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Address by

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It is a great pleasure -- and challenge -- to appear before you today to lead off your program on "The World Economy and Peace." But I am also conscious that you have set a daunting challenge for me. I was asked to address the state of "the existing world market economy and how it might be modified to enhance prospects for peace" -- all in thirty minutes.

My refuge is that I only have to introduce the subject -- to presumably make a few provocative or tantalizing comments, fly home, and leave it to all the rest of you to develop the subject adequately.

The importance of the subject is undeniable. It's occupied the minds of thinkers from time immemorial. No doubt cavemen fought each other with stone axes over what we would now call access to resources and markets. There are passages in the Bible and Plato alluding to trade and peace. In the more modern era, Karl Marx and John Maynard Keynes both dealt with the subject -- in quite different ways!

An economist looking at problems of trade and peace starts with some simple propositions. Nations are not equally endowed with resources or skills. Consequently, there is an urgent need to trade with each other to enhance standards of living.

When economists read history, they observe those circumstances have sometimes lead to political temptations for stronger and more dominant powers. They might seek territorial expansion or political hegemony over other nations. Or, more benignly, special trading relationships are developed with others. But, by definition, some are excluded from such arrangements. Consequently, commercial jealousies and rivalries emerge.

Looked at from a strictly economic standpoint, economists have emphasized time and again that free and open trade with everyone would maximize economic gains through the operation of laws of comparative advantage. Stepping outside their own discipline, some economists have drawn a political conclusion as well: free trade would also remove one important incentive to political conflict and war among nations. A leading thinker on the subject, Jacob Viner, writing as World War II ended, summarized the case this way:

> " . . . universal free trade would make every country dependent on other, and often distant, countries for some of the essentials of civilian life and of warfare and therefore would make war obviously a more hazardous enterprise than it is today. . . Second, . . . under free trade the proportion of the population whose everyday means of livelihood is directly or indirectly dependent on the uninterruped continuance of foreign trade would be a maximum . . . Third, under universal free trade, the attractiveness of territorial expansion, in so far as this is based on economic considerations, would be very much reduced. Fourth, the frictions and controversies which result from contact with or even mere knowledge of the existence of foreign trade barriers, tariff discriminations, and colonial preferences would be eliminated."

Well, that's an attractive case for an economic theorist dedicated to free trade. And so far as it goes, it seems to me fundamentally correct.

But there is something lacking. We don't have an economist's ideal of free trade. And Viner's argument implicitly assumes that free trade is operating within the context of relatively fully employed, growing economies with a high degree of price and exchange rate stability. Take those assumptions away, and trade distortions, perceived and real, can become fertile ground for tensions and acrimony.

Here in Seattle, you look out across the broad Pacific from an area characterized by great natural resources. At the other end of the economic spectrum, it is also the home of one of America's great companies, with a strong position in one of our most technologically advanced industries. You have a natural dependence on trade, and large potential markets.

But there is an understandable feeling of grievance: those seeming competitive advantages do not seem to be fairly reflected in trade patterns. With our national trade deficit running at a rate of some $125 billion a year, and with imports continuing to grow much faster than a slowing domestic economy over the past year, those complaints are echoed through much of the industrial and agricultural sectors of our economy.

In the circumstances, protectionist sentiment is coming to a boil. And, in greater or lesser degree that's true in some other countries as well. It's happening out of sheer frustration, even though I suspect most thoughtful observers, in government and out, recognize precisely the dangers that Viner warned against -- of one restriction breeding another, of trade antagonisms spilling over into political relationships, and of damage to the economic prospects and political cohesion of the Western world.

The day is long since past when we could safely think about dealing with trade frictions by retreating within ourselves, even for a country so large and diversified as the United States. We tried that once in 1929, with miserable results. We have too many mutual dependencies today, and the results could be no better. Boeing, after all, does sell a lot of planes abroad, and the Northwest still ships a lot of logs and lumber -- even if those shipments at times seem subject to less than fair competitive practices. And that story could be repeated for any region.

Protectionist threats are sometimes rationalized by the argument that they are a legitimate negotiating tactic, essential to deal with the perceived inequities. We can all understand and empathize with that approach. We need to bring the message to others that trade is a two-way street. But let's be sensitive to the danger that today's negotiating tactic may become tomorrow's reality. There have to be more constructive approaches if the protectionist stew is not to boil over and burn us all.

The basic function of a conference like this, it seems to me, should be to explore and encourage those more constructive approaches. We should be working toward creating those conditions in which trade will flourish to the mutual advantage -- and be seen to be in the mutual advantage -- as Viner assumed.

We don't, in my opinion, have far to look to see the areas where action is necessary. In broad terms, they are widely understood. But there is a big gap between understanding and effective action -- and so long as there is, prospects for economic and political harmony will be jeopardized.

One essential approach, if a liberal trading order is to be sustained, politically as well as economically, is to make sure the rules for trade are fairly and uniformly applied. Virtually every country, with some justice, feels it has grievances -- certainly including the United States. And because we all "sin," to a greater or lesser extent, each of those complaints has a degree of legitimacy. And experience shows that those grievances are often hard to deal with, one-by-one.

That is especially true when trading rules and codes of behavior are obscure, ineffective, or unenforced. And as the nature of trade shifts into new products or services, with more governmental intervention and with more countries becoming heavily involved, the more the complications and the dangers increase.

That is the basic reason there has been a lot of discussion -- most prominently at the recent Economic Summit -- about the idea of launching a new round of multilateral trade negotiations. The idea has borne fruit in the past with the successive Dillon, Kennedy, and Tokyo rounds of negotiations in the GATT negotiations that successfully propelled the industrialized world toward more open trade and helped to support the unprecedented pattern of world growth over the post-war decades.

That growth has itself naturally raised new issues. For instance, developing countries and many services are not clearly covered by existing GATT codes. Nor is the treatment of a number of important commodities and such matters as subsidies really adequate for existing circumstances. Thus, there is plenty of reason to move forward once again for technical and objective reasons. And, it seems to me there is an even more compelling political reason.

The Summit called for "tangible progress in relaxing and dismantling trade restrictions." Certainly, the Administration in Washington is deeply committed to that approach. But, of course, nations collectively have been doing the opposite. They have not done so by any single dramatic act, but by conceding to the domestic pressures here and elsewhere, "small" protectionist measures in one area or another.

Given the strength of the pressures, we can with some justice, claim some success in holding them at bay -- the essentials of a liberal trading order have been defended. But I doubt the protectionist pressures can successfully be turned back toward freer trade by a succession of small bargains. More general multilateral negotiations, to which there can be political commitments by all participating countries and a wider area for mutual concessions, stand a better chance of galvanizing the necessary support and energies. Or to put the point more simply, a good offense may be the best defense.

I do not want to suggest multilateral agreements to reduce trade restrictions, important as they are, end our trading problems. Freer trade will not in itself end the massive deficits in our own trade accounts, or the surpluses of Japan, nor will it assure the growth and prosperity in national economies necessary to support a liberal trading order. Indeed, such trade agreements, if they are to be possible at all, will need to be accompanied by other actions to reduce present trading imbalances and support growth.

The fact is that the recent trends in the external economic position of the United States are not sustainable indefinitely. Over the past two and half years, our trade deficit (and the deficit on our current account, which measures trade in all goods and services) has increased by about $100 billion, almost entirely because of rapidly rising imports. Today, non-oil imports account for some 18 percent of the total output of goods in the United States, a larger share by 3-1/2 percentage points than in 1982 and 10 percentage points more than 20 years ago.

From the standpoint of the American consumer, those imports have brought great benefits in terms of more choice of products at lower prices. It has, in the short-run, brought benefits to our trading partners, which have had high levels of unemployment or which, as in Latin America, have desperately needed to improve their own external accounts. But in the absence of a roughly parallel increase in exports, it has also impacted sharply on the growth of our own manufacturing and mining industries, and has required massive borrowings from abroad to pay the bills. Indeed, in the space of only a few years, the United States is shifting from the world's largest creditor to its largest debtor.

We are a big and strong country, and we can carry those debts if we have to. But the trend is ominous. At some point, the pressures on our industries could undermine our own economic growth and the confidence that underlies the ease which we can now borrow abroad.

If all that's true, one might conclude that the solution is both urgent and simple -- a direct across-the-board assault on the trade deficit by tariffs or other restrictions. But it's not that simple. The trade imbalance reflects in significant part a massive imbalance in our own policy posture. Unless we deal with that underlying imbalance, a basic force driving the poor trade performance will be left unchecked. Protectionism would reap a grim harvest in terms of higher prices, retaliation, and shrinking trade, while leaving the source of the difficulty unresolved.

The imbalance to which I refer is, of course, the deficit in our Federal budget. In the end, we have to finance that deficit out of savings, ours or those of some other nations.

In a good year, like 1984, we generate in this country net savings -- by businesses, by individuals, and by state and local governments -- of about 8-1/2 to 9 percent of the GNP. That's within a range that has persisted for 30 years. As we have learned from experience, it's hard to change. At the same time, we invested last year in housing, inventories, and plant and equipment about 6-1/2 percent of the GNP (net). With the Federal deficit added, demands on savings ran to nearly 12 percent of the GNP. The difference between our capacity to save and the need for finance was made up by borrowing from abroad. That borrowing is necessarily matched by a current account deficit, and the rapidly rising imports have generated that deficit.

So we are in a dilemma. On the one hand, we count on savings from abroad to help, directly or indirectly, to finance our Federal deficit. On the other hand, we understandably are concerned about the large and growing trade deficit that threatens to sap the vitality of our industry. But the capital inflow and the trade deficit are two sides of the same coin. Do away with the trade deficit, and we also would do away with the net capital inflow. Without the capital inflows, pressures on our domestic financial markets would increase, undercutting prospects for housing and investment.

The lesson is plain. We should be less dependent on capital inflows to maintain balance in our domestic capital and credit markets. But we don't want to cut back on investment. The only reasonable alternative is action on our budgetary problem.

Let me put the point directly. Action to reduce the budget deficit must be a fundamental part of any constructive effort to deal with the trade imbalance. It is thus a basic element in the effort to support and maintain a liberal trading order.

That, as you well know, implies tough political choices. I have no competence to suggest where those budgetary savings should be made. But I do know that progress needs to be made, and made p.d.q.

The Senate, as you know, recently made an encouraging start in that direction. Now it is the turn of the House. There is no more urgent business than achieving a reconciliation of difficult approaches toward achieving the needed savings. Your representatives in the Congress will need your strong support to complete that effort.

So far, we have been able to enjoy a strong expansion despite the growing trade deficit, although signs of strain are showing. As I suggested a few moments ago, the United States, for more than two years, has also been able to act as a kind of motor for the economy of the industrialized world as a whole.

We've provided strong markets for the hardpressed developing countries that must expand their exports. Foreign capital has come to our shores freely, easing the pressures on our domestic financial markets.

But now we have to begin working back toward a more sustainable balance -- the sooner the better.

There are clear responsibilities for other countries in that effort. Japan, for instance, is broadly in the opposite position from the United States. It generates a high level of net savings, roughly twice our own level relative to GNP. Those savings are not fully utilized at home. It exports huge amounts of capital, and with it a huge amount of manufactured goods, far more than it imports.

No doubt it can and must do more to open its markets, to the ultimate benefit of its own consumers. But that will not alone be enough to make really rapid progress toward closing its

$40 billion current account surplus; it will also need to generate more "home grown" expansion, instead of relying so much on exports to generate growth.

Meanwhile, Europe has been mired in historically high levels of unemployment, despite a generally improved trade performance. I am in no position to offer detailed policy prescriptions. Moreover, there are some encouraging signs that we can look forward to a little faster domestic expansion in both Japan and Europe. But clearly, much remains to be done, in the words of the Summit communique, "unremittingly to pursue . . . policies conducive to sustained growth and higher employment."

There is another area that needs attention as part of a growing world economy. The imbalances in growth and trade among the industrialized countries have been accompanied by large changes in exchange rates. Indeed, those changes -- marked by an extremely strong dollar and relative weakness of the yen and especially European currencies -- have been the mechanism inducing, in large part, the shifts in trade. There has been a great and understandable reluctance by most countries to intervene strongly in the exchange markets. And I think there is a wide area of agreement that such intervention, standing alone, could hardly be successful in achieving greater stability if more fundamental policy imbalances are not corrected. But the goal of greater stability is important.

The kind of extreme volatilty we have seen -- particularly when measured over periods of months or years -- is hardly acceptable. Patterns of trade are distorted. The laws of comparative advantage that underly our theorizing about free trade are, in a practical sense, undermined when price incentives can change so radically without equivalent changes in underlying economic circumstances.

That instability is a signal that some thing is askew. But there is no point in railing about it without facing up to the source of that instability -- that would fall into the category of shooting the messenger.

We have made a lot of progress, not just in the United States but elsewhere in the industrial world, in bringing inflation down. The job isn't done. But we collectively have inflation under better control. Inflation rates among industrialized countries more nearly converge than at any other time since the dollar was floated in 1973.

In concept, that should, in itself, contribute to more stable exchange rates. But of course other imbalances remain, including our budgetary difficulties which help to keep inflationary expectations alive. There are, as I noted, differences in economic growth rates and prospects.

As we deal with those problems, exchange rates should reflect more reasonably underlying economic circumstances. If not, it seems to me the inference to be drawn is clear. The governments of the world will have to give more attention to the requirements for greater stability, lest fluctuations in exchange rates undermine the very goals of the liberal trading order we want to support.

Finally -- in terms of the order of my remarks today but not in the sense of the intrinsic importance of the subject -- we will have to more fully recognize the problems and potential of the developing countries if trade is truly to promote our common prosperity and contribute to political stability.

As you know, a number of developing countries -- basically those expanding the most rapidly -- became large borrowers in international markets during the 1970's and early 1980's. Major commercial banks around the world were eager lenders in a context of rapid growth, relatively low interest rates, and accelerating inflation. But when conditions changed -- in terms of better control over inflation, higher interest rates, and more sluggish growth -- both borrowers and lenders found themselves vulnerable. The international financial system and the trade it supports were in jeopardy.

The response to crisis was heartening. A number of major borrowing countries undertook strong measures to adjust their external accounts, including measures to deal forcibly with

<u>their</u> budget deficits and to curtail monetary growth. They cut back on swollen imports, and because the crisis centered in Latin America where we have particularly close trading relationships, the effect on our own exports for awhile was disproportionate. Banks, recognizing their self-interest in an orderly resolution of the problem, joined cooperatively in providing limited amounts of new money when needed as part of the adjustment effort and in restructuring old loans so they could be serviced.

At the center of the entire process stood the International Monetary Fund. It has worked with the indebted countries to develop needed adjustment programs. It has helped coordinate the banks in developing their lending programs. It has provided an essential margin of the needed new funds.

The Fund could play that role for one reason -- as an international organization with membership of nearly all countries, it could be accepted as a neutral arbiter. It also had professional competence. And it had funds at its disposal to help carry out its purposes.

The challenge remains. The debt problem is still with us, and it will have to be resolved ultimately in the context of growth.

Success will require continuing self-discipline by the borrowing countries. More than that, they will have to make their economies more competitive, efficient, and flexible. In many cases, that will require steps to liberalize, in the old fashioned sense of the word, their own economies, making them more attractive for investment by their own citizens as well as by firms from abroad.

And, the borrowing countries, as they do produce at competitive prices, will need open and growing markets abroad.

That need be no threat to the industrialized world. The indebted countries have, and will continue to have, large import needs. Those needs that can be satisfied only by countries like the United States.

Of course, we can expect competition. But their growth, and our growth, will ultimately be spurred by fair competition.

Rising trade need not mean one-sided trade -- and all sides can benefit.

I can't go deeply today into the problems of the developing world and their solutions. But I would submit to you that we have had in the past few years a vivid demonstration of the central importance of strong international institutions in managing the world economy. The IMF was there, fortunately for all of us, to help deal with crisis. The World Bank, the InterAmerican Development Bank, and the Asian Development Bank -- institutions whose business is long-term development -- have also contributed constructively. Their role will be even more important as the borrowing countries begin to deal with the need for more fundamental restructuring of their economies.

No doubt, as with any human institution, the international financial organizations will need to adapt and change in response to shifting circumstances. But my point is a simple one. It's hard to visualize an effective trading system -- a system in which all can participate and grow -- without organizations like these to help protect the financial structure and support development. They provide a forum for developing -- and enforcing -- the rules of the game. They provide needed financial lubricants, even if the driving engine of the world economy must be found in the performance of individual countries. They are a force for cohesion and consensus.

And they will not be able to operate effectively without the support and encouragement of their leading stockholder, the United States.

The burden of my remarks can be summarized in a few sentences.

If we are interested in the prosperity of the United States -- as we must be -- we are going to have to find that prosperity in a larger world order. In this day of instantaneous communication, relatively cheap transportation, and constant travel, we are not going to be satisfied to live in isolation. We need world markets in which to sell -- and in which to buy.

That means we have to opt for open trade. That trade will have to be supported by generally accepted rules of the road, perceived to be fair and reasonable by all participating countries.

All countries that participate in the system will need to deal with imbalances in their own national policies. We can't expect to pass our internal problems off on others. In the process, the success of one country will help its trading partners. And the responsibilities of the United States today, as the largest and strongest country, are especially great.

If we are to be less dependent on foreign capital, this country will have to face up to the need to deal with its budget deficit. That measure -- thought of as a purely domestic economic and political matter -- has great implications for our trade, for financial markets, and for other countries as well.

All countries have a strong interest in nurturing and supporting the international institutions -- the GATT, the IMF, and the development banks. Those institutions, created by imaginative men in the aftermath of the most destructive war in history, reflect and incorporate our common interest and our common vision of a liberal world trading order in which all can prosper -- and stay at peace.

I don't think it stretches the facts to claim that all of this is part of a kind of intellectual consensus among thoughtful people, here and elsewhere. It is certainly part of our common rhetoric.

But, of course, we need more than rhetoric. We need practical measures to implement that consensus. Otherwise, it will be shattered -- shattered by the exigencies of the economic and political pressures.

Our trade <u>is</u> way out of balance. There <u>are</u> legitimate complaints. Exchange rates <u>are</u> too volatile. Unemployment around the world <u>is</u> too high. The international institutions have no strong domestic constituency.

You are meeting at a timely hour. Your agenda is ambitious -- as it should be. None of us can do it full justice, in all its detail and implications.

But the fact you have taken this initiative at all is what strikes me as important. For out of this kind of debate and discussion we can help build the intellectual foundation for policies that can support both peace and prosperity. And we can begin to move from intellectual consensus to constructive action.

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