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Remarks of

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Chairman, Board of Governors of the Federal Reserve System

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and

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I greatly appreciate this opportunity to meet with so many leaders of Canadian life. And it's both a special honor and reassuring to have close to my side two of those responsible for conducting your own financial policies. Michael Wilson has played a constructive role in our international deliberations from his very first days in office, and my central banking colleague, Gerry Bouey, is dean of the Group of Ten central bank governors. His good sense, his good will, and long experience have long greatly facilitated our cooperative efforts.

I know that up here in Canada it's sometimes said that running economic policy is akin to the hazards of sharing a canoe with an elephant.

Well, that's an example of how perspectives can differ, even across the most open border in the world.

Ever since my family first exposed me to Barnum and Bailey, I have seen the place of the elephant in the scheme of things rather differently. He is usually a placid, friendly beast, with his feet on solid ground. Lots of times he is driven around in circles.

But when necessary, he's also asked to lead the parade. In both roles, he's expected to carry heavy burdens and plod along predictably and quietly, providing a steady platform for the acrobatics of others and oblivious to all the distractions around him.

Now, I realize the United States may not always bear out my more benign view of an elephant, and there's much more at stake in the world economy than any circus. But the thrust of my remarks tonight on the world economy has one point common to any complicated performance -- the success of the entire enterprise is dependent upon all the participants playing a constructive role.

The United States, simply by virtue of its size, is typically the focus of attention. What we do measurably affects others, perhaps Canada most of all. We would forget that at our own peril, not least because of what an economist calls "feed back" effects on our own economy. Naturally, domestic pressures, economic and political, as in any country, sometimes divert our attention. But I think it is also true that our basic and continuing economic interests -- in stability and growth, in open markets, and in effective competition -- coincide with the broader international interest.

But I must also emphasize the United States is not the whole of the world economy -- far from it. In fact, our relative weight has tended to diminish steadily over the years. Measured by GNP, at the end of World War II we were more than 40 percent of the whole; today the fraction is less than a quarter.

Obviously, the cumulative effects of what other countries are doing on the world scene are even more important than what we do. The reality of that cumulative impact may be obscured because, individually, other countries have less economic weight, and they may discount the effects of their actions on others. But recent developments illustrate clearly what we should know anyway -- even the United States is not an island unto itself.

Why, for awhile this fall, I even feared that you here in Toronto might intrude on that great American institution, the World Series. It inspired me to do a little research about the National Hockey League. I couldn't find out for sure what nation the word "National" in that name is supposed to refer to. But I did find out that it took nine American players, on the average, to equal the point production of one Wayne Gretzky.

The imbalances in the world economic league may be less striking, but they are evident nonetheless. And they won't be corrected without complementary action by a number of countries.

Looking at the industrial countries as a group, there has been good progress over the past three years, particularly when measured against the turmoil and instabilities of the 1970s and at the start of this decade. Employment is now growing almost everywhere, and inflation has been halved or more, from the two-digit range early in the decade to less than 5 percent this year and last. Happily, both Canada and the United States have had better than average experience both in reducing inflation and in growth.

Moreover, that progress toward price stability has been extended through a period of economic expansion about to enter into its fourth year. I believe sustained expansion over time (and, I might add, lower interest rates) depends crucially on our collective ability to maintain greater price stability. Fortunately, there are favorable signs in that area. Competition in world markets is intense; capacity is readily available; raw materials, including petroleum, are in ample supply; and wage and other cost pressures are much more moderate. Policy makers virtually everywhere, against the experience of the 1970s, are properly more sensitive to the inflationary threat in the conduct of monetary policies.

In that sense, we have a good foundation upon which to build. But it's also plain that unemployment is still far too high in most industrial countries, and progress is threatened by increasing strains and distortions within national economies and between them. By and large, economic growth has been less than earlier in the postwar period, and it will probably be slower this year than last, even though unemployment remains in most countries at exceptionally high levels.

That is, of course, true of the United States itself. But in our case, after two years of particularly rapid expansion and sharp declines in unemployment, some slowing was perhaps natural.

Moreover, demand in the United States has been relatively well maintained. Domestic demand over the past 15 months has continued to rise at a rate of more than 3-1/4 percent a year, in contrast to a rate of increase in output of only 2-1/4 percent. Final sales to consumers, to government, and for investment and housing have been still larger, running to about 4-1/2 percent over the period.

The difference between growth in U.S. demand and U.S. output is a reflection on our rising trade and current account deficit. In effect, while we have created more than 9 million jobs in three years within the United States, we have also turned to importing (net) well over 3 percent of our gross national product. The effect has been to create export opportunities and stimulate job creation elsewhere, more in Europe and Japan than in Canada because your imports have also been rising. Even so, employment increases have been much slower abroad. As a result, the unemployment rate has, as you are well aware, remained over 10 percent in Canada, and it is at about the same level in Europe, where some 20 million are jobless.

If we look to the south of us, to the hundreds of millions living in the heavily indebted countries of Latin America and elsewhere, the challenges are even more pressing. About three years ago, a potential financial crisis burst on the world scene as one developing country after another faced an inability to service its debts in a timely way. Strong efforts by the borrowing countries themselves, and cooperation among creditor countries, the IMF, and the involved commercial banking community, have helped diffuse and manage that threat. Most of the borrowing countries have made enormous progress toward achieving a better balance in their external accounts. Some of them have begun to grow again. The continuity of debt service has been largely restored.

But amid that progress, the strains and frustrations are evident. Much of the growth achieved by the borrowing countries so far -- and it's far from uniform or satisfactory -- has gone into improving their external positions; domestic living standards have not recovered fully, or at all. Increasing doubts have arisen about the continued availability of a margin of external finance needed to support growth, inflation remains rampant in some countries, and the structural reforms required to <u>sustain</u> growth are, at best, only beginning.

I might point out, too, that the remarkable progress that the indebted countries have made toward balancing their external trade position has as its counterpart increased exports to, and decreased imports from, the United States. Our trade balance with Latin America has deteriorated by $20 billion since 1981, accounting for considerably more than half of their collective improvement.

Plainly, the economic elephant of the United States is carrying a heavy load. With a trade and current account deficit approaching $130 billion overall, it's showing the strain, in political as well as economic terms. Under the pressure of rising imports, manufacturing activity as a whole has been stagnant for a year, and some industries are losing jobs. Many individual farmers, with exports diminishing and prices low, face financial crisis. And, as you are well aware, the strongest tide of protectionist pressures is running since the ill-fated 1930s, despite the continuing growth of total jobs and economic activity.

To put it simply, the pattern of progress in the world economy over these past three years is being undermined. It's not just a matter of economic strains -- huge trade deficits in the United States and counterpart surpluses elsewhere, stagnant employment in Europe and elsewhere, and the pressures of debt in the developing world -- but also the political frustrations they breed. Surely, precisely the wrong response would be to permit those frustrations to boil over in short-sighted approaches -- protectionism, defaults, and inflation -- that could only aggravate the situation, undermine the progress that has been achieved, and set back prospects for years to come.

Happily, I believe those dangers are fully recognized by the responsible leaders in almost every country. What we have neglected, at least until now, is dealing with the imbalances at their source with a sufficient sense of urgency, and with adequate recognition of the complementary roles for all the leading countries.

No doubt there is a human tendency to look to the other fellow, or to the other country, to do its part, and hope that's enough. No doubt, the needed measures are also politically difficult. But there is also no doubt that, if we are to be successful, it will have to be a joint effort.

The broad directions that the effort must take were pretty well summed up in the communique issued by the Group of Five at its special meeting in New York a few weeks ago. The speeches and communiques at the recent World Bank-IMF meetings in Seoul reiterated the same themes.

In the United States, where the expansion has been so relatively strong, and which has provided so much of the impetus for world growth, the trade deficit has now reached a level that cannot be sustained, threatening to undercut our stability and implying less stimulus to others. Despite a relatively accommodative monetary policy, interest rates remain high historically, aggravating the strains on our own financial system and the developing world and drawing capital from abroad.

The clear policy prescription boils down to meaningful and assured progress against our record budget deficit. Relative to the size of our economy, our $200 billion deficit happens to be little or no larger than the deficits of a number of other industrialized countries -- Canada's as you know, is a significantly larger portion of your GNP. But this is one area in which absolute size counts, and counts greatly. Our deficit not only looms large relative to our own limited propensity to save, it represents a significant drain on world savings. It has implications for interest rates abroad as well as at home.

In a real sense, we have been fortunate that funds have flowed so freely to the United States in recent years, reflecting to a considerable extent widespread confidence in our prospects. We would not have been able to finance the federal deficit, on top of rising expenditures for plant and equipment and housing, without that net capital inflow. But it is clearly not healthy for the largest and richest country in the world -- in its own interest or that of others -- to use up so much of the world's savings to finance a budget deficit. Our lending abroad has practically stopped, we are becoming a debtor nation, we have less investment and housing than would otherwise be possible, and our trading position is deteriorating. Sooner or later, the process is unsustainable, and it had better be approached constructively rather than in crisis. That is why so much is riding on the current debates in the Congress aimed at finding a constructive approach.

But, important as it is, further action on our budget deficit cannot be the entire answer, even if, contrary to the fact, it could be implemented immediately. It's also true that our trade deficit, the enormous trade and current account surpluses of Japan, and the growing surpluses elsewhere, are directly influenced by the relative sluggishness of growth in most other countries. What is needed, in particular, is more "home grown" expansion in some other industrialized countries, rather than such heavy dependence on the United States or other foreign markets for stimulus.

I realize a key factor inhibiting action to promote greater growth at home has been concern over inflation, particularly against the background of depreciating domestic currencies vis-a-vis the dollar, and relatively large budget deficits. But in some key countries -- especially Japan and Germany -- a remarkable degree of stability has been achieved for some time. Certainly, that progress needs to be consolidated. But that process is now being assisted by the more recent tendency for their currencies to strengthen. Moreover, in some cases remaining budget deficits reflect in good part the sluggishness of economic activity rather than a structural imbalance between receipts and expenditures or the deficit could be readily financed from savings now going abroad. The case for domestically led expansion seems particularly strong in Japan, given its enormous trade surplus and high level of domestic savings.

Japan is the second largest economy. By every economic characteristic, it should also be able -- in its own interest -- to help lead the world toward more open markets rather than feeding protectionist instincts in the United States and elsewhere. And, without in any way wanting to intrude upon your own debate about the wisdom of a free trade area with the United States, let me suggest that the direction of that initiative -- looking toward reducing rather than increasing trade barriers -- seems to me highly constructive. Specifically, it seems to me wholly consistent with the larger concept that, rather than yielding to protectionist pressures, we look toward means for widening and reinforcing the area for liberalizing the world economic order.

In that context -- a reduced budget deficit in the United States, greater growth elsewhere, and open trade and investment -- exchange rates can and should play a role in adjusting external imbalances. That is the point made by the Finance Ministers and Central Bank Governors of the G-Five in New York recently, and there has been close cooperation in recent weeks among them in encouraging some appreciation in other leading currencies relative to the dollar through exchange market intervention.

Important as that effort can be, however, it is no substitute for more fundamental measures. Indeed, large changes in exchange rates, without dealing with the underlying sources of imbalance, are not an easy or painless solution -- they carry risks of their own.

I suspect no part of the world would reap greater benefits from a sustained growth in the industrial world, from more open trade, from lower interest rates, and from better aligned and more stable exchange rates than the middle-income countries of the developing world. But, to take advantage of that benign economic climate abroad, they will also need to make reforms at home.

By and large, those countries, concentrated largely in Latin America and on the western rim of the Pacific, maintained exceptional growth records in the 1970s and early 1980s. But in a large number of instances, that growth entailed very heavy borrowing from abroad -- and much of that capital, rather than contributing to productive investment, in effect only replaced a chronic outflow of their own savings. It cannot be entirely coincidental that countries that did manage to create a hospitable environment for investment and for effectively utilizing the savings of their own citizens are those that, in the 1980s, have been able to manage their debts most easily and have continued to grow.

I cannot help but be encouraged by the sense that many of the most important leaders of Latin America -- and they are democratically elected leaders -- have spoken out forcibly about the need for structural change -- for more competition to spur efficiency, for more private initiative and investment and fewer government enterprises, and for more "openness," at home as well as in trade.

I know there is a long distance from recognition of a problem and from generalized statements of intent to practical policy changes -- changes that mean more competition and departure from deeply embedded ways of doing business. I also know that even in the best of circumstances, sustained growth by developing countries will require some margin of external financial support.

And the better assured that necessary support, the easier it should be for the borrowing countries to marshall the will and the effort to make the fundamental policy changes needed. The frustrations and uncertainties implied by crisis management of debt can too easily divert attention from that effort.

Recognition of those interlocking needs of the heavily indebted developing countries -- for structural change at home and for a margin of external financial support -- is the essence of the proposals set out by Secretary Baker a few weeks ago. He called upon the World Bank and the official regional development institutions -- notably the Inter-American Development Bank in which Canada is a leading participant -- to more actively provide some of the needed finance in the form of relatively quick disbursing loans.

Those institutions are financially capable of responding to the need. But the finance can only prudently be made available as countries in fact undertake the policies needed to encourage and sustain growth -- growth that over time will ease the job of servicing the debt. The needed structural change could affect many different aspects of economic life -- modernization of agriculture, privatizing government enterprises, liberalizing imports, market-oriented pricing -- depending upon the needs and circumstances of individual countries. Moreover, close attention will continue to be required as well to the need to contain excessive budget deficits and to maintain appropriate monetary and exchange rate policies -- the kind of thing with which the IMF has been so active. And both policy changes and finance will have to be tailored, case by case, to the specific requirements of particular countries.

In such circumstances, the international banking community could be expected to do its part as well. The banks with large loans already outstanding, have, of course, a lot at stake. Years of good growth -- growth that can be sustained without the kind of massive injections of new money characteristic of the 1970s and early 1980s -- would be the best possible solvent of the debt problem. It would, at one and the same time, reduce the interest burdens of the borrowers, relative to the size of their own economies, and reduce the exposure of banks, relative to their capital and assets. But for a time, that growth in most of the indebted countries will require some moderate availability of loans beyond what can reasonably and equitably be supplied by official sources.

The challenge is clear. Each part of the overall effort -- by borrowers, by international institutions, and by banks -- is essential to the success of the whole. And it would be unrealistic to anticipte that any part could proceed for long without the support of the others.

All of that implies a very large cooperative effort. Can a large number of banks from many countries, with different exposures and particular interests, develop a common approach responsive to the needs and reflecting their basic community of interest? Can the borrowing countries themselves develop policies that will first of all command the confidence of their own citizens, stop capital flight, and build sustained growth? Can the international institutions effectively encourage and assist that process, acting in the interests of world development and growth?

It's obviously a tall order -- but neither are we starting with a blank piece of paper, building from scratch. We have by now a lot of experience in dealing with the debt problem, and some concrete successes.

The initial responses to Secretary Baker's initiative are encouraging. Clearly, much more must be done.

But we also know that adversity clarifies choices, and minds. The yeast of change is at work, in Latin America and elsewhere.

The enlightened self-interest of borrowers and lenders alike seems to me to point fundamentally to the benefits of a cooperative effort.

In the end, the success of that effort, like so much else, will depend upon the world economic climate. The prospect for sustaining growth and working toward lower interest rates in the United States -- and in Canada, too -- rests on maintaining the progress against inflation. The prospect would be greatly assisted by clear and effective action to reduce our budget deficit in the United States, and by yours as well.

But other industrial countries need to help carry the torch of growth. And those in the strongest external position can, by opening markets, help us all resist the siren song of protectionism. All of that, more certainly than any intervention in exchange markets, would help assure a better international balance and well-aligned exchange rates.

This is a time of opportunity -- but of danger as well. We can't expect perfection in the timing and execution of every policy -- the world is too uncertain, and our abilities too frail, for that.

But we don't need perfection. What we do need is a strong sense of the right direction -- and I think we have that.

We need to realize how the actions of each country fit into a coherent whole -- and I think we are gaining that.

And, of course, we need practical action. That's sometimes the hardest part. But there is too much at stake to fail to carry through.

And so long as we understand that we are dependent on each other -- that seizing the opportunities requires complementary action by us all -- I will remain confident of our success.

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