residential construction is growing at a healthy pace. On the other hand, the energy industry, along with those sectors that are most exposed to international trade--farming and manufacturing--have suffered adverse effects more serious than these macroeconomic indicators reveal.

The imbalance between the international and domestic sectors can be traced to the demands of a large federal deficit, which made people believe that U.S. interest rates would remain high by past standards. These expectations attracted foreign investors to dollar-denominated assets. This strong international demand for dollars drove up the value of U.S. currency on foreign exchange markets. By February of last year the dollar had reached a point almost 90 percent above its 1980 trough, on a trade-weighted basis. Because of the dollar's high value, much of the growth in consumer purchases, as well as that of business investment in equipment, was met by foreign suppliers. At the same time, American farmers and manufacturers found it increasingly difficult to sell their products abroad because their prices to foreigners were much higher. Although the dollar has been declining steadily and substantially over the last year and a half, our trade deficit remains at record levels. Some lag was expected before the trade balance improved, but the length is somewhat surprising.

One reason we haven't seen a turnaround in the U.S. net export position despite the dollar's more than one-third drop against the currencies of Japan and Europe is that economic performance elsewhere in the world has remained slower than in the United States. In fact, GNP fell in the first quarter in a number of advanced economies, though activity did pick up in the second quarter, at least in Germany and, more modestly, in Japan. Despite these more positive second quarter indicators, however, growth in the other advanced economies has been sluggish. Probably the main reason for such

performance is that, in contrast to the United States, domestic demand in Japan and Europe has been weak. Fiscal policy has not been stimulative even though inflation has been moderate and unemployment rates are stubbornly high in many European countries. In Britain, Holland, and Belgium, 1986 is likely to be the fifth straight year of double-digit joblessness. France's unemployment rate has been rising for several years and as of June stood at 10.7 percent. In West Germany, unemployment has remained around 9 percent since 1983.

Less developed countries, or LDCs as they are often called, have also experienced moderate growth thus far in 1986. Their diversity renders an average somewhat meaningless, but it is clear that debt restructuring and repayment problems have not yet been resolved. Still, some countries are doing much better. In Brazil counter-inflationary measures have proven successful, and growth is quite healthy. In many Latin American nations, in fact, the decline in interest rates has been a real boon. On the other hand, the drop in oil prices is having a devastating effect on some oil-exporting LDCs like Mexico, Nigeria, Ecuador, and Venezuela.

Outlook

Turning to the future, I think that there are several factors that warrant optimism. In the case of the United States, inventory replenishment should give the economy a boost in the third quarter. One reason recent data for the second quarter shows very slow growth is that inventories were cut sharply. While that news was bad for the past quarter, its future implications are positive. Factory managers and retailers have drawn inventories down to very low levels. Thus any increase in demand is likely to be passed through to production quickly, and I think that such demand will come.

Consumer spending is another source of strength. Recent figures have looked

quite strong, and the prospects seem good for that trend to continue, though at a more modest pace. Even though GNP rose at only 0.6 percent in the second quarter, personal consumption expenditures were up by nearly 6 percent. The drop in oil prices that has been so painful to the oil patch has bolstered household discretionary income nationally. As people spend less on gas and oil, they increase purchases of other goods like housing, furniture, cars, and a variety of services. I look for sustained and reasonably good growth in consumer spending.

What accounts for the disparity between rapid gains in domestic demand and very little advance in overall output is that the trade deficit worsened. The continuing sluggishness of demand in our major trading partners has been a major cause of our worsening trade deficit. In addition, with the decline in energy prices, oil imports have picked up, making our trade balance worse despite the dollar's depreciation. It will take time for the drop in the dollar to bring relief to U.S. manufacturers and farmers. Some delay in the economy's response to a lower dollar is to be expected since an upturn in net exports typically follows a currency depreciation or devaluation only with a lag. Because the dollar price of imported goods rises while that of exported commodities remains unchanged, the trade deficit initially worsens, especially for trade flows covered by past contracts. Later the volume of imports slows in response to price increases, and the amount of exports rises as American goods become cheaper abroad. Still, we don't have to wait until exports begin surpassing imports again to see a rebound in GNP. Even if the trade deficit merely flattened, its drag on overall GNP growth would be reduced and the pace of expansion would accelerate. For instance, if the trade deficit had not worsened from 1984 to 1985 but merely stayed the same, albeit quite large, GNP growth would have been 1 1/2 percentage points higher last year. When we add up these current strengths and weaknesses, the balance suggests that economic growth in 1986 will be respectable. In addition, the pace of expansion should pick up in 1987.

Europe's growth during the remainder of 1986 should be a little higher, though on average this year might fall below last. However, 1987 should bring a further resurgence. Germany especially could accelerate. One favorable factor for many European nations is the oil price declines. Since energy costs affect so many economic activities and Europeans lack the domestic energy resources that favor the United States, the reduction in oil prices is especially significant. The factor determining whether or not Europe gains momentum is fiscal policy. Measures to cut personal taxes and to increase business investment would fuel domestic demand and thus offset the effect of slower export growth. This, in turn, would also help to correct the U.S. trade imbalance.

Japan's economy may not rebound as much, however, because of its more constrained consumer sector and its relatively small unused capacity. Unemployment, for instance, is only 2.7 percent. As in Europe, changes in fiscal policies in Japan have not gone beyond the talking stage. Moreover, there are fundamental factors that engender a high savings rate and relatively less consumption in that island nation.

Non-oil exporting LDCs should gain strength especially in 1987 as the industrial nations of the world rebound. LDCs depend heavily on advanced economies to absorb their exports. Lower interest rates, the drop in oil prices, and progress toward reducing inflation and restructuring their economies toward a greater role for markets are additional favorable factors that underlie this outlook. However, oil-exporting developing countries such as Mexico and Venezuela are likely to continue to have problems at least until the price of oil stabilizes. Still, the progress toward averting an economic crisis that has been achieved thus far is encouraging. Mexico has joined the General Agreement on Tariffs and Trade, agreed to liberalize import restrictions, reduced or eliminated many subsidies, eased foreign investment procedures, and started

plans to sell or close many state-owned enterprises. I hope Mexico's response to this extremely difficult situation will prove an example to other developing nations, and I think it will if we in the industrialized world do our share in resolving some important issues. Before I discuss these, though, I'd like to turn briefly to what this outlook implies for the pulp chemicals industry.

Implications for Pulp Chemical Producers

Your industry is very much an international one, as you well know. The source of the chemicals you produce is ultimately wood, and despite America's vast forest lands, there are important foreign competitors, especially Canada and Sweden. U.S. pulp chemical exports to Europe and Japan, both major markets, should improve as a result of the dollar's one-third decline against most Europe currencies and 40 percent drop against the yen. Moreover, the fact that the dollar has also declined by more than one-fourth versus the Swedish krona also suggests that America's competitive position vis-a-vis Sweden, a major supplier to the European market, will improve. Unfortunately, there has been virtually no currency realignment between the American and Canadian dollars. In fact, the U.S. dollar has actually appreciated slightly since February 1985. This fact indicates that competition will remain keen over the near term.

In the longer run, the pulp chemicals industry will be affected by several developments. Increased competition is likely to come from third-world producers like Brazil. Another important change will be in the area of technology. Countries like Finland have already made strong advances in this realm. Although energy prices recently have plummeted, efficiency in controlling energy inputs, which constitute a major share of pulp production costs, will no doubt have a major impact on profitability and worldwide success. Finally, the long run outlook of the pulp chemicals industry, like that of an increasing number of companies, will depend on how well the world's advanced economies solve some fundamental problems.

Issues and Problems

One such problem is the debt that continues to burden many developing countries as well as U.S. financial institutions. The substantial decline in interest rates that we have already experienced makes it easier for indebted countries and their lending institutions to restructure and service this debt. However, the decline in the value of the U.S. dollar will make exports of some developing countries whose currencies are not pegged to the dollar more expensive to Americans. LDC earnings and growth could decline as a result. I am hopeful that America's colleagues among the industrial nations can help take up the slack that may develop in LDCs' export markets. The economic fundamentals are in place for such a transition, but Europe and Japan have not exhibited the political willingness to absorb a larger share of LDC exports or even to sustain a reasonable level of domestic growth by stimulating domestic demand.

The LDC debt situation is a matter of concern for several reasons. First, servicing this debt is exerting considerable drag on the economic growth of developing countries. Debt service is consuming about one-fifth of the value of products that these countries are exporting. Consequently, LDCs are able to import less equipment and other products that they need to carry out their development plans. In addition, the austerity measures that were imposed by these countries in exchange for International Monetary Fund (IMF) loans during the past several years have lasted longer than leaders and citizens of these countries expected, and they are feeling increasingly frustrated with the stalled progress in resolving the debt problems and raising living standards through economic development.

Aside from the hardships imposed on citizens of LDCs, this debt poses serious threats to the continuing stability of the international financial system. The huge size of

the financial institutions involved, the concentration of their foreign loan exposure to a small number of countries, and -- in a few cases -- their precarious balance sheet situation suggest that serious problems in one or two countries or institutions could send shock waves through the entire international financial system. Although substantial progress has been made since 1982 toward resolving the debt crisis and the problem at present does seem well contained, the recent sharp drop in oil prices adds a new element of concern. The reduction in export earnings due to the fall of oil prices is exacerbating the problems faced by Mexico and other oil-exporting LDCs and their creditors.

A second major international issue confronting us is the currency system and the present alignment of the world's major currencies. From a system of fixed exchange rates that endured for almost thirty years, we have shifted the financial basis of international trade and investment to a far more flexible system based on floating exchange rates. The system has worked fairly well since its inception in 1973, but in the past five years certain problems such as volatility and trade imbalances have become more severe. Some people have begun to suggest that we should abandon the system of floating exchange rates adopted in 1973 or at least introduce restraints on this system that would prevent currencies from deviating so sharply.

Recognizing that the misalignment of currencies and associated imbalances in the U.S. economy could have serious repercussions on economic growth elsewhere, the world's five leading open economies--France, Germany, Great Britain, Japan, and the United States--promulgated the G-5 accord last September to extend the dollar depreciation that had already occurred in 1985. Through a combination of intervention in foreign-exchange markets and changes in domestic policies designed to narrow the interest-rate differential between the United States and the other four signatories,

substantial progress was made in lowering the dollar even further. It's not clear to me that seeking further dramatic declines in the value of the dollar would be the best way to narrow the huge trade and current account deficits that the United States has been incurring in the last several years. The ultimate inflationary effects could be troublesome here, and, if unaccompanied by offsetting policy changes, could lead to much slower growth among the world's other advanced economies. Such a further slowdown there would no doubt have repercussions among the export dependent LDCs, and the effects of that would ultimately be felt among America's financial institutions. In my opinion, the best long-run approach to easing world trade imbalances would be based on greater fiscal stimulus in other advanced economies to spur their domestic demand, reduced federal deficits in this country, and a heightened orientation by U.S. business and financial institutions to the growth potential of foreign markets.

A final problem is that of trade barriers. It seems as though we've reached a plateau in the progress we've made since World War II toward freer trade. Japan has done fairly little to open up its financial services to outsiders despite official affirmation of such a policy. European countries have numerous trade restrictions and nontariff barriers that seem designed to keep out such growth industries as insurance, data processing, and other services in which the United States has an edge. The U.S. record on this score is by no means perfect. We place quotas on foreign-made cars, textiles, and sugar, for example. Our extensive consumer product regulation is viewed by some competitors as a nontariff barrier. Beyond what already exists, recent legislative proposals could greatly increase protectionist barriers in this country if enacted. That would indeed be cause for concern. If current shortsightedness led the United States and other countries to repeat the beggar-thy-neighbor policies that helped thrust the world into depression during the 1930s, the outlook for economic growth here and around the

world would be seriously compromised.

Policy Implications

Although the three issues that I've raised--LDC debt, currency alignments, and trade barriers--do not lend themselves to easy solutions, several recent policy proposals, along with the generally positive prospects for the international economy promise at least short-term improvements. This could allow some breathing space to formulate and implement long-term structural solutions. With regard to LDC debt, the recent proposal, supported by both the Fed and the U.S. Treasury, that American banks increase lending to the most heavily indebted LDCs is an important step in the right direction. By fostering faster growth, increased lending would obviate the need for developing countries to reduce imports unduly, impose severe fiscal restraints, and undertake other extreme belt-tightening measures. In addition, this initiative's call for developing nations to make structural economic changes that would place more reliance on the private sector should address the inflation problems besetting many developing countries, whose excessive dependence on the public sector has tended to worsen inflationary pressures. Another inflation-fighting aspect of this proposal is its call for LDCs to discourage protection of domestic industries, a move that would open up internal prices to more competition.

On the subject of currency alignments, I would strongly object to a return to fixed exchange rates. Experience, as well as economic theory, has taught us that even relatively free markets adjust better to shocks than do bureaucracies. Nonetheless, I find some merit in proposals to intervene when necessary to keep exchange rates within fairly wide "target zones" so that they do not become grossly misaligned. However, adhering to such zones will require greater coordination of fiscal and monetary policies

on the part of the world's advanced economies. Moreover, the United States will also have to undertake other fundamental changes, such as boosting productivity and increasing our pool of funds available for domestic investment and financing needs by reducing the demands of the public sector and increasing personal savings.

Finally, with regard to the issue of trade barriers in the United States as well as other advanced countries will have to adopt measures designed to ease the strains of adjustment for those employed in industries in which advanced economies are losing their comparative advantage to lower-cost developing nations. I wish I could give you two or three easy solutions along these lines. Unfortunately, I don't know of any panaceas. A more neutral tax system would be a good starting place. However, the tax reform package we seem likely to get looks like it will discourage some types of investment. I want to point out, though, that much of the investment we've had in the 1980s has been in offices, hotels, and similar structures. Their supply far exceeds current demand, and so tax reform to remove this distortion in investment funds is really for the best. I hope that under the new system we will see more investment in equipment.

Whatever other measures we adopt to help distressed industries and their workers must be designed to promote necessary changes while bringing immediate relief to those in need. We must avoid the situation that we have in many agricultural programs where policies to aid troubled farmers don't provide income sustenance directly to those most in need but instead work through price mechanisms, often bringing added revenues to already prosperous and efficient producers and in so doing foster excess production, lower prices, and more problems in the long run. Aside from specific transition measures, somewhat faster economic growth would be a boon because it would provide more opportunities and greater rewards for workers who have realized the need to make

career changes and have begun to work toward this end.

In addition, these transitional measures ought to be supplemented by international negotiations to redirect the course of international trade toward greater economic integration and cooperation. A key measure I would like to see adopted is the incorporation of services into GATT--the General Agreement on Tariffs and Trade--since this sector is one in which the United States often has a strong comparative advantage. The plethora of nontariff barriers in advanced economies needs to be rolled back. Finally, the rapidly industrializing developing nations need to do more to apply the rules of GATT to their own commercial policies. The last is especially important in view of the fact that some of these countries are generating large trade surpluses and yet their currencies have not appreciated relative to the dollar as the yen, Deutschemark, and other advanced economies' currencies have done in the last year.

Conclusion

Summing up the international outlook, I believe that the United States economy should rebound in the months ahead and that we will see definite gains in some of our troubled sectors. Global economic performance should follow suit, especially in 1987. The significance and complexity of the longer-term and more fundamental issues that I've outlined should not be underestimated. Nonetheless, I am heartened by some of the recent policy initiatives to address these problems and by the growing public awareness of the importance of international trade and finance.