Strengthening International Economic Policy Coordination

Good evening, ladies and gentlemen. I am delighted and honored to have this opportunity to address you as a part of the ongoing Olin Fellowship Program here at Fairfield University.

The subject I would like to peruse with you is the rapidly changing character of the global economic and financial system. My principal message is that the changes we are seeing in the global economy make it important that we strengthen the process of multilateral economic policy coordination and cooperation.

For the typical citizen here in the United States, symptoms of the changed character of the world economy surround us. When our clock radio—which is probably imported—awakes us, the morning news will usually include a report on overnight stock market developments in Tokyo, the dollar-deutsche mark exchange rate in Frankfurt and the London gold price fixing. Many drive to work in imported cars and even those driving domestic cars probably know that their car is better and cheaper because of the competition of imports. Once in the work place, elements of international trade and finance now have a significant direct or indirect bearing on virtually any type of business enterprise I can imagine—small or large. Indeed, whether it is gyrations in the world price of oil, changes in the dollar exchange rate, or changes in interest rates in a major foreign capital, none of us is insulated from economic and financial developments occurring far beyond our national boundaries.

The extent to which these symptoms of the changed character of the world economic and financial system abound in our daily lives is, in some respects, a more recent phenomenon in the United States than in most other countries of the world. This is so in part because our economy is so large relative to others and in part because we are more economically self-sufficient than are most of the other nations of the world. But, to paraphrase the English poet John Donne, no nation is an island, even a nation as large, as dynamic, and as rich as ours. The energy shocks of the 1970s, the behavior of world equity markets last fall, and our large trade and payment imbalances remind us of that in blunt terms.

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One consequence of this, of course, is that to a greater extent than was once the case our economic well-being is more closely tied to the economic well-being of others, just as theirs is even more tightly bound up in how we manage our affairs. This, of course, is why each nation of the world, but especially the major nations of which the United States remains the most important, must increasingly view its prospects and its problems in a global context and in a manner that guards against the dangers of myopic

Remarks by E Gerald Corrigan, President of the Federal Reserve Bank of New York, before the Olin Fellowship Program of the Fairfield University School of Business, October 11, 1988 approaches to economic policy. Let me cite an example or two of the dangers I have in mind.

- First, we all know that one of the pillars of growth, prosperity, and rising standards of living on a worldwide basis is to be found in free, open, and fair trade between nations. Yet, as we look around the world, it is quite apparent that the maintenance and strengthening of practices and policies that are consistent with the principle of free trade cannot be taken for granted. For example, protectionist sentiments are lurking in the shadows here in the United States; the further economic and financial integration of Europe planned for 1992 is viewed by some as a move toward a "fortress Europe" that will be open internally but closed externally; finally, several nations in the Pacific Basin continue to record very large trade and payment surpluses in a context in which there is at least a question as to how open those economies are to imported goods and services.

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  one of them represents a clear and present danger to the world trading system that has flourished in the postwar period. Rather, my point is that each of them reflects concerns and attitudes in one country or group of countries that, at least in part, reflect conditions or perceived attitudes in other countries. Protectionism is at work in the United States partly because of concerns about imports but more so because of perceptions of foreign markets being closed to U.S. goods and services. Similarly, at least part of the motivation for European economic integration seems to be spurred by concerns about protectionism in the United States, the Canadian-United States trade agreement, and the apparent technological gap between the United States and Japan on the one hand and Europe on the other.

  This linkage in attitudes — however loose and imprecise it may be — is potentially of great importance since it implies that if one nation or group of nations begins to slip into a more protectionist mode, retaliatory actions by others could follow swiftly. Should that begin to occur, we would find ourselves confronting not only a clear and present danger to world trade, but also a major threat to growth and prosperity on a worldwide scale.

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- Seoond, we all know that the United States trade deficit is unsustainable, but what is not always clear is the recognition that there are limits as to how and how quickly that deficit can be eliminated in a context of noninflationary growth in the United States and the world economy. For one thing, we in the United States simply do not have the industrial capacity or the slack in labor markets needed to generate the output of manufactured goods that would be needed to eliminate the trade deficit in the near term. Partly for that reason, but also because of the nature and size of the adjustments required in the surplus nations, the elimination of the trade deficit in the context of growth must be viewed over a time horizon of several years and in a context in which success depends not just on what we do but also on the policies and performance of trading partners. Fortunately, the initial phases of the adjustment process are now well underway, but we still have a very long way to go.

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- Third, the fact that it will take some time to wind down our trade deficit points to another area in which we must exercise vision and patience, and that relates to the growth of foreign investment in the United States. One does not have to look very long or very hard to find expressions of concern about the speed with which foreigners are accumulating assets — both securities and hard investments — in the United States. Those concerns are, in some respects, understandable, but the hard fact of the matter is that as long as we have current account deficits, foreign investment in the United States must increase

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Stated differently, current account deficits — like all deficits — must be financed and, one way or another, the financing of the current account deficit will manifest itself as a net increase in foreign holdings of United States assets. Indeed, it is precisely the cumulative effects of the string of large current account deficits over recent years that — in a proximate sense — account for the substantial change in our net financial position with the rest of the world over that period.

That is, if we go back to 1981, which was the last year in which the United States had a current account surplus, the stock of U.S -owned foreign assets exceeded the stock of U.S. assets owned by foreigners by about $140 billion. At the end of this year, the stock of U.S. assets — stock, bonds, government securities, factories, farm land, real estate, and so forth — owned by foreigners will exceed the stock of U.S. foreign assets by something close to $500 billion. As a very rough approximation, that swing in balance sheet terms from a net foreign asset position of $140 billion to a net liability position of about $500 billion reflects the cumulative sum of the current account deficits we have incurred since 1981. In addition, because those net foreign obligations must be serviced, we now face a situation in which the current account deficit is larger than the trade deficit.

Looked at somewhat differently, even if we assume a straight-line adjustment to current account balance over the next few years, we are still looking at prospective current account deficits that will almost surely aggregate to at least a couple of hundred billion dollars. But, whatever the precise amount, net holdings of U.S. assets by foreigners will increase by about that amount. The issue, therefore, is not whether we are happy with that outcome — which, by the way, brings with it many beneficial results. The issue is how do we and others manage our affairs so that the prospective deficits are financed in the most painless way possible and that we and others follow through on the policy initiatives needed to better insure that the underlying imbalances in trade and payments will be rectified.

The examples I have just cited, bearing as they do on the persistent and large international trade and payment imbalances in the world economy, are illustrations of why it is so important that policies are aimed at the causes, not the symptoms, of these problems and why it is so very important that we find even more effective ways to cope with these problems in a framework of international cooperation and coordination.

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That, of course, has not been, and will not be, easy because the underlying causes of these imbalances reflect both national and international considerations and because they reflect both macroeconomic and structural or microeconomic forces that have built up in the global economy over a long period of time. In the United States, for example, the heart of the problem lies with the combination of large budget deficits and a very low rate of net private savings. But those macro elements in the United States have been compounded by other factors such as cost and quality deficiencies in at least some sectors of U.S. manufacturing industries. In Europe, sub-par growth in domestic demand, relatively high rates of unemployment, and various structural rigidities have also contributed to these imbalances over time. In Japan and the Pacific Basin, very high savings rates, the historic orientation to export industries, and the visible and invisible barriers to imports have also played a role, as has the debt crisis in much of the developing world And all of these factors have, to a degree, been amplified by the extreme gyrations and volatility in exchange rates that have

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characterized the last decade or so.

Fortunately, and reflecting in part the efforts of the G-5 and G-7 Ministers of Finance and Central Bank Governors, the last few years have witnessed an intensified effort to attack these problems on both a national and an international scale. And those efforts are clearly bearing fruit. The composition of output in Japan, the United States, and much of Europe has shifted in the right direction even as growth has been maintained; inflation has been reasonably well contained; the U.S. trade deficit in real GNP terms has fallen from a peak of $157 billion in the third quarter of 1986 to $90 billion in the second quarter of 1988; bilateral and multilateral efforts aimed at more open markets abroad are having a measure of success even if the going is tough and slow; productivity and quality gains in U.S. manufacturing are clear and impressive; and the general pattern of behavior in exchange markets in recent months is distinctly more constructive. But, as I said earlier, we still have a long way to go.

To successfully complete the transition to a more balanced world economy surely means that each country must address its own problems. But, in my view, it also means that we must redouble efforts aimed at greater elements of international policy cooperation and coordination, including broad-based financial, political, and moral support for the key multilateral official institutions such as the International Money Fund, the World Bank, and the General Agreement on Tariffs and Trade.

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In urging this, I recognize that there are skeptics who question how much has been, or can be, achieved through the efforts of, say, the G-5 or G-7. The skeptics point out that governments are not prepared to cede sovereignty; that is true. They point out that the process is inevitably confronted with conflicting objectives; that is true. They point out that the tools available for coordination are imperfect at best; that is true. They point out that some aspects of the process—perhaps especially the economic summits of the heads of state—appear to be short on substance and long on ceremony; that may also be true. But what they fail to point out is the alternative.

I, for one, don't really see an alternative other than each country slowly but inexorably drifting in the direction of beggar-thy-neighbor attitudes and policies that can only work to the detriment of all. More importantly, on the positive side of the ledger, I also believe that efforts to date have played a distinctly positive role in getting the necessary adjustment process moving in the right direction. Indeed, even if the process has done nothing more than help each country see its own economic problems and prospects as others see them, the process has value.

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Since I believe the process has done that and more, I believe we should build on our success and seek out ways to further strengthen the spirit, and the substance, of international economic policy coordination. In saying this, I am mindful that we must guard against inflated expectations as to what can be achieved. Similarly, we surely must guard against the illusion that policy coordination can take individual countries—including the United States—off the hook in terms of the things they must do in their own right. Looked at in this light, policy coordination is not, nor can it ever be, a substitute for sound and disciplined policies on the part of individual countries. But, at the very least, international communication, cooperation, and coordination can help to provide a framework that supports the dictates of discipline on the part of individual countries while at the same time reinforcing the mutuality of interests among nations. In addition, the process as a whole breeds familiarity among the participants, a familiarity that can be absolutely invaluable when adversity strikes suddenly, as for example when the debt crisis exploded in the summer of 1982 or when

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worldwide equity markets collapsed last fall.

To put this in a slightly different perspective, let me share with you an excerpt from a letter written by one leading international economic statesman to another. The excerpt reads as follows:

> "I have always taken the position that both you and we had three possible courses in our relations with each other. One was to deal wholly independently with our respective problems, without any relations, and in complete ignorance of what the other was doing, in other words to ignore each other; another might be to pursue a wholly selfish policy, each disregarding completely the interests of the other, and possibly pursuing a policy antagonistic to the other; and the third might be to adopt a policy of complete understanding, and exchange of information and views, and to cooperate where our respective interests made it possible. How can there be any choice between these three, nor any ground of complaint, so long as we are right and not afraid of our critics?"

That letter, ladies and gentlemen, was written by Benjamin Strong, Governor of the Federal Reserve Bank of New York, to Montagu Norman, Governor of the Bank of England, on March 21, 1921. Perhaps there really is nothing new under the sun.