CHAPTER 7

The United States in the International Economic System

THE SUCCESSFUL IMPLEMENTATION OF POLICIES to control inflation and restore vigorous real growth in the United States will have a profound and favorable impact on the rest of the world. As the President told delegates at the 1981 Annual Meetings of the World Bank and International Monetary Fund, ". . . the most important contribution any country can make to world development is to pursue sound economic policies at home." More generally, the Administration's approach to international economic issues is based on the same principles which underlie its domestic programs: a belief in the superiority of market solutions to economic problems and an emphasis on private economic activity as the engine of noninflationary growth.

This chapter reviews three areas important to U.S. international economic policy: the role of the dollar in the international monetary system, the increased importance of international trade and finance for the U.S. economy, and the evolving role of international institutions in promoting a more open international economic environment.

During much of the postwar period, under what was known as the Bretton Woods system, most governments held their exchange rates fixed against the dollar by intervening in the exchange markets whenever supply of and demand for their currencies were not in balance at the prevailing exchange rate. The U.S. Government usually did not intervene in the exchange markets, but stood ready to buy and sell gold against dollars at a fixed price with foreign official agencies. In 1973 the Bretton Woods system of fixed but periodically adjustable exchange rates collapsed. An increasingly expansionary U.S. monetary policy and a decline in U.S. economic performance accelerated that collapse, but the end of the fixed-rate system probably would have occurred in any case.

Although the role of the dollar in international markets has declined somewhat over the past three decades, it remains the central currency of the international monetary system. Consequently, both the United States and the rest of the world benefit from having a strong and stable dollar, that is, one with stable purchasing power.

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This cannot be met through government intervention in exchange markets. Rather, it requires that the United States pursue noninflationary economic policies designed to strengthen its economic performance.

A strong economy requires the maintenance of open markets both at home and abroad. Open trade based on mutually agreed upon rules is consistent with, indeed intègral to, the Administration's commitment to strenthening the domestic economy. The maintenance of open markets has become increasingly important in recent years as the shares of foreign trade and investment have grown relative to the size of the U.S. economy.

International institutions have contributed greatly to the economic prosperity the world has enjoyed since World War II by helping to promote increased international trade and investment and to strengthen individual economies. In his World Bank-International Monetary Fund speech President Reagan also remarked that, "The Bretton Woods institutions and the General Agreement on Trade and Tariffs (GATT) established generalized rules and procedures to facilitate individual enterprise and an open international trading and financial system. They recognized that economic incentives and increased commercial opportunities would be essential to economic recovery and growth." As the economic environment in which these institutions operate continues to change, we must assure that these institutions continue to evolve in a manner suitable to maintaining and strengthening the open international economic system from which we all benefit.

INTERNATIONAL FINANCIAL MARKETS

THE DOLLAR IN THE INTERNATIONAL SETTING

The availability of a stable and convertible dollar for use as a store of value and a medium of international exchange contributed significantly to the sustained world economic recovery following World War II. The U.S. dollar still holds a major position in world financial markets. However, this position was weakened by high and varying inflation in the United States relative to that abroad during the 1970s. Poor U.S. economic performance and stronger records in such countries as Japan and West Germany led to a depreciation of the dollar in foreign exchange markets and to the diversification of private and official asset holdings in international financial markets into other currencies. When the purchasing power of the dollar became less stable than the purchasing power of other major currencies, foreigners did not want to continue to hold as large a share of

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their wealth in dollar-denominated assets or rely as much on the dollar as the standard currency in international transactions.

The dollar remains the principal currency for international commercial and financial transactions. Because of this, both the United States and the rest of the world would benefit from a stronger and more stable U.S. dollar. The strength and stability of the dollar depend directly on the ability of the United States to pursue noninflationary economic policies. In the late 1960s and the 1970s the United States failed to meet this objective. A continuing high and varying rate of inflation led to a sharp decline in the dollar's foreign exchange value during the late 1970s and to the dollar crisis of 1978, which threatened the stability of international financial markets.

It would be desirable to lessen the differences in economic policies and performance at home and abroad which have caused much of the exchange-rate volatility in the recent past. Formal arrangements which peg exchange rates, however, cannot guarantee lasting coordination, as was demonstrated by the history of the Bretton Woods system. As a general proposition, one way to achieve compatibility of policies is for countries *voluntarily* to adopt the monetary rule of a large country whose avowed goal is to stabilize prices. Such a commitment becomes a *de facto* affiliation which will last as long as that larger country performs its task reliably and the smaller countries determine the arrangements to be beneficial. The larger country must be aware that a systematic oversupply of its money will erode confidence and hence reduce the foreign exchange value of its currency. In international markets, where there is competition among monies, high confidence monies eventually replace low confidence monies.

EXCHANGE-RATE MOVEMENTS

Changes in exchange rates, like changes in stock market prices, are largely unpredictable in the short run. New infomation continuously leads exchange-market participants to revise their forecasts of the state of the economy and the stance of economic policies. Exchange rates can exhibit large short-run fluctuations in response to such changes in economic outlook.

Over a longer period, exchange-rate changes reflect differences in inflation rates between countries; that is, purchasing power parity should hold in the long run. In Chart 7-1, measures of the nominal and the real effective exchange rates are shown for the United States from 1973 to 1981. The real effective exchange rate is here defined as the nominal effective foreign exchange value of the dollar (a trade-weighted exchange rate) multiplied by the ratio of the U.S. consumer price index (CPI) to the foreign consumer price index (March 1973=100). Purchasing power parity holds when the real effective

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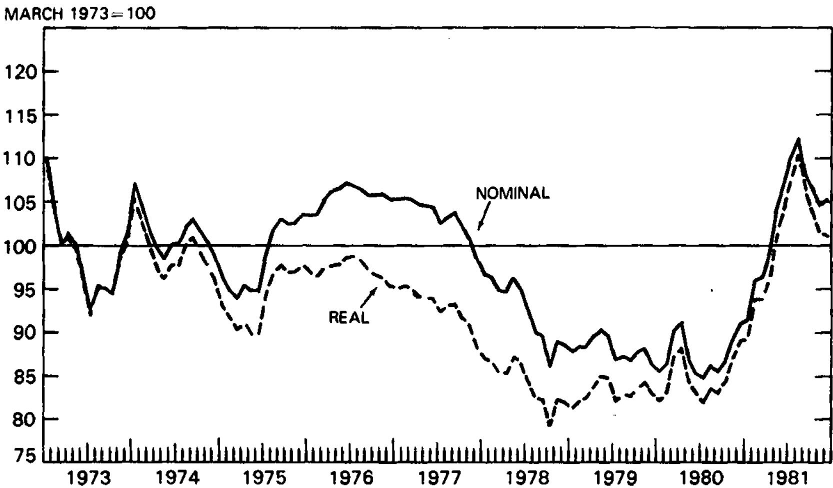
exchange rate is 100; below 100 the dollar depreciates in real terms; above 100 the dollar appreciates in real terms. Two observations about the graph are in order. First, there were substantial and persistent deviations from purchasing power parity but a tendency for the real effective exchange rate to gravitate around the 100 line. Second, nominal and real effective exchange rates generally moved in the same direction.

Chart 7-1

Nominal and Real Effective Foreign Exchange Value of the Dollar



NOTE.—THE EFFECTIVE EXCHANGE RATE IS COMPUTED USING MULTILATERAL TRADE SHARES OF THE G-10 COUNTRIES PLUS SWITZERLAND. THE REAL EXCHANGE RATE IS CALCULATED BY ADJUSTING THE NOMINAL INDEX FOR RELATIVE MOVEMENTS IN CONSUMER PRICES (THIS IS ONE AMONG VARIOUS WAYS TO MEASURE REAL EXCHANGE RATES).

SOURCES: DEPARTMENT OF LABOR AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

The substantial movement in this measure of real exchange rates, however, does not invalidate the long-term purchasing power parity relationship. There are three main reasons why short-run deviations from long-run purchasing power parity occur. First, changes in the general price level, accompanied by changes in the ratio of traded to nontraded commodities prices (the internal terms of trade), affect real exchange rates. This is so because the net export surplus (deficit) of the country experiencing an improvement in the relative price of traded goods rises (falls). For a given price level, the exchange rate must adjust to restore long-run equilibrium in the current account.

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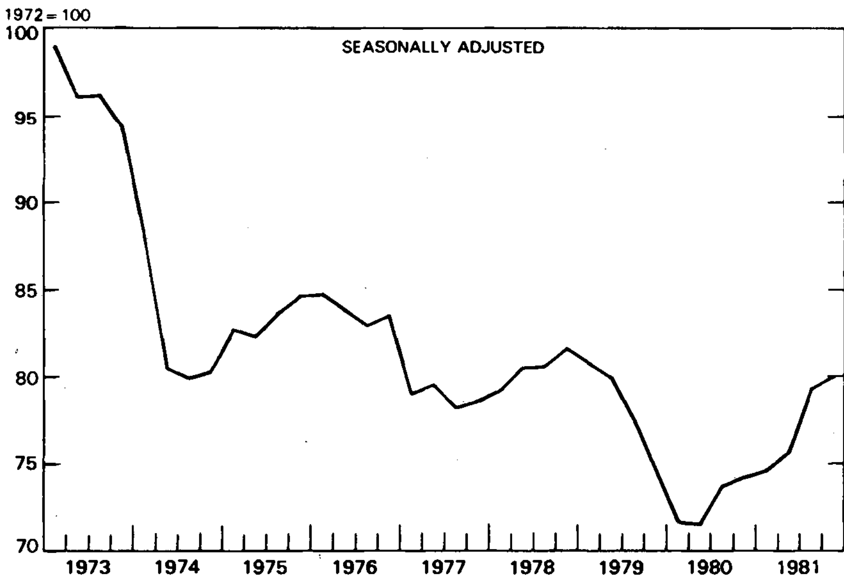
Movements in real exchange rates also can take place because the "terms of finance" change. That is, there may be shifts in the currency preferences and risks faced by participants in international financial markets which in turn affect expected yields on assets denominated in various currencies.

Finally, real exchange rates tend to move in the same direction as nominal exchange rates because prices change more slowly than nominal exchange rates. As a consequence, changes in monetary policy quickly affect nominal interest rates in financial markets, and more gradually, the price level. Thus, changes in monetary growth affect both real and nominal exchange rates in the short run. Over the longer term, however, monetary growth does not influence real exchange rates.

All of these forces have been present during the last decade. Over this period the U.S. economy has been subjected to significant changes in the prices of internationally traded goods, especially oil. For instance, the external terms of trade, measured by the ratio of the price deflator for exports of goods and services to the price deflator for imports of goods and services, fell sharply in 1973 and in 1979 as the two oil price shocks of the 1970s left their marks on the U.S. economy (Chart 7–2). In addition, the U.S. economy became

Chart 7-2

U.S. External Terms of Trade



NOTE.—DATA ARE RATIO OF IMPLICIT PRICE DEFLATOR FOR EXPORTS OF GOODS AND SERVICES TO IMPLICIT PRICE DEFLATOR FOR IMPORTS OF GOODS AND SERVICES.

SOURCE: DEPARTMENT OF COMMERCE.

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much more open in the 1970s than it used to be. As an example, exports as a proportion of gross national product (GNP) nearly doubled during the 1970s.

Historically, real exchange rates generally have moved in the direction of restoring long-term equilibrium in external accounts. In the 1977–78 period the United States had a cumulative current account deficit of $28.2 billion. The United States and foreign central banks then intervened massively in an effort to contain the depreciation of the dollar. Foreign net purchases of dollars were more than double the amount of the cumulative current account deficit. Yet the dollar continued to depreciate, both in nominal and real terms. Market participants judged the intervention to be ineffective and viewed the deterioration in the U.S. current account as an accurate reflection of underlying U.S. economic policies and performance. The depreciation was pronounced and persistent, but achieved the expected result of redressing the current account imbalance during 1979 and 1980.

In 1981 the dollar appreciated sharply, both in nominal and real terms. The nominal appreciation of the dollar on a trade-weighted basis relative to other major currencies was 15.6 percent. This movement is explained only in part by the current account surplus of the United States relative to that of its trading partners. Another factor was a shift toward dollar-denominated assets, which may have been a consequence of the President's economic recovery program. Large sales of dollar assets by foreign central banks and an increase in foreign interest rates relative to U.S. interest rates did little to prevent the dollar from rising. The growing preference for dollar-denominated assets relative to other assets reflected a positive response to underlying economic policies of the Administration.

OFFICIAL INTERVENTION IN THE EXCHANGE MARKETS

There is a long tradition among monetary authorities of intervening in the foreign exchange markets to prevent what is known as overshooting, undershooting, or, more generally, disorderly market conditions. But there is no conclusive evidence that official intervention in the past has achieved its purpose. The large purchases of dollar-denominated assets by foreign central banks in 1977–78 did not prevent the dollar from depreciating, and their large sales of dollar assets in 1980–81 did not prevent the dollar from appreciat-

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ing. Moreover, intervention may have been counterproductive. Market participants did not know whether it signaled a change in monetary policy, thereby leading to increased uncertainty on their part.

When the previous Administration left office, intervention by the United States was being conducted at a relatively high volume, virtually on a day-to-day basis, with the objective of using the periods of dollar strength first to cover outstanding foreign currency liabilities and later to build foreign currency reserves. This was the first time, at least in recent history, that the United States had embarked on a deliberate policy of acquiring substantial foreign currency reserves. (For a brief history of U.S. Government intervention in the exchange markets, see the appendix to this chapter.)

Early in 1981 the new Administration scaled back U.S. intervention in foreign exchange markets. In conjunction with a strong emphasis on economic fundamentals, this Administration has returned to the policy of intervening only when necessary to counter conditions of severe disorder in the market.

As in the past, no attempt has been made to define disorderly market conditions in advance. When making a decision on whether exchange-market conditions justify intervention, the U.S. Government will consult closely with the governments of other major industrial countries. Also as in the past, the Department of the Treasury and the Federal Reserve will keep the public informed regarding U.S. exchange-market intervention policy. Although the Administration does not expect intervention in the exchange markets to occur on a regular basis, it will continue to monitor closely developments in those markets.

With the President's economic program firmly in place, and with the Federal Reserve following a policy of gradually reducing the rate of monetary growth to a noninflationary level, the occurrence of disorderly conditions is likely to be significantly less in the future than in the past. But unforeseen circumstances at home or abroad could cause disorderly conditions, and intervention may at times be necessary.

IMPLICATIONS FOR U.S. MONETARY POLICY

In Chapter 3 it was argued that monetary authorities have the ability to achieve given values and growth rates of nominal magnitudes

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and that price stability is the principal objective of monetary policy. Under such a policy, interest rates cannot be fixed. But market interest rates and exchange rates are related by what is known as interest rate parity: the premium in the forward exchange markets approximates the difference between comparable domestic and foreign interest rates. It follows that as interest rates change over time, nominal exchange rates will vary as well. A stable price level, therefore, may not necessarily imply constant nominal interest rates or constant exchange rates.

Price stability in the United States might lessen considerably the dispersion of inflation rates now prevailing in the world, but cannot eliminate them altogether. Economic policies and performance will continue to differ from country to country. Hence, exchange rates will adjust to reflect such differences. But even if differences in inflation were to disappear, exchange rates would have to accommodate changes in relative prices. Real exchange rates cannot be held constant in dynamic economies. The greatest contribution that U.S. price stability will make to the exchange market is that it will act to reduce exchange rate volatility.

Current U.S. monetary and intervention policies are not expressions of "benign neglect." That notion was based on the premise that the foreign trade sector of the United States was so small relative to the rest of the economy that it could be ignored. By contrast, the Administration stresses the pivotal role of the United States in the world.

TRADE ISSUES AND POLICIES

TRADE IN THE U.S. ECONOMY

Foreign trade has become a vital factor in U.S. business activity and employment. In 1980 exports and imports of goods and services each represented over 12 percent of the gross national product. Twenty years ago exports were less than 6 percent of GNP; imports, less than 5 percent. Much of this shift has occurred in the last decade, during which exports and imports as shares of GNP have about doubled. In real terms, however, the rate of growth in U.S. imports of goods and services was stronger in the 1960s than in 1970s, while U.S. export growth was stronger in the 1970s than in the 1960s. The improved export performance reflects two key factors apart from the evolving ramifications of the trade liberalization of the postwar period and the real depreciation of the dollar in the 1970s: our increased trade with developing countries, whose real GNP growth slowed less in the 1970s than that of the developed countries,

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and our specialization in exports of high technology products, agricultural products, and services.

Recent movements in merchandise trade are shown in Table 7-1; they reflect in part cyclical factors. The sharp decline in real GNP during the second quarter of 1980 was accompanied by a substantial drop in U.S. merchandise imports. From a seasonally adjusted total of $65 billion in the first quarter of 1980, merchandise imports fell to $59 billion in the third quarter. At the same time, demand for U.S. exports remained buoyant, yielding in the third quarter of 1980 the smallest merchandise trade deficit since 1976—$11.6 billion at an annual rate. Thereafter, the rebound in U.S. economic activity from the extremely weak level in the second quarter of 1980, coupled with a slowing of growth abroad and the lagged impact of dollar appreciation on U.S. international competitiveness, acted to widen the deficit. By the the last quarter of 1981, it had risen to $37.0 billion at an annual rate.

TABLE 7-1.—*U.S. merchandise exports, imports, and balance, 1977-81*

[Billions of dollars; f.a.s.]

Period	Exports		Imports		Balance
	Agricultural	Nonagricultural	Petroleum and products	Nonpetroleum	
1977	24.3	96.5	45.0	106.7	−30.9
1978	29.9	112.2	42.3	133.5	−33.8
1979	35.6	148.9	60.5	151.3	−27.3
1980	42.2	181.7	78.9	170.4	−25.3
1981 [1]	44.2	192.0	77.6	186.4	−27.8
1980:					
I	10.3	44.6	21.2	43.9	−10.1
II	10.1	45.6	21.0	41.4	−6.7
III	10.8	45.4	17.4	41.8	−2.9
IV	11.1	46.1	19.3	43.4	−5.6
1981:					
I	12.7	48.3	20.8	44.9	−4.7
II	11.0	49.3	21.2	46.1	−6.9
III	10.0	47.9	17.9	47.0	−7.0
IV [1]	10.4	46.4	17.7	48.4	−9.3

[1] Preliminary.

Note.—Data are on a balance of payments basis and exclude military.
Quarterly data are seasonally adjusted.
Data contain revisions for the first three quarters of 1981.
Detail may not add to balance due to rounding.

Source: Department of Commerce, Bureau of Economic Analysis.

A very broad breakdown of trade by major commodity groups is also shown in Table 7-1. Until recently, agricultural goods accounted for about 20 percent of total U.S. exports. Quarterly changes in the value of U.S. imports during 1980 and 1981 were determined largely by movements in the value of petroleum imports. Petroleum import volume in 1981 declined 13 percent compared to 1980, in the face of an increase in price of 12 percent. The value of petroleum imports fell dramatically in the last half of 1981, with both volume and price declining. The latter reflected reduced worldwide demand for oil

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due to the continued appreciation of the U.S. dollar and the downturns in economic activity in the United States and Europe, all in tandem with adjustments to oil inventories.

While the dollar price of oil has fallen, the appreciation of the dollar has caused the price of oil in European and Japanese currencies to rise. For Europe and Japan, therefore, oil import values rose more rapidly than in the United States during 1981 and a parallel increase in their concern with their own trade balances has added to protectionist pressures in some of those countries.

Although cyclical factors have played and will continue to play an important role in movements of the trade account, the strong appreciation of the dollar through much of 1981 has already begun to be reflected in trade flows. While changes in economic activity are quickly translated into movements of exports and imports, changes in relative prices generally take more time to alter trade flows. Hence, trade flows in early 1982 will continue to be influenced by the earlier sharp real appreciation of the dollar.

In some instances the impact of exchange-rate changes in 1981 was stronger than cyclical effects. U.S. imports of nonpetroleum products grew steadily throughout 1981, despite the weakening of U.S. economic activity. The volume of nonpetroleum imports grew very strongly, while their price fell during the year, both reflecting the appreciation of the dollar.

THE STANCE OF U.S. TRADE POLICY

The Administration spelled out in its July 1981 "Statement on U.S. Trade Policy" its commitment to pursue, at home and abroad, policies aimed at achieving open trade and reducing trade distortions. There are five central components to that policy.

- *Restoring strong noninflationary growth at home.* Fundamental to any effective trade policy is carrying out domestic programs that increase the incentives to invest, to raise productivity, and to reduce costs, thus helping to lower inflationary pressures. These policies will strengthen the ability of American firms to respond to changes in domestic and international markets.
- *Reducing self-imposed trade disincentives.* Confusing and needlessly complex laws and regulations that inhibit exports and imports will be reformed.
- *Effective and strict enforcement of U.S. trade laws and international agreements.* Our policy toward other nations' barriers to trade and to investment or export subsidies is one of strong opposition. Our trading partners must recognize that it is in their own interest, as well as ours, to assure that international trade and investment remain a two-way street.

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- *A more effective approach to industrial adjustment problems.* In a healthy economy some industries and regions will grow more rapidly than others, and some sectors will experience more difficulty. If unhindered, the market will signal these changes and provide incentives for adjustments. Market forces, rather than government bail-outs, will be relied upon to make appropriate adjustments.
- *Reducing government barriers to the flow of trade and investment among nations.* To this end it is necessary to continue efforts to improve and expand existing international trade rules, particularly into the areas of services and investment.

At home, as well as in other nations, public policy discussions about international trade often lead to disagreement. The direct beneficiaries of import relief or export subsidy are usually few in number, but each has a large individual stake in the outcome. Thus, their incentive for vigorous political activity is strong.

But the costs of such policies may far exceed the benefits. It may cost the public $40,000-$50,000 a year to protect a domestic job that might otherwise pay an employee only half that amount in wages and benefits. Furthermore, the costs of protection are widely diffused—in the United States, among 50 States and some 230 million citizens. Since the cost borne by any one citizen is likely to be quite small, and may even go unnoticed, resistance at the grass-roots level to protectionist measures often is considerably less than pressures for their adoption.

The decisions taken in trade cases inevitably reflect political and social forces as well as basic economic considerations. The record of decisions, not surprisingly, continues to be mixed. For example, the extension of the Multifiber Arrangement, agreed upon in December 1981, is more restrictive than open-trade advocates might have preferred, but the principle of openness was adhered to closely in the decision concerning the nonrubber footwear industry. A similar contrast can be found in the automobile and industrial fastener cases.

CHANGING ATTITUDES TOWARD INTERNATIONAL TRADE

The gradual opening of the world economy to trade in the postwar period has brought major benefits both to the United States and to our trading partners. Long experience has shown that the benefits of trade tend to be mutual. Competition, whether domestic or international, fosters the allocation of resources to relatively more productive activities. Better products, at lower prices, appear in the marketplace. Consumer choice is expanded. Technologies are more readily diffused. Inflationary pressures are reduced. With time, productivity, and hence income, rise.

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The benefits from open trade are derived as much from reductions in barriers to imports as from expansion of exports. American exporters seek foreign buyers who have access to the U.S. dollars necessary to buy U.S. goods and services. While the U.S. dollar is a convertible currency that is widely used in a variety of international transactions, significant amounts of dollars are made available when Americans import foreign goods and services, paying in U.S. dollars. Put simply, our imports put U.S. dollars into the hands of foreigners who then use those dollars—be it to buy U.S. goods, services, or assets, or to exchange currencies with others who want dollars. In the short run, we can, and in many cases do, lend foreigners the dollars to finance their purchases of our exports. When such loans are made at market rates of interest, trade is advanced. But when government-subsidized credit is provided, instead, such funds are denied to other, more productive uses.

Restricting U.S. imports would reduce the amount of dollars available to those in other countries who would buy our wheat, aircraft, chemicals, or machinery unless we made up the difference by loans to foreigners. In some cases, the connection between imports and exports is even more direct. Import restraints can reduce employment and profits in our more productive export industries. The nonrubber footwear industry offers one such example. U.S. exporters of hides to foreign shoe producers suffered as a result of our restraints on imports of foreign shoes. More generally, import restriction by one country may invite others to retaliate.

Pressures for retaliation, which tend to strengthen when, as now, output growth rates are declining and unemployment is rising, are one of a number of forces threatening to stem the growth of world trade. In the last year or so, the U.S. automobile, footwear, steel, and textile industries have been among those actively seeking relief from import competition. There are similarly strong pressures for government subsidy of export expansion—for example, in agriculture and in high technology industries.

Such pressures for further government intervention reflect a potentially troublesome "neomercantilist" view which stresses export expansion to the near exclusion of all other factors in a healthy international trading climate. If the U.S. Government, the reasoning runs, were to take steps to favor sectors with export potential, the domestic economy would benefit. In this view, a large surplus in the merchandise trade account is deemed an unmitigated "good," a deficit "bad."

There is a fundamental inconsistency between such neomercantilism and the overall economic philosophy of the Administration, which is committed to the goal of less, not more, government inter-

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ference in the marketplace. It is just as easy to waste taxpayer dollars and scarce economic resources on subsidizing exports as it is to waste them on better-known examples of Federal profligacy. What is desirable, indeed necessary, is that, consistent with the Administration's "Statement on U.S. Trade Policy," the U.S. Government assure the proper enforcement of trade laws, remove any unnecessary domestic impediments to trade, and likewise seek elimination of foreign trade barriers which effectively limit our exports.

Competitiveness that is impaired by market forces should not be restored by raising tariffs or subsidizing export industries. Such actions simply protect the trade-dependent industries, inviting them to postpone the steps necessary to meet world competition while raising costs to consumers and reducing the choices available in the marketplace. Policymakers can design and implement policies that invite improvements in investment, productivity, and employment, but the decision on whether to make such improvements is best left to the private sector.

THE SIGNIFICANCE OF EXTERNAL IMBALANCES

In most circumstances a trade deficit by itself should not cause concern. A trade deficit is a narrow concept. Goods are only part of what the world trades; another major part of trade is composed of services. Hence, the current account, which includes both, better indicates the country's international payments position. But the current account balance is not a complete measure of international competitiveness either. What also matters is how current account deficits are financed.

Table 7–2 sets out the major components of the current account of the U.S. balance of payments: exports and imports (from Table 7–1), services, and unilateral transfers. The growing importance of trade in services is evident. The major contributor, by far, to the surplus on services is investment income. Net investment income rose from less than $18 billion in 1977 to almost $33 billion in 1980. As has been the case in the recent past, large surpluses in the services account offset large deficits in the merchandise account, yielding a small surplus in the current account for the first three quarters of 1981.

Concern with the country's international payments position is appropriate when the basis of that concern is that the country is simultaneously experiencing a sustained deficit in its current account and a persistent depreciation of its currency in the exchange markets. The joint occurrence of these two events should alert economic policymakers to the possibility that the country may be losing competitiveness.

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TABLE 7-2.—*U.S. international transactions, 1977-81*

[Billions of dollars]

Period	Merchandise[1]			Services			Unilateral transfers, net	Current account balance
	Exports	Imports	Balance	Exports	Imports	Balance		
1977	120.8	151.7	−30.9	63.5	42.1	21.4	−4.6	−14.1
1978	142.1	175.8	−33.8	79.0	54.2	24.8	−5.1	−14.1
1979	184.5	211.8	−27.3	104.5	70.1	34.4	−5.6	1.4
1980	224.0	249.3	−25.3	120.7	84.6	36.1	−7.1	3.7
1981[2]	236.1	264.0	−27.8					
1980:								
I	55.0	65.0	−10.1	30.9	21.0	9.9	−1.9	−2.1
II	55.7	62.4	−6.7	28.0	20.4	7.5	−1.3	−0.5
III	56.3	59.2	−2.9	30.4	21.0	9.4	−1.5	5.0
IV	57.1	62.7	−5.6	31.5	22.2	9.3	−2.3	1.4
1981:								
I	61.0	65.7	−4.7	33.3	23.9	9.5	−1.5	3.3
II	60.4	67.3	−6.9	34.6	25.0	9.6	−1.5	1.1
III[2]	57.9	65.0	−7.0	36.2	25.2	11.0	−1.9	2.1
IV[2]	56.8	66.1	−9.3					

[1] Excludes military.
[2] Preliminary.

Note.—Data are on a balance of payments basis.
Quarterly data are seasonally adjusted.
Merchandise trade data contain revisions for the first three quarters of 1981.
Detail may not add to balances due to rounding.

Source: Department of Commerce, Bureau of Economic Analysis.

It is particularly important not to become unduly preoccupied with the trade or current account balances with a single foreign country. Any policy to reduce a bilateral imbalance by restricting imports is likely to reduce the absolute volume of trade, and in consequence, the level of economic well-being of both countries, and could have wider repercussions. A far more constructive approach would be for the nations with restrictive trade practices and institutional barriers to imports to reduce systematically those obstacles to the freer flow of trade and investment. Actions like those recently taken by Japan, for example, should prove far more beneficial than measures by the United States to restrict imports.

More broadly, and setting aside the sometimes significant statistical discrepancies, global current account imbalances must add up to zero. All countries cannot possibly run surpluses simultaneously. If each nation tried to achieve such a goal, strong deflationary forces would be set in motion. Today, for example, the Organization of Petroleum Exporting Countries (OPEC) continues to report large current account surpluses; these have to be matched by current account deficits in other countries. Given the important role of the United States in world financial markets, one need not be concerned if the U.S. current account moves into deficit as domestic economic policies begin to revitalize the economy. With strong domestic performance, U.S. import demand will also strengthen; the effects of this revitalization on U.S. exports will take more time. Thus, a deficit on current account will simply reflect the adjustment process at work.

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Nor should a current account deficit that is comfortably financed by net inflows of capital evoke concern. The relationship is straightforward: goods and services comprise one aspect of international commerce, financial and real assets another. If foreigners purchase more U.S. real and financial assets in the United States—land, buildings, equities, and bonds—then the United States can afford to import more goods and services from abroad. To look at one aspect without considering the others is misleading.

In sum, the macroeconomic significance of a current account deficit depends on what gave rise to it and how it is financed. It is in itself neither good nor bad. Nor should exchange-rate changes required by long-term current account considerations be viewed as, in themselves, good or bad; the costs to society of suppressing exchange-rate movements must be compared to the costs of allowing those movements. It is for these reasons that interference with market mechanisms—whether in markets for goods or markets for foreign exchange—is not part of the Administration's policy.

DEVELOPMENT, ADJUSTMENT, AND INTERNATIONAL INSTITUTIONS

THE HERITAGE AND THE CHALLENGES

In his speech to the World Affairs Council of Philadelphia on October 15, 1981, President Reagan said:

"The postwar international economic system was created on the belief that the key to national development and human progress is individual freedom—both political and economic. This system provided only generalized rules in order to maintain maximum flexibility and opportunity for individual enterprise and an open international trading and financial system."

The record of this economic system is a record of more achievements than failures. As Table 7–3 shows, the industrialized world has not been the only beneficiary of an open international trading and financial system. A number of developing countries have done well too. The real per capita GNP of 60 middle-income countries rose about as fast as that of the industrial countries over the period 1950 to 1980, while GNP in those middle-income countries grew over 30 percent faster than in the industrial countries. On the other hand, there are many low-income countries whose economic progress has been disappointing.

As a result of faster economic growth abroad than in the United States, the U.S. share of world output declined substantially over the same period. Immediately after World War II this share was estimated to be approximately 40 percent. By 1950, with Europe and Japan

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back on their feet, it had declined to one-third. It dropped to 25 percent by 1970 and further declined to 23 percent by 1980.

TABLE 7-3.—*Real GNP growth rates, 1950 to 1980*

[Average annual percent change]

Country grouping	GNP	GNP per capita
Industrial countries	4.2	3.2
Market	4.2	3.1
Nonmarket	4.5	3.4
Developing countries	5.5	3.2
Middle-income countries	5.6	3.1
Low-income countries	5.1	2.9
Capital-surplus oil exporters	11.2	7.9

Note.—Country groupings are classified according to *World Development Report*, 1981, World Bank.

Source: National Foreign Assessment Center.

Despite this favorable record for much of the rest of the world and the United States, the open international system today faces three major challenges. The first challenge arises from the conflict between each country's short-term internal domestic objectives and mutual longer term external interests. In the past, leadership in meeting such a challenge was provided by large countries. The United Kingdom fulfilled this role for much of the 19th century up to World War I, while the United States played a larger role after World War II. Under U.S. leadership the Western alliance developed a nuclear "umbrella," achieved massive reductions of tariffs and other impediments thus giving major impetus to world trade, and created an international monetary system which provided rules of conduct for adjusting balance of payments imbalances. In today's environment, addressing issues such as defense and the evolution of international economic arrangements are part of this challenge. The nature and mutual importance of these issues implies that solutions to these problems must be arrived at through consultation.

The second challenge is to maintain an open international economic system. A new wave of protectionism has taken the form of quotas, subsidies, international cartels, administrative delays, and burdensome enforcement of product standards. Imposition of such measures has increased dramatically since the international negotiations in the Kennedy Round (completed in 1967) sharply reduced both tariffs and the scope for their future use. The gains made in opening markets for international trade, investment, and finance are now threatened.

The third challenge is to respond to the aspirations of the developing countries for greater growth and development. Work under the rubric of the New International Economic Order, as well as the

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Brandt Commission report and the Tinbergen report, have focused global attention on important development and resource issues before the world community. While these reports make an effective case for aid to the least developed countries, they in general place too much emphasis on resource transfer and not enough emphasis on resource development through private market mechanisms. Indeed, these reports tend to downplay the role of the private sector in the development process and instead rely on governments and international organizations as the best vehicles to promote development.

As already noted, a sizable number of developing countries have done well in the post-World War II era. On the other hand, developing countries continue to be justified in claiming that the world trading system discriminates against them. Some industrial countries have restricted trade in sensitive sectors of particular export interest to developing countries, such as textiles.

MEETING THE CHALLENGES

The U.S. response to these challenges is based on an explicit shift toward market-oriented solutions to economic problems. Solutions to common problems in the world economy should be found through continued efforts at cooperation and consultation among nations. These efforts should aim at a renewed resolve to fight inflation and secure higher investment with sustainable growth. At the Ottawa Summit in July 1981 the President, along with other Western leaders, reaffirmed "our common objectives and our recognition of the need to take into account the effects on others of policies we pursue. We are confident in our joint determination and ability to tackle our problems in a spirit of shared responsibility . . ."

International cooperation is particularly vital in stemming the drive for greater protectionism both at home and abroad. The response of many countries during the recent period of sluggish worldwide growth has been to call for or impose new barriers to investment and trade flows. The United States will continue to resist these tactics and work for reductions in trade barriers through the General Agreement on Tariffs and Trade (GATT) and through bilateral relationships.

In approaching the challenge to contribute to the needs of the developing world, the Administration seeks to emphasize the important and historically dominant roles of trade and investment in economic development. Although economic assistance on concessionary terms continues to be a vital part of U.S. policy, establishment of a vibrant private sector through trade and investment offers the best hope for sustained noninflationary growth. The program for action that the

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President put forth at the Cancun Summit in October 1981 contains five guiding principles for development policy:

- stimulating international trade by opening up markets;
- tailoring particular development strategies to specific needs and regions;
- guiding assistance toward the development of self-sustaining productive capacities;
- improving the climate in many developing countries for private investment and technology transfer; and
- creating a political climate in which practical solutions can move forward rather than founder on the reef of government policies that interfere unnecessarily with the marketplace.

In line with these principles, the major goal of concessional foreign aid programs should be to help those poorer countries which, for reasons beyond their control, have not been able to improve their standards of living. The rationale for aid to countries whose low economic performance results more from inappropriate domestic policies than from external factors needs to be reexamined.

EVOLVING ROLE OF INTERNATIONAL INSTITUTIONS

The United States recognizes the important roles and specialized functions of the international financial institutions and believes these institutions must continue to evolve. It is important to review the roles of these institutions to ensure that they remain effective in the years ahead. Most importantly, these institutions should be directed toward promoting market-oriented rather than government-administered solutions to international and domestic economic problems.

General Agreement on Tariffs and Trade

The General Agreement on Tariffs and Trade has served the world well in promoting and monitoring progress toward a liberalized trading system. Originally written in the immediate post-World War II era with a small number of Western industrial countries as Contracting Parties, the GATT system has had to adapt to the changing world economy. During the 1960s a Part V was added to the General Agreement to take into account the special problems of developing countries and to allow many of them to be brought within the GATT system. Special Protocols of Accession were drafted to bring Eastern European nonmarket economies under the GATT umbrella as well.

Over the years, the emphasis of GATT has been altered to cope with the ingenuity of governments and interest groups in devising new forms of economic protectionism. The first several rounds of ne-

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gotiations under GATT were concerned mainly with reducing high tariff levels. The Kennedy Round, in addition to achieving sizable tariff reductions, made a modest attempt to negotiate other commitments—including one on antidumping—while the principal focus of the Tokyo Round (completed in 1979) was on extending GATT discipline to areas other than tariffs. These agreements proved decisively that the GATT system is flexible and can be improved over time.

However, GATT now faces a challenge because of increasing protectionist pressures worldwide and because the effectiveness of GATT rules, which formally include all goods, has tended in practice to be limited to trade in manufactures. GATT must now address areas of international commerce where existing norms are inadequate, such as agriculture, and must define its role in establishing norms in areas which traditionally have not been dealt with in GATT, such as trade in services. Another area where distortions exist and where greater international efforts are needed is in international investment. Finally, steps to integrate developing countries more completely into the GATT framework should be made, along with efforts to encourage nonmembers to join agreements under GATT.

A new political impetus among developed and developing countries is required to revitalize GATT. The GATT Ministerial meeting set for November 1982 will offer the international community an opportunity to maintain momentum toward a more open trading system.

The World Bank

The International Bank for Reconstruction and Development (IBRD) was created to lend funds for reconstruction of the war-ravaged economies and for economic development. Having accomplished the first task admirably, it has, over the last quarter century, come to focus heavily on the second. With the creation in 1956 of the International Finance Corporation—mandated to promote private sector enterprise in developing countries—and in 1960 by the establishment of the International Development Association (IDA) to lend on highly concessional terms to the poorest countries, the World Bank group was formed.

During the 1970s these three institutions underwent rapid growth and innovation, some of which has been controversial. President Reagan indicated at the 1981 World Bank-International Monetary Fund Annual Meetings that because the United States strongly supports the World Bank, the Administration also feels "a special responsibility to provide constructive suggestions to make it more effective." A major U.S. policy reassessment of the World Bank and the regional development banks was thus carried out during 1981 and the final report was recently released.

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That study strongly endorses the overall performance of the multilateral development banks, but also identifies key aspects which require improvement. Loan quality, not quantity, should have highest priority. In addition, renewed attention should be focused on the criteria under which countries "mature" from soft loan window to hard loan window, and "graduate" to unsubsidized participation in international capital markets. The study recommends that the United States should begin to reduce its contributions to the soft loan facilities, noting that such reductions would not adversely affect users of these facilities as long as strengthened "maturation" and "graduation" policies are followed.

In further assessing how the World Bank can be most effective, it is useful to distinguish between its soft loan window (IDA) and its hard loan window (IBRD), since these give it the capacity to tailor its financing to a broad range of developing countries. There is no dispute that a good many countries need development assistance. But views do vary on how best to give assistance—that is, through loans or grants—and whether assistance should be on a multilateral or bilateral basis. A multilateral approach to official aid has the presumed advantages of being cost-effective (that is, greater volumes of resources can be obtained for a given budget dollar), of allowing politics to be bypassed to some extent, and of facilitating policy reform by conditioning loans and grants on certain changes. An arguable disadvantage is that taxpayers in donor countries lose some control both over where aid goes (since decisions are made collectively) and how it is used. Verification of the effectiveness of aid is an issue which was emphasized at times during the 1970s when the Bank itself was among the chief spokesmen for larger aid programs. In light of these considerations, the Council takes the view that official aid would be more effective on a bilateral basis, and the Administration has repeatedly stressed its intention to pursue a larger bilateral aid program.

In any case, soft loan resources disbursed by the World Bank should be directed to countries which are making serious attempts to develop their economies on a rational basis but have inadequate debt-servicing capacity and hence have little or no access to credit markets. Part of the inability of some countries to achieve greater development can be traced to their domestic policies, and aid from both the soft and hard loan windows should be more explicitly conditioned on improvements in those policies. In practice, there has been resistance in some recipient countries to adopting policies which reduce government intervention and allow a fuller play of market forces. The chances that more efficient development will take place

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are improved to the extent that the lending activities of the Bank are designed so as to generate an increase in privately produced output.

Finally, there remain unresolved questions about the future size and emphasis of World Bank activities. The success of the Bank should not be measured by its ability to obtain funds from donor countries, but rather by its performance in fostering economic growth in developing countries.

The International Monetary Fund

The International Monetary Fund (IMF) currently provides a framework in which governments can consult and cooperate in determining the structure and functioning of the international monetary system. In particular, the Fund extends technical assistance and temporary balance of payments financing to members, in part conditioned on the implementation of economic policy measures designed to correct the factors underlying their balance of payments imbalances. In addition, it serves as a means for monitoring the exchange rate arrangements and policies of member governments. Finally, the IMF is also charged with reviewing the adequacy of international liquidity and with supplementing reserves, when necessary, through the allocation of Special Drawing Rights.

The Administration's approach to the IMF reflects a basic view of the world economy which focuses on economic fundamentals, support for timely adjustment, and recognition of the pervasiveness and benefits of market forces. The IMF Articles of Agreement recognize that exchange-rate stability requires stability in the underlying economic and financial determinants of exchange rates.

Although nations may differ on the appropriate degree of exchange-market intervention, there is consensus that exchange-rate developments are influenced fundamentally by domestic economic conditions within member countries. The Administration strongly supports further development under the IMF surveillance procedures of what has become known as the Article IV consultation process.

Under the second amendment to the Articles of Agreement, the Fund set forth a set of principles to govern developments and policy actions that are consistent with an open international economic system. In cases where the Fund believes that these principles may not have been honored, it may send a staff mission to a member's capital to discuss the member's economic policies with government officials.

IMF Article IV consultations contribute to international stability in a number of ways. First, such consultations provide information to member governments regarding the national economic policies of

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other member governments. Such information may be helpful in shaping each member's domestic policies as well as useful in avoiding conflicts because of misundertandings. Second, Article IV consultations provide a valuable base of information for Fund staff assessments of global economic and exchange-rate developments which in turn provide useful information for national economic authorities. Third, Article IV consultations provide a framework for frank critiques among the representatives of member governments. Fourth, Article IV consultations provide a base from which all nations can develop a better understanding of the economic linkages among nations. And finally, these consultations can help a country to identify and address emerging payments problems at an early stage.

The Administration, however, has encouraged the Fund to give renewed attention to the kinds of financial programs that it supports in member countries. The U.S. Government has stressed the importance of effective IMF conditionality in promoting balance of payments adjustments. The justification for IMF financing is to encourage appropriate payments adjustment.

With the emergence of very large imbalances in world payments since 1974, a major effort was made to expand access to IMF resources and to enhance the Fund's ability to support its members' adjustment efforts. The access of individual countries to IMF financing has been increased significantly. In addition, IMF resources have been expanded through the implementation of a 50 percent quota increase at the end of 1980 and through the establishment of IMF borrowing arrangements with Saudi Arabia and a few other countries. The duration of IMF adjustment programs has been lengthened in many cases because of the structural nature and depth of countries' adjustment problems. Also, greater emphasis is being placed on structural change—the reduction of economic distortions and disincentives, and enhancement of factors that will lead to greater saving, innovation, investment, and growth.

The IMF must ensure that its increased resources are used in a manner that is consistent with its Articles of Agreement. Traditionally, this has meant that access to IMF resources is available on a temporary basis to countries confronted with an external imbalance and willing to undertake economic policy adjustments to eliminate these imbalances and repay the Fund. Effective balance of payments adjustment frequently requires wider acceptance of market-oriented solutions. Import and export restrictions, price controls, rigid exchange rates, and excessive government regulation often prevent a country from achieving a sustainable balance of payments over time as well as higher domestic growth rates.

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Finally, the Administration has looked closely at the justifications for a new proposed allocation of Special Drawing Rights. This issue is controversial, given some countries' financing problems and differences of opinion about the meaning and role of international liquidity. Although many countries have advocated an increase in holdings of this international reserve asset, the United States has opposed such an allocation at this time, given world inflation and the current level of world liquidity. Even a modest new allocation of Special Drawing Rights in present circumstances would appear to conflict with the policies of monetary restraint being pursued in many countries.

Most international institutions were created after World War II, each with clear objectives to satisfy. Over the last three and a half decades the economic environment has changed dramatically, and the member governments of these institutions have had to reach agreement on how to reorganize the priorities and functions of the institutions. These institutions continue to play vital roles in the world economy. But to guarantee their ongoing viability, member governments must continue to review the approaches and goals of these institutions in light of the changing economic environment.

APPENDIX TO CHAPTER 7

U.S. POLICIES ON EXCHANGE-RATE INTERVENTION SINCE 1973

The current era of floating exchange rates formally began in March 1973, when most major industrial countries abandoned their efforts to maintain fixed-exchange rates against the dollar. Although rates were no longer held fixed, many governments outside the United States continued to intervene in exchange markets from time to time to influence their exchange rates. Initially the United States adopted a policy of nonintervention, but substantial changes in dollar exchange rates led the United States to intervene during the summer of 1973 and from late 1974 to early 1975.

In July 1973 the U.S. Government adopted a policy of active intervention at whatever times and in whatever amounts were appropriate for maintaining orderly market conditions. In November 1975, as part of the "Declaration of Rambouillet" following an economic summit meeting, the heads of the industrial countries announced that they had agreed to act to counter disorderly market conditions or erratic fluctuations in exchange rates. Although the difference between the statements may appear to be only one of nuance, the latter statement more accurately reflected what in effect was a limited intervention policy on the part of the United States.

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The previous Administration also began its term of office supporting limited intervention in exchange markets. Official U.S. statements, however, were interpreted as favoring a decline in the dollar to reduce the U.S. current account deficit (that is, "benign neglect" of the dollar). Using Federal Reserve swap arrangements, the United States intervened in support of the dollar, beginning in September 1977.* In total, the United States sold (net) $2.6 billion in foreign currencies in support of the dollar between September 1977 and March 1978, financed by Federal Reserve and Department of the Treasury drawings under swap agreements. When the dollar recovered in the second and third quarters of 1978, the United States was able to acquire $2.1 billion in foreign currencies, permitting repayment of a substantial portion of the earlier swap drawings.

In April 1978, pursuant to the notification provisions of the amended IMF Articles of Agreement, the United States notified the IMF that, ". . . exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the [U.S.] authorities will intervene when necessary to counter disorderly conditions in the exchange markets."

The definition of disorderly markets was left open and of necessity subject to interpretation by officials. Although at times intervention was heavy, it is fair to characterize U.S. policy until late 1978 as one in which intervention was the exception, and not the rule.

In late 1978, however, the character of U.S. intervention changed. In August 1978 pressure on the dollar renewed amid spreading recognition of serious U.S. economic problems—including inflation and inadequate energy adjustments—and growing skepticism over the effectiveness of the previous Administration's plans to deal with them. President Carter announced a dollar support package on November 1, 1978. A major element of this program was a commitment to a more active intervention policy, to be funded by mobilizing large foreign currency resources, including the issuance of foreign currency securities (which became known as "Carter bonds"). From November 1, 1978, until shortly after the Administration took office in January 1981, U.S. intervention in exchange markets often reached massive proportions by historical U.S. standards (although not by the more activist standards of many foreign governments). As of March 1981, the U.S. Government had acquired $11.9 billion worth of foreign currencies. Since the values of these currencies dropped dra-

*Under a swap agreement, the Federal Reserve and Department of the Treasury borrow foreign currencies from foreign central banks and then use the currencies to intervene in foreign exchange markets. The United States has used swap agreements with Belgium, France, Germany, Japan, the Netherlands, and Switzerland since July 1973, all but Belgium and the Netherlands since November 1978.

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matically relative to the U.S. dollar in 1981, as of October 31, 1981, the government (Federal Reserve System plus Treasury) sustained a bookkeeping loss on these holdings of $661 million. This loss would have been realized had the United States sold these currency holdings and repaid its liabilities.

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