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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Trade

Committee on Ways and Means

House of Representatives

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Mr. Chairman and Members of the Subcommittee:

You have raised with me a number of important questions concerning the state of the world economy, and particularly the U.S. trade position and our increasing international indebtedness. There are, indeed, serious problems in these areas that, left untended, would pose great dangers both for us and our trading partners. At the same time, our responses, and those of other countries, need to be well considered as well as forcible -- well considered in terms of their consistency with sustainable world growth, a greater degree of international financial stability and a trading order able to support that growth.

The burden of my comments today is that much of the groundwork has been, or is being laid, for such an approach. I realize the results so far are uneven. Frustrations abound, here and abroad. Margins for error have been pretty well exhausted. But I also sense a wider appreciation of those risks, a larger degree of consensus on the directions we must take in economic policy here and abroad, and greater willingness to explore and perhaps deal with some of the longer-term "systemic" issues.

The most striking reflection of the strains in the world economy is the enormous imbalance in our trade accounts and the counterpart surpluses of some countries abroad. When I appeared before this Subcommittee in April 1984, our trade and current account deficits were already big and getting bigger -- running around $110 billion. Two years later, in the second quarter of 1986, those deficits approached $150 billion.

I emphasized in that earlier appearance that those external deficits were related to more fundamental factors -- relative rates of economic growth, the size of our budget deficit, exchange rates, and the international debt crisis.

Those factors remained adverse for some time longer. As a result, there are still no clear signs that the trade deficit is declining, and we have continued to see marked instability in exchange rates and strong protectionist pressures. But I also believe that prospects are now more hopeful. Some basic corrective forces have been put in place, and others are receiving more attention. As a result, we have the clear opportunity for a more favorable conjuncture of policies and results.

Certainly, industrialized countries generally -- and many developing countries as well -- have made considerable progress toward restoring a greater sense of price stability, one prerequisite for sustaining economic growth and greater interest rate and financial stability. Current exchange rate relationships place our industry in a far better competitive position among the industrial countries than for some years; I see no need for further adjustments on anything like the scale or speed of the past 18 months. You and your colleagues now appear to be dealing with the budget deficit more forcibly -- an approach that, if carried through, will reduce our dependence on foreign capital and provide protection against a resurgence of inflation. Moreover, there have been some signs in some major foreign countries recently, most notably Germany, of a resurgence of domestic demand after a considerable period of sluggishness. There appears to be growing recognition of the crucial importance of sustaining that demand.

The Trade Accounts -- Problems and Prospects

In 1980, the United States had a small trade deficit and the current account -- benefitting from earnings from our net overseas investment -- was in virtual balance. Since then, the value of imports, other than oil, has almost doubled. Total imports are running at some $360 billion, despite large declines in the oil import bill.

In contrast, the total value of U.S. merchandise exports has been little changed on balance during the 1980s, running currently at around $220 billion, or only about 60 percent of our imports. An actual decline of more than a third in exports of agricultural products has been only partially offset by a rise in the dollar value of exports of manufactured goods, which must make up the bulk of our export sales. In volume terms, total exports have actually declined a bit -- by about 3 percent -- since 1980.

That swing in our trade accounts is one reason -- the most important reason -- that domestic manufacturing activity has been sluggish during much of the current period of economic expansion. It is also a factor restraining the willingness of manufacturers to invest for future expansion.

At the same time, the surplus we have traditionally run on services and other current account items has virtually disappeared, reflecting primarily the growing amounts of interest paid on our increasingly heavy overseas indebtedness. Borrowing abroad is, of course, a necessary counterpart of a current account deficit. But we have been dependent on foreign borrowing in another sense as well; it has had the practical effect of largely offsetting the huge demands on our money and capital markets from the budget deficit.

Convenient as that borrowing has been however, that process is not sustainable indefinitely.

We are now by far the world's largest debtor country, and even under favorable circumstances that net indebtedness will increase substantially further in the years ahead. Of course, our external debt, relative to our GNP, is still rather modest. Nonetheless the trend is disturbing.

Over time, interest on that debt will have to be paid, implying the need for relatively more exports and fewer imports. Unless the foreign funds have, directly or indirectly, been employed in building productive investment, the implications for growth in American living standards are adverse. Unfortunately, given our budget deficit, savings patterns, and the trend of plant and equipment spending, the evidence suggests that most of the funds available from abroad have indirectly supported consumption rather than adding much to our productivity or productive capacity.

That is a long-term consideration. In the more immediate future, the relevant question is whether foreigners will remain so willing to employ so large a fraction of their own savings in our markets. The question could become more pointed if and as their own economies expand more rapidly, as we would like to see.

In that respect, much turns on confidence -- confidence that the U.S. will in fact sustain growth without reigniting inflation; that the dollar will tend to stabilize in the exchange markets; and that, over time, our trade balance will decline, reducing our need for overseas financing.

There are, of course, strong domestic reasons why a reduction in our trade deficit is essential. For a time, it could be argued that the rising level of imports and accompanying capital flows brought short-term benefits to most Americans. We could enjoy relatively cheap and high quality imports, intense competition helped stabilize the domestic price level, and the ready availability of funds from abroad meant that we could finance the federal deficit at lower interest rates than would have otherwise been possible. But the process also squeezed our industrial base, severely affecting a number of industries and workers.

The strains are now showing economically and politically. Indeed, prospects for continuation of the economic expansion through 1987 and beyond are heavily dependent on an improved trade balance. The relevant question is how to achieve that result, consistent with our growth and stability and that of the world at large.

Toward a Constructive Solution

No single measure, here or abroad, is likely by itself to restore a better balance in our trade position without damaging other important objectives, including prospects for world growth. That is particularly true of a scatter-gun approach toward protectionism.

I well understand, at a time of stress in important regions of the country and particularly in the light of evidence of restrictive practices by others, the temptations to move in that direction. But I hope we are fully aware of the risks. The results now would be no better than in the 1930s; then, one protectionist measure bred others, and world trade and economic activity were depressed together.

We preach to Latin America and others the need to find solutions to their problems in the context of an open trading system, and in the efficiencies and productivity that fosters. But of course that won't work unless our market and others' are open to them. And the lesson of the benefits of a liberal trading order is equally applicable to all of us.

Our effort, instead of retreat, must be directed toward opening other markets, and toward assuring trade can proceed on fair and reciprocal terms. In the broadest sense, that is of course what drove our negotiating efforts at Punta del Este, as we and others worked to launch a new round of GATT negotiations. Strengthening the agreed set of international trading rules is essential to provide a fair and more comprehensive framework for the conduct of international business. It is part of a constructive response to protectionist pressures.

I realize that is the work of years. More can and should be done to deal, case by case, with particular problems with particular trading partners in the nearer term. You are familiar with those efforts -- with both the successes and the frustrations. But I know of no other way of proceeding without damaging our fundamental objectives.

In terms of achieving decided improvement in our trade balance, other approaches will in any event be quantitatively far more important. One of those approaches is to maintain a value for our currency vis-a-vis other industrial countries that permits our companies to compete effectively. Judgments in this area are always difficult and results are the acid test. However, in contrast to the situation 18 months ago, and assuming growing markets are open to us, my sense is that we are for now reasonably close to an appropriate adjustment in that area. Whether that will remain a fair judgment is, of course, dependent heavily on prospects for enhancing productivity in industry and maintaining reasonable price stability.

I realize that, even with the dollar more than 30 percent below its average level in early 1985 (and about 40 percent lower in terms of the Japanese yen and the West German mark), our overall trade balance has yet to improve. That is not entirely surprising. We are still experiencing some of the lagged effects of the extraordinary strength of the dollar earlier. Many of those exporting to us have been willing to reduce previously wide profit margins, or for a time to forego profits for market share. Some U.S. industries operating at a relatively high level, and reluctant to expand capacity, have raised their own prices as the exchange rate has fallen. Moreover, when prices of imports rise, so for a time will the total import bill, widening the trade deficit until competitive adjustments are made.

More broadly, we need to recognize that exchange rate changes <u>alone</u> will not assure the lasting competitiveness of our industry or the large shift of resources necessary here and abroad to restore better balance to the world economy. Indeed, without support of other policies, exchange rate changes can be counter-productive in important respects -- inflationary in the United States, and a restraint on demand and economic activity abroad.

Fortunately, the sharp decline in oil prices has, until now, more than offset the effects of the declining dollar exchange rates on producer and consumer prices in the United States. The countries with the greatest exchange rate appreciation -- Japan and Germany -- have experienced a levelling or even decline in the volume of exports and some increase in imports, as they inevitably must if their trade surpluses are to decline.

Looking ahead, the relevant question is whether the large shift in resources implicit in reducing our trade deficit, and the surpluses of others, can be accomplished in a framework of non-inflationary growth, here and abroad. It is that underlying question that seems to me to lie behind so much of the active trans-Atlantic and trans-Pacific economic dialogue in recent months -- a question that sometimes seems to be obscured, rather than enlightened, by focus on the timing or wisdom of particular policy measures, fiscal or monetary, by one country or another.

The basic point is that the adjustments required, by their nature, must be two-sided. The United States, if it is to reduce its trade deficit substantially, must be prepared, <u>in relative terms</u>, to reduce the rate of growth in domestic consumption in favor of the external sector and investment. At the same time, we will have to be prepared to rely less on capital inflows to finance domestic needs. For other countries, with excessively large trading surpluses, the opposite must be true -- relatively stronger growth in domestic demand and consumption and more fully utilized domestic savings as their trade balances decline.

The clear implication is that broadly complementary approaches are necessary in the common interest. For the

United States, orderly reduction in the budget deficit remains a key, and the external sector (and manufacturing activity) should provide more of the impetus to growth. For other countries some appropriate mix of monetary, fiscal, and other policies to sustain and enhance domestic demand are required if their trade surpluses are to decline in a context of healthy world growth.

While international consultations and discussions can help clarify these issues, decisions on the precise nature and timing of particular fiscal or monetary measures naturally will remain within the province of national governments, subject to their individual analyses of economic developments and outlook. Sometimes, coordination of particular actions -- such as monetary policy decisions -- may indeed be important to avoid unwanted effects on exchange markets or financial markets generally. But what is far more critical than the precise timing of particular measures is achieving a realistic understanding of the interactions among national economies, and acting upon that understanding to maintain the momentum of non-inflationary growth.

The most recent developments are reasonably encouraging. As I noted earlier, we do appear to be making some progress toward reducing our budget deficit, even if all the optimistic assumptions underlying the program now under Congressional debate are not borne out. Economic activity -- and particularly domestic demand -- turned stronger in the spring and summer in Germany (and to a lesser extent in Japan), following substantial sluggishness.

I realize questions are raised about the "staying power" of those changes, here and abroad. That is why it is so important that there be full understanding among governments of what is at stake and of the need for continuing appraisals of progress and the possible need for complementary actions. As you know, the Economic Summit at Tokyo last spring strongly emphasized the need for maintaining close contacts among economic officials, for close review of economic indicators, and for mutual assessment of the outlook. The series of meetings before the annual sessions of the Governors of the IMF and the World Bank next week will provide ample opportunity to further that effort.

The Heavily Indebted Developing Countries

Those meetings will also devote a lot of attention to the continuing problems of many countries in Latin America and elsewhere burdened with heavy debt as they work to restore greater growth and stability. Plainly, those problems will to some extent be with us for some time -- warning enough of the wisdom of seeking solutions to our own "adjustment" problem before it reaches crisis proportions. The evident fact that large difficulties remain should not, however, obscure the very real progress that has been made.

Indeed, for most of the indebted countries the necessary external adjustment has already been substantially achieved. Taken as a group, the 15 heavily indebted countries more or less arbitrarily associated with the so-called

"Baker Plan" were in rough current account balance in 1984 and 1985. In 1981 and 1982, in contrast, they had an aggregate deficit of about $50 billion. In other words, the collective trade surpluses of those countries rose to the point that they offset interest payments on outstanding debt. Interest payments themselves, reflecting developments in world financial markets, are now moving lower.

To be sure, that effort for a time was accompanied by sharply lower imports, recession, and lower standards of living. Moreover, for about two years, there has been little new <u>net</u> lending to those countries by the world's commercial banking system. As we look ahead, those circumstances need to change. Ultimately, the debt burdens can be carried only in the context of healthy growth, which in turn implies more investment and imports. For most of the indebted countries, some margin of funds will be required from abroad to meet those needs although not nearly so much as during most of the 1970s and early 1980s.

Fortunately, there are encouraging signs of progress in those directions. A number of the heavily indebted countries are now growing again, in some cases with vigor. That is true in the case of the largest single debtor country, Brazil. Helped by the reduction in world interest rates, external interest burdens are being reduced appreciably in some countries relative to exports or other measures of capacity to pay. A number of Latin American countries have also taken striking initiatives toward dealing with chronic inflationary problems.

Potentially equally important, considerable if uneven progress has been made toward liberalizing the economic structures of borrowing countries in ways that should encourage more growth and productivity over time, in the process justifying new equity investment and some lending by international institutions and banks. That progress has been particularly evident with respect to the trade sectors of a number of countries.

The main motivation clearly is to improve the efficiency and competitiveness of their own export industries. However, the result should certainly be to enhance opportunities for exports from the United States and other industrial countries. A more favorable attitude toward private investment, both by their own citizens and by foreigners, is another indication of a generally more outward-looking market-oriented approach.

It would be too much to claim that this progress is uniform or yet firmly ingrained in economic or political structures. But against the very different pattern of the past -- a pattern extending over decades of inward looking efforts at self-sufficiency and strong state control of industry -- the sense of change is impressive. I believe it is deeply in those countries' interest, and ours, to see that process continue and mature, for it will ultimately provide the basis for renewed prosperity, higher living standards, and greater political stability. To achieve that end, it is also evident that much will depend upon the cooperation of creditor banks and governments in supporting effective economic programs, sustaining a reasonably favorable world economic climate, and maintenance of open markets.

The sharp decline in oil prices earlier this year threatened to set back the entire effort. To be sure, pressures on some countries were moderated by lower oil prices. But that same development had an enormous adverse impact on major oil exporters such as Mexico, Venezuela, Ecuador and Nigeria. At the low oil prices reached this summer, for instance, Mexico would lose more than a third of its total 1985 exports, perhaps a fifth of its government revenues, and the equivalent of more than 5 percent of its GDP. With the exception of Venezuela, there was no large cushion of external reserves to buffer the shock.

Inevitably, that situation has posed a severe new challenge to all the parties concerned. Mexico, Nigeria and Ecuador have each responded with strong new efforts to deal with budgetary deficits, to improve efficiency, and to promote longer-run efficiency and longer-run adjustment.

In the case of Mexico, the basic orientation is symbolized by a long-debated decision to join GATT. In that spirit, import restrictions are being rationalized and liberalized, some state-owned enterprises are being made available for sale (or, if too inefficient, shut down), subsidies are being reduced and eliminated, and procedures for approving foreign investment are being eased.

The IMF is supporting those efforts. It has agreed in its own lending program to imaginative new approaches to help assure growth and guard against further adverse oil contingencies. The World Bank is ready to provide sizable new credits to assist sectoral and structural adjustment, with appropriate monitoring of progress. At the same time, significantly larger financial resources than anticipated earlier for Mexico will have to be marshalled from both official and banking sources abroad to help ease the transition, to maintain continuity in debt service, and to provide a solid base for renewed growth.

That combination of adjustment, structural change, and appropriate financing in support of renewed growth is the essence of the approach set out by Secretary Baker at Seoul last year.

What remains to be done in the case of Mexico is completing financial agreements with commercial bank creditors both to restructure outstanding debt at acceptable terms and to provide the needed margin of new credits, comparable in total to those supplied by official sources.

The net amount to be made available by commercial banks through the end of next year would run to a little less than 7 percent of outstanding loans. That is a sizable amount, but it should be kept in perspective. It is so large only because of the size of the decline in oil prices -- a decline that has reduced expected financing needs of some other countries. Looking back, commercial banks' claims on

Mexico appear not to have increased significantly for more than 2 years. Taking Latin America as a whole, present indications are that lending volumes, taking one year with another, both for official and commercial bank lenders, should remain generally within the amounts foreseen by Secretary Baker a year ago.

Moreover, taking the entire period since mid-1982, there has been a striking decline in the exposure of American banks to the heavily indebted countries of Latin America relative to their capital. That ratio for all significant lending banks fell from about 120 percent of bank capital to less than 75 percent at the end of March 1986, a decline of 40 percent. Those exposures are actually considerably less than in 1977 when the data were first collected.

Success in dealing with the debt problem in Mexico, as elsewhere, remains totally dependent upon a strong sense of inter-dependence and commitment by borrowing countries, commercial bank lenders, international institutions, and governments. Each of the parties has a lot at stake. The debtor countries plainly both want to maintain their creditworthiness and to restore growth and stability -- and those objectives are closely related. Major commercial banks remain heavily exposed and want borrowers to be able to service their debts. Governments and international institutions, like the borrowers and private lenders, have a strong interest in international financial order, in expanding markets, and in reduced imbalances. And, of course, relationships beyond the purely economic are at stake, for the United States most of all.

That sense of mutual interest is being strongly tested once again, under the pressure of oil prices that few had anticipated. But after months of delay, substantial progress is now being made, not only in Mexico but elsewhere. Obviously, the job is not complete, and time is short. But I know of no other workable approach to meet the basic objectives.

And all of the parties -- borrowers or lenders -- have an enormous interest in the success of the whole. Moreover, success in the Mexican effort -- now at the crucial stage -- will set a most promising example for dealing with the needs of other countries.

Among the beneficiaries of renewed growth in Latin America should be the U.S. trade position. Traditionally, we had a sizable surplus in manufactured goods with that area, and a small surplus overall. Those surpluses fell away in the 1980s as the United States absorbed the brunt of the necessary adjustments in the trade position of the borrowers. But now, Latin America imports should resume growth more or less in line with their exports, and, with adequate financing, probably faster. Latin America is a natural market for us. With a more competitive dollar, our exports are in a position to gain both absolutely and relatively.

An Interdependent World

It has become a cliche to refer to the interdependence of national economies in the world today. But cliche or not, it is a reality, and our policies -- those of the United States and other countries -- must recognize that reality.

The range of considerations and policies I have touched upon today illustrates the point:

- The United States must continue to work toward reducing the federal budget deficit.
- We must keep inflation under control, partly to preserve the competitiveness of U.S. goods, but also to contribute to greater stability of exchange rates and prices in markets generally.
- Other industrial countries must ensure adequate growth of domestic demand as their external trade surpluses shrink.
- Developing countries need to work forcibly and effectively to improve their economic efficiency and stability.
- International financial institutions and commercial bank creditors need to support those efforts.
- All countries must resist protectionist pressures.

If all these things are done reasonably well, then the outlook for sustained and more balanced growth in the world economy for the period immediately ahead is good.

If we can go still further, and incorporate some of the lessons of the past into more coherent and effective trading and monetary systems, then we will have greatly enhanced the prospects for sustaining good performance in the more distant future. That is the challenge for the years ahead.

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