

THE INTERNATIONAL ECONOMIC SITUATION
Outline of Remarks by Robert P. Forrestal, President
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To the Atlanta Consular Corps
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I. Introduction

- A. It's a pleasure to have an opportunity to speak to representatives of Atlanta's international community at a time when the international economic situation occupies more of our consciousness on a daily basis.
- B. Today I'll give you an overview of the current international economic situation and the outlook for the year ahead, beginning with the United States and then turning to the other major industrialized countries as well as the developing nations. By way of conclusion I'll discuss some of the international issues which will affect all of us.

II. Economic Conditions and Prospects in the United States

- A. In the year ahead, I look for a continuation of last year's performance as measured by the major economic indicators.
 - 1. GNP again 2 1/2 percent
 - 2. Unemployment, which has held steady at 6.7 percent for three months after holding around 7 percent for most of 1986, may fall only a little bit further if at all.
 - 3. Inflation, with rise in import prices occasioned by dollar's decline and without benefit of oil price reductions may reach 4 to 4 1/2 percent compared to just 1.9 percent on an annual average basis last year
- B. My expectations of moderate growth are based largely on international developments because the other major components of GNP—consumption, investment, and government purchases—don't look all that promising.
 - 1. I don't think consumption will be weak, but neither do I expect it to be the stimulus to the economy it has been in recent years.
 - a. Debt may be high, but so are assets; the consumer has rising net worth deriving from gains in the stock market and home values in most markets.
 - b. But our very low savings rate makes further increases in consumer spending unlikely.
 - 2. Investment can't be expected to lead growth either.
 - a. Will be aided by inventory rebuilding; there was considerable drawdown of inventories in the last quarter of 1987. That cleared inventories and set the stage for resumed production growth this year.

- b. Still, business investment, particularly in structures like offices, along with multifamily residential construction is hobbled by excess supplies and new tax provisions.
- 3. Government deficits are on a downward slope, thankfully, but this means less fiscal stimulus than in the past.
- 4. This leaves us net exports as the only potential engine for growth. It is an uncertain source for growth, but one I believe will materialize.
- C. Since we pin much of our forecast for growth on international trade, let's examine the prospects for America's major trading partners.

III. Conditions and prospects for other major industrialized nations.

- A. Canada, which sends 4/5 of its exports to the United States, is particularly sensitive to our economy.
 - 1. Canadian dollar is now rising against ours, making Canadian goods more expensive on our market. Ironically, that could help Canada by forestalling protectionist sentiment here, perhaps the main threat to continued growth in their economy. Progress in recent trade talks encourages me that the issues between us can be resolved reasonably.
 - 2. Assuming progress continues, Canada's recent pattern of moderate growth, which came in at around 2 percent last year, should be maintained.
 - a. Unemployment should hold at under 10 percent.
 - b. Inflation, which has fallen below 4 percent may accelerate due to recent wage gains. The rise in the Canadian dollar might be expected to help keep their inflation moderate.
- B. The pace of West German growth, a decent 2.5 percent in 1986, seems to be weakening, and a minor recession is even possible.
 - 1. The cause is the rapid appreciation of the Deutschemark against most currencies other than the yen.
 - 2. Germany, heavily dependent on exports, is hurt by rise in DM.
 - 3. One positive aspect of rising currency is low domestic inflation, and Germany actually had deflation—overall fall in prices.
 - 4. Unemployment, which has fallen below 9 percent, is still high by their standards, and I am pessimistic about improvement, given the currency situation.
 - 5. The tax-cut plan aimed at stimulating domestic consumption will likely remain unsettled during the state elections scheduled over the next seven months. This effort could have far-reaching effects, but not in the near term.

- C. Japan's position similar to Germany's--rising value of the yen contributing to sluggish growth at around last year's pace of 2.5 percent, higher unemployment, and price deflation.
 - 1. Lagged adverse consequences of the strong yen hurts them particularly when competing against the other Asian nations, who have had only minor currency gains, but Japan can still compete because of its edge in quality, technology, and productivity.
 - 2. Further, the strong yen combined with the lower price of oil, especially in yen terms, has led to price declines or deflation, rather than inflation, in Japan.
 - 3. I foresee continued growth for Japan because there will still be foreign markets for their goods, and they have made some, if provisionally minor, moves toward domestic demand stimulus. Clearly, however, their growth itself will not be a locomotive pulling along US growth.

- D. Britain should enjoy moderate growth in 1987, perhaps as high as 3 percent in GNP, but unemployment and inflation will remain high in comparison to other advanced economies.
 - 1. The recently announced budget represents prudent rather than expansionary fiscal policy.
 - 2. Upturn in oil prices has lifted sterling. High currency values will hurt competitive position of British industries.
 - 3. Unemployment remains over 11 percent and will probably not improve.
 - 4. Inflation, at around 4.5 percent last year, should be reduced if the pound continues its present strength.

- E. Growth in France has been and should continue to be positive but slow, on the order of around 2 percent.
 - 1. This has not been enough to keep the unemployment rate from continuing its steady rise. It is now nearly 12 percent, and I don't foresee relief soon, especially as the franc's rise against the dollar and many non-European currencies leads me to expect only moderate growth at best.
 - 2. The bright side is the dramatic lowering of France's once high inflation rate to levels comparable to that in the U.S., helped by the rising franc and last year's decline in oil prices.

- IV. Among the less developed countries, the outlook is clouded by massive debts and repayment difficulties, exemplified most dramatically by recent events in Brazil
 - A. Brazil, which was held up as a beacon of hope in last year's darkening picture, is now in default.
 - 1. After years of austerity, which meant among other things cutbacks in imports, under political pressure Brazil increased demand last year and

was able to return to rapid real growth.

2. However, higher demand increased imports from the artificially low level, which had enabled it to meet its interest payments in preceding years.
 3. But higher imports narrowed Brazil's trade surplus, which in turn forced Brazil to draw down its foreign exchange reserves sharply, until most of foreign interest payments had to be suspended
- B. More recently an earthquake disrupted Ecuador's oil exports, that is, two-thirds of its total exports, raising another foreign exchange problem
- C. Will other major debtors follow this pattern of default?
1. I think not. We have not as yet seen any evidence that they will.
 2. The overall LDC debt situation has not changed much. It is still relatively stable insofar as we seem to be closer to neither a full resolution nor a systemic crisis, but this doesn't give hope for much growth in that part of the world.
- V. In general, I see the outlook for the world's economy as promising modest growth but also bearing several weighty issues that could, if unattended, arrest or reverse even this modest growth in the long run. These issues include imbalances in global trade patterns, inappropriate fiscal policies, and protectionism
- A. World trade patterns need to undergo a major shift.
1. The United States needs to boost exports
 2. Other advanced industrial economies need to rely less on exports and more on domestic demand.
 3. LDCs need to get back on track of faster economic growth
 - a. This is essential so that they can raise living standards at home.
 - b. It's also in the best interest of banks in advanced economies because improved living standards in LDCs make the option of revolution--which would probably mean repudiation of debt and a total loss of principal--less likely
 - c. This will also help the United States since they could buy many of our manufactured goods if they weren't strapped with so much debt.
- B. Fortunately, the currency realignment we've had has set the stage for such a change.
1. The cumulative decline in the dollar's value has been significant, and in my view--as well as the financial leaders of the G-6 countries--sufficient.

2. The dollar's decline has also broadened.
 - a. The two-year drop in the dollar's value had until fairly recently been paced by the swift relative appreciation of currencies in Japan and Europe and was for the most part nonexistent elsewhere.
 - b. But studies at the Atlanta Fed show the dollar's decline has been more of a global event for the past seven or eight months--that is, even the currencies of Canada and the newly developing Pacific rim nations are appreciating against the dollar, though the margin of decline is still much smaller
 3. The depth and now the broadening scope of the dollar's decline seems to be having an effect on U.S. flows
 - a. In nominal or current face value terms we are still seeing reports of record trade deficits, for instance the report last week that our broadest trade balance measure--the current account--registered another record deficit in the fourth quarter of 1986. Recent monthly nominal merchandise trade figures have also not shown any clear signs of improvement, although they have probably bottomed out.
 - b. However, it is the real trade balance which contributes to or detracts from our overall economic growth, and in the last quarter of 1986, the latest period for which we have data adjusted for prices changes, real U.S. net exports improved
- C. I only hope that the anticipated turnaround will come soon enough to divert the forces of gloom from undermining our economy along with the rest of the world's by burdening American trade policy with protectionist baggage.
1. While I sympathize with the agony of industries, some of them in our own region, which are losing ground to foreign competition, I look with dismay upon the many calls for protection.
 2. That route can only lead to retaliation, inefficiency, and erosion of our purchasing power and free choice as consumers.
 3. Other domestic policy changes would do far more to speed up the process.
 - a. A sustained attack on the federal budget deficit is the most direct way we in the United States can improve our position in international trade.
 - b. Japan and West Germany could stimulate their domestic economies more aggressively, making them less dependent on exports as sources of growth; for example, Germany could accelerate its tax cuts
 - c. Japan and Taiwan should lower the import barriers which make it impossible for many of our goods and services to penetrate their markets.

D. Solutions to the LDC debt situation are less clear cut.

1. For Ecuador, the problems are related more to a natural disaster than to economic ills and fairly routine measures like loaned oil from Venezuela, along with some loan restructuring and postponements of scheduled debt service, could bring relief.
2. For Brazil more funding seems to be necessary, at least, as a transition mechanism
3. From a broader perspective, we must ensure that the LDCs are brought back into partnership with the United States and other advanced countries for the reasons I outlined earlier—domestic living standards and growth markets for advanced economies like U.S.
4. We all agree on the long-term goal since the alternative seems to be impoverishment of these countries and the possibility of political turmoil and debt repudiation. The problem is how to get there.
 - a. The U.S. policy debate pivots on the ideas advanced by Secretary Baker, which focuses on additional funding and a variable payment schedule, and Senator Bradley, which involves some forgiveness of current loans.
 - b. There's also the idea of converting some of the debt to equity, a move the Japanese seem to be taking the lead in experimenting with
 - c. Personally, I favor the Baker plan, which is being tested in Mexico
 - d. However, I admit the complexity of the situation will require flexibility and compromises

VI. Conclusion.

- A. In sum, I am worried about the LDC debt situation. I do think we have in place the mechanisms to deal with the situation, but it is likely to take a very long time.
- B. Meanwhile, I am concerned that protectionist sentiment might spill over into actual policy measures.
- C. The moderate rate of growth I have projected for the world's advanced economies and the turnaround in the U.S. trade deficit which I foresee should allow us a breathing space in which we can work to resolve the debt situation and chase protectionism into the shadows.