

**THE INTERNATIONAL OUTLOOK**  
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**To the Worldwide Partners of GKR International**  
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Good afternoon! It is a pleasure and an honor to speak to this gathering of people who deal in international markets on a daily basis. You know from personal experience how close we are to achieving a single global market. While this historic transition has been under way for some time, events during the past year have brought dramatic new evidence of its imminent consummation. I refer, of course, to the moves by the communist nations of Europe to shed their insularity and by the European Community to accelerate its market integration. I would like to give you my views on these encouraging global developments this afternoon. Potential countervailing forces still exist, however, and I will also talk about the continuing imbalances in world trade and the danger of a new round of protectionism here and abroad. To set the stage for these thoughts, let me first give you my outlook for the international economy.

**International Outlook**

I shall begin with the United States, where I believe that economic growth in this country will be slower in 1990 than it was in 1989. Gains in real gross national product should decelerate to a rate of about 2 percent for the year. However, I do not see any signs on the horizon that suggest this seven-year expansion is about to end. Even with more moderate growth, I expect little or no rise in the unemployment rate because the labor force is also increasing more slowly. While we are unfortunately not likely to make much further progress in reducing inflation this year, I do not see the situation getting any worse. Prices are likely to increase around 4 1/2 percent after a spurt early in the year. Still, this rate is much too high in my opinion, and I am concerned that we not become complacent with it.

Unlike recent years, when consumption or export-driven manufacturing has been a clear leader in propelling U.S. expansion, I do not expect one particular sector to set the pace in 1990. Indeed, the kind of growth I anticipate should be largely the result of momentum from past expansion that is fairly well distributed among the various parts of the economy.

The general outlines of my projections for the U.S. economy apply on average to the world's major industrialized countries as well. I expect somewhat slower growth--but no global recession--while inflation and unemployment remain in the present range. Economic growth among these countries should back off about half a percentage point overall to the vicinity of 3 percent on average for the year. Prospects for inflation are mixed. Price pressures should worsen a bit in Germany and Japan, change little in Italy and France, and perhaps decline in the U.S. by the end of the year. Unemployment will probably remain relatively high in Europe, though below the double digit rates of the mid-1980s, and low in Japan--probably just over 2 percent.

Turning to the outlook for individual countries, Germany performed considerably better in 1989 than many predicted, probably growing a little more than 4 percent. In 1990 expansion should slow marginally to about 3 1/2 percent while inflation accelerates to a little above 2 1/2 percent. One of the greatest uncertainties in the outlook for Germany involves the outcome of the impending monetary unification of East and West Germany, whereby the East German currency--the Ostmark--will be replaced by the Deutschemark. The terms of this conversion were announced earlier this week. Wages and pensions, along with savings deposits up to the U.S. dollar equivalent of about \$2,000 per person, will be converted at a one-for-one rate. Other deposits will be converted at two Ostmark per Deutschemark.

In working out this arrangement, German policymakers faced a considerable dilemma. In reality, the West German mark is worth more than the Ostmark, given the

greater industrialization that has occurred in West Germany. However, joining the currencies at exchange rates that truly reflected this disparity would likely have increased outmigration from East Germany. Such a labor drain would potentially precipitate a downward spiral in the East's economy. A conversion rate that more closely mirrored underlying conditions would also hurt people on pensions and perhaps lead to social unrest. The alternative chosen may well carry inflationary implications for the unified German economy, though the Bundesbank has a history of successfully resisting inflation in the postwar period. In any event, the adjustment will create some disruptions in both economies but promises opportunities otherwise unavailable.

I expect that the pressure U.S. firms feel from their German competitors could lessen this year as Germans turn their attention to the unification issue and to new opportunities throughout Eastern Europe. Moreover, the mark has strengthened significantly over the past few months, which should lower the relative prices of U.S. exports. Still, any effect of this exchange-rate shift on the pattern of trade will not be felt for some time. One reason for the mark's recent gains has been the expectation that Germany's export markets stand to improve from developments in East Europe. These potential new markets for German products--especially the capital goods needed by fledgling industries--could boost Germany's trade sector for many years to come. Greater demand might also exacerbate inflationary pressures, though.

Italy and France have been growing 3 to 3 1/2 percent per year over the past several years, and are likely to continue expanding at a pace near the lower end of that range. Both countries have been profiting from growing exports to Germany, and they are well positioned to benefit from the opening of the Eastern Bloc. Their inflation picture was stabilized by their currencies' link to the West German mark. Thus, inflation will probably hold at around 3 percent in France and 6 percent in Italy. However, the potential for greater price pressures Germany may also make it difficult to prevent these

rates from rising.

Spain and Portugal have been growing faster than most other economies in the European Community during the past several years. They should probably do the same in 1990 though at a somewhat reduced rate. This moderation in growth will not be entirely unwelcome since rapid growth has been accompanied by inflationary pressures in both economies.

In the United Kingdom and Canada, much of 1989 was spent fighting inflationary pressures, and neither can afford to let up much in the year ahead. Consumer prices in the U.K. rose about 8 percent in 1989 and will probably go up another 6 percent in 1990. The country's fiscal surpluses prompted the government to cut taxes, which had the effect of unleashing consumer spending and, in time, price pressures. This increased demand also added to Britain's persistent trade deficit, which is considerably larger than that of the United States as a percentage of GNP. Meanwhile, the battle against inflation pushed interest rates up and helped keep the pound high on foreign exchange markets. The pound's relative strength added fuel to the trade deficit. In 1990, the dampening effect of the trade deficit on manufacturing will probably more than offset stimulus from strong domestic demand. This shift should bring moderate growth in the U.K. this year--at about the rate I expect for the United States.

Canada's foreign trade sector, like the United Kingdom's, was hurt by a relatively strong currency in 1989. Canadian economic growth will likely slow this year in a similar fashion as well. Since commodities play a major role in Canadian exports, the country will continue to receive a little help from somewhat higher oil prices, which should carry over into 1990. Weakness in the U.S. auto industry, however, is likely to exert a negative spillover effect.

Japan will almost certainly post another year of solid growth. Strength in

investment will probably help Japan lead the industrialized countries in growth at a rate of about 4 1/2 percent. Additional support should come from a pickup in consumer demand. The weakness of the yen over the past year will probably slow or halt the shrinkage in Japan's trade surplus.

Like Japan, the newly industrializing countries of the Pacific Rim--Taiwan, Korea, Hong Kong, and Singapore--should also enjoy strong export-driven growth. These nations seem to be moving to more sophisticated export products and transferring lower value-added production to places like Thailand, Indonesia, and Malaysia. Taiwan and Korea have experienced some labor unrest that could lead to higher costs. Nonetheless, their growth could well be bolstered by orders for products diverted from China as a result of that country's political uncertainties.

Unfortunately, the prospects for many other developing countries, particularly those in Africa, are far more bleak. Their economies are moving backward, bringing physical suffering in the present and compromising their ability to build for future international competitiveness. In addition, their economic weakness denies the rest of the world, and not least the United States, potentially strong markets for exports. On the brighter side, Treasury Secretary Brady's plan has begun to move us in the new direction of reducing debt in the LDCs. I think this will be helpful especially to Latin America, where other promising changes are already taking place in several countries. Still, we must continue to make this issue a top priority for their sake and for our own, if we are to make progress toward a fully healthy international economy.

In sum, Japan and Germany will probably continue to grow at a fairly robust pace, while the United States, Canada, and England decelerate to a moderate rate. This should lead to growth on average among the industrialized economies in the 3 percent range in 1990. It appears, however, that trade imbalances will continue and that inflation, while well below the rate of the early 1980s, still carries troublesome implications in many



countries.

### **Opportunities in the Global Market**

Thus the short-term economic picture looks fairly good, at least among the industrialized countries. Meanwhile, as everyone is by now aware, a single market of global proportions is taking shape, and this bodes well for the future. Two areas in which the pace of economic integration has been extraordinary in the past year or so have been the Eastern Bloc countries and the European Community (EC). The nations of Eastern Europe and the Soviet Union want to move toward the political and economic self-determination their Western European neighbors already enjoy, and I believe they will. As they do, they could ultimately provide fertile markets for outside goods and services as well as sources for labor, materials, and technical innovations. Equally important, their emergence from isolation may mean that the world can begin spending less of its energy and resources arming for war and more on raising living standards.

Of course, the process of change in the communist bloc may not be smooth in either an economic or a political sense over the next few years. For one thing, these countries have no experience with market mechanisms. They also lack convertible currencies and the financial infrastructure to interact effectively with outside countries. They have almost no money and capital markets to funnel savings into investment and they lack effective central banks to keep price pressures in check. They need an infusion of capital to get started as well. With the exception of East Germany, though, none of them has benefactors able to supply the level of assistance required. Additionally, let us not forget that our hopes outstripped reality in the case of China in May and June of last year. Still, I feel the move toward market and political liberalization is inevitable over the long term in China as well as the rest of the nonmarket economies. There is simply no way to eliminate the weaknesses from their systems of production without fundamental reforms.

A second important European story has been the EC's progress toward market integration at a rate that would have seemed impossible even two years ago. As you well know, in the first few years of this decade Europeans will draw together into a market with more consumers than in this country. This development will have a variety of major consequences. For the United States, the dismantling of barriers to shipping and selling goods should open that large market for the kind of retailing to which we are accustomed here. U.S. industries are geared toward long manufacturing runs that supply products to nationwide retail outlets and distributors with numerous local accounts. It seems likely that post-1992 Europe will tend toward a similar market structure, and this shift should work well for U.S. producers. Also, freer flows of capital within the EC will probably hasten the consolidation of industries there. The creation of new pan-European multinationals promises to raise the level of competition in Europe and eventually in this country as well, benefiting consumers in both places.

Unfortunately, the U.S. industry with which I am most familiar and which plays a keystone role in our economy--financial services--is being kept from gearing up for the global market in an optimal way by anachronistic regulations. Multinational corporations are attracted to banks that can offer "one-stop" convenience for a full array of services from loans to underwriting equity issues as well as the capacity to handle sizable transactions. U.S. banks remain strapped by lack of uniformity in state and national banking laws and by our failure to complete the task of product deregulation in this country. Many European countries have long had "universal" banking, which allows a range of activities--some forbidden to U.S. banks--to be carried on under a single umbrella. Moreover, in 1992, geographic barriers to international expansion in the EC are scheduled to come down. Thus, for the sake of U.S. businesses as well as U.S. banks, it is therefore important that Congress take three fundamental actions: (1) reform deposit insurance; (2) repeal current product restrictions covering commercial banks; and (3) enact interstate banking legislation. Together, such measures would strengthen U.S.

banks and allow them to diversify their activities and geographic scope and better serve their customers seeking to transact business overseas.

In sum, I believe the events taking place in the EC and Eastern Bloc nations symbolize the progress toward a global marketplace that ultimately holds the promise of greater and more sustainable growth worldwide--not to mention the incentive to achieve renewed progress toward financial services industry deregulation in this country.

### **Dangers to the Emerging Global Order**

However, the process of globalization faces numerous tests before it can be fully accomplished. Disproportionate imbalances in world trade have persisted in spite of the realignment of exchange rates since the dollar hit its peak in early 1985. Such disparities have led to a resurgence of protectionist sentiment in this country, and protectionist factions have also emerged in other countries. I would like to round out my remarks this afternoon with a few words on these dangers to the emerging global order.

The United States has run large merchandise trade deficits with a number of countries over the past several years, but our continuing deficit with Japan remains one of the most troublesome issues in the global market. Recent talks between these two countries have highlighted structural features in both economies that encourage deficits here and surpluses there. Japan has a rigid distribution system that works against new suppliers, including those from abroad. That country also allows strategic alliances among corporations that would be viewed as collusive here. In addition, tax considerations along with public policies designed to preserve small family farms constrain potential U.S. agricultural imports.

The United States' greatest structural problem is a large federal budget deficit coupled with a low domestic savings rate. This country's need to import capital to fund our financing and investment needs was really at the root of our large trade deficits in



the mid-1980s. Both Japan and the United States have made a little progress toward altering these deeply ingrained patterns. Cuts in U.S. defense spending seem likely over the next several years, but pressure to boost domestic spending--for education, drug enforcement, and the homeless--may limit progress on deficit reduction. Therefore significant changes here--as in Japan--will not be noticeable for some time. Thus, we can expect our large trade deficit with Japan to linger for some time.

Even though the U.S. trade deficits with Japan, Germany, and other countries have arisen largely as a result of domestic U.S. developments, they have fostered a resurgence of protectionist sentiment that is a second danger to the continued advance of globalization. I have heard people say several times in recent weeks: "The cold war may be over, but the trade war has begun." Last year the United States fired a salvo that escalated trade tensions when it passed trade legislation with a provision for punishing a "hit-list" of supposedly unfair trading partners. Emotions also run high in other parts of the world. Some people fear that the EC market opening could stall at the Atlantic Ocean. Since the basis of the emerging global economic order is international trade, it goes without saying that the process of market integration would be severely hampered by a new round of protectionism. Historically, protectionism has tended to spread and escalate as countries whose products were discriminated against threw up their own barriers in retaliation. More recently, the economic problems of former communist bloc nations have offered dramatic evidence of how barriers to trade can isolate and impoverish entire societies.

Nonetheless, there is a large enough constituency for the backward step of protectionism that I believe we stand at a crossroads in the development of the global market. In this light, the United States faces two important challenges. One is to address our savings deficiency with its attendant exacerbation of trade imbalances. The most important step that could be made in this direction would be for Congress to

bring federal government spending more into line with receipts. Our second challenge is to renounce the use of protectionism in our own international trade relations and thereby exert world leadership in this vital area by reaffirming our long-standing advocacy of free trade as the surest path to higher living standards for all.

## **Conclusion**

In conclusion, the year ahead promises to be a good one for the United States and the world's industrialized countries. We can expect reasonable growth with somewhat diminishing price pressures, though we cannot afford to be complacent about inflation. In addition, we could see further progress in extending the reach of the global market toward countries that have not enjoyed the full benefits of international trade for some time. The countries of Eastern Europe and the Soviet Union are poised to begin the arduous task of restructuring their economies. We in the United States also have important challenges to work through. Along with the other industrialized nations, we must hold firm to our belief in free markets and reject economic sanctions and protectionism. In this way we can move closer toward fulfilling the vision of an interactive world economy in which these and other weapons of international policy have been abandoned in favor of peaceful competition in the marketplace.