FROM THE AMBASSADOR

BRITISH EMBASSY,
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16 April 1985

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
LONDON SW1

Prime Minister
A good, clear speech which Oliver Wright judges will be a harbinger of the US approach at the Economic Summit.
CDP. 19/4

My dear Secretary of State,

ECONOMIC SPEECH BY SHULTZ AT PRINCETON ON 11 APRIL

1. The enclosed speech by Shultz, summarised in my telegram No 1251, is clearly an important one. Armacost, at lunch today, agreed that it was intended to be a preview of forthcoming attractions at the Bonn Economic Summit.

2. Like Gaul, it is divided into three parts: a sort of confession of error, in that Shultz recognises that the factors which caused the annus mirabilis of 1984 cannot be sustained; a resolution of amendment of life, in that he recognises that the central objective of US economic policy must be the reduction of the twin deficits; and a request that others take up the running as the US slows down.

3. The main message of the speech for Bonn is in the third part. It is that the right way forward is a sort of bargain under which the Americans would take the steps necessary to control their twin deficits (short of increases in tax rates), and restrain Congressional tendencies to protectionism, if we Europeans do our part to reduce the structural rigidities in our economies, the Japanese liberalise their trade and investment policies and the LDCs adopt more liberal and growth-orientated policies as well as continue with their structural readjustment of the last few years. None of these components is a new suggestion, but the combined package is a new coherent whole. I wonder whether it could conceivably constitute a fair outcome of the Bonn Economic Summit if it could be incorporated in the final communique.

4. The speech also seems to represent, especially when read in conjunction with Secretary Baker's proposal for a high-level meeting on international monetary reform, a chink in the hitherto rather rigid position of the Americans on the relationship between their budget deficit, the dollar, and the economies of other

/countries

countries. Armacost told me that while it very much represented Shultz's own thinking, it carried considerable weight given Shultz's experience of international economic matters and it had been cleared at the White House and with Secretary of the Treasury Baker, with whom Shultz, said Armacost, had "a comfortable relationship".

4. I am sending copies of this letter to the Secretary of State for Trade and Industry, Sir Robert Armstrong, Sir Crispin Tickell and No 10 Downing Street, and am making arrangements for the Chancellor and Governor to have copies while they are here in Washington for the IMF/IBRD meetings.

Yours ever,

Oliver

Oliver Wright

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NATIONAL POLICIES AND GLOBAL PROSPERITY

ADDRESS BY

THE HONORABLE GEORGE P. SHULTZ

SECRETARY OF STATE

BEFORE THE

WOODROW WILSON SCHOOL OF
PUBLIC AND INTERNATIONAL AFFAIRS
PRINCETON UNIVERSITY

PRINCETON, NEW JERSEY

THURSDAY, APRIL 11, 1985

EMBARGOED UNTIL DELIVERY, SCHEDULED FOR APPROXIMATELY 2:00 P.M., EST, APRIL 11, 1985. NOT TO BE PREVIOUSLY CITED, QUOTED FROM, OR USED IN ANY WAY.

My theme today is simple: The American economy is a success story -- a dramatic success story. But success brings with it new challenges, which we must address with great energy in order to preserve and build on the success we have achieved.

We face a paradox. In the past two years, our economy has made the strongest recovery of any in the last three decades, and the expansion remains robust. Yet we also see, in our domestic and international economic relations, some unusually large and important imbalances:

-- a large net capital inflow,

-- an exceptionally strong dollar,

-- the largest trade deficit in our history, and

-- large and continuing deficits in the U.S. federal budget.

What relationship is there, if any, between our clear economic success and these equally clear imbalances? How do these imbalances relate to each other? What are our prospects if the imbalances continue? And what conclusions follow for economic policy -- in this country and in other countries?

These are the issues I would like to discuss with you today.

The economic policies of this Administration -- reducing the role of government, promoting private initiative, and encouraging free trade -- have led the United States out of recession and toward prosperity. We can be proud of our economic performance. Our expansion has led to export-induced recoveries abroad -- underscoring the interdependence among the world's economies.

In large part, the imbalances I mentioned have contributed to our economic success; some are partly the result of it. To a degree, they have been exacerbated by the economic policies of other nations. Whatever their source, my main conclusion can be stated up front: These imbalances are interrelated, and they must be corrected if we are to maintain the momentum of our economic success. We -- and other countries -- share a responsibility to make some hard political decisions.

Let me focus on these imbalances, first as they impact on the American economy, and then as they are mirrored in other countries. Then I will lay out the policy responses I see as necessary -- responses by all nations -- to keep the world economy on the path of sustained, non-inflationary growth.

Capital Flows

First, the large net capital inflows into the United States.

An impressive investment boom has driven American economic expansion in the past three years. To a large extent, this boom reflects the new investment incentives the Administration provided in its first term -- including incentives for vital research and development, which is the source of future investment. Gross saving by individuals, business, and state and local governments also recovered from its recession low of 18 percent of GNP in 1982 to 20 percent in 1984.

But with the federal deficit, gross national saving alone could not finance this higher level of investment. In 1984, gross saving in the United States by individuals, businesses, and state and local governments ran about $730 billion. On a basis net of capital consumption, the figure was $325 billion. These are healthy amounts by recent standards. After taking account of the large federal deficit, however, total national saving amounted to only about $150 billion on a net basis or $555 billion on a gross basis -- considerably less than the $635 billion recorded in gross private domestic investment in 1984.

As measured by our current account deficit, net capital inflows into the United States were about $100 billion last year. This is almost one-fifth the size of our gross national saving -- and two-thirds the size of our net national saving -- and has been an important factor in financing the expansion of our investment and therefore of our economy.

These inflows have come about largely because of the health and vigor of our own economy, in contrast with the less attractive conditions for lending and investment in other countries. But they come to some degree at the expense of building up foreign claims on the United States. On the basis of current trends the United States will soon become a large net debtor nation -- our foreign liabilities could exceed our foreign assets by $100 billion by the end of the year.

And underlying conditions are bound to change in the future. As opportunities to invest improve in other countries, capital inflows into the United States will slow down and outflows will increase. In other words, even if we are prepared to finance investment in the United States through a continuing net inflow of funds, we cannot count on attracting adequate funds indefinitely.

Without a compensating increase in domestic saving to support our own investment -- and if our federal deficit continues to preempt a large portion of domestic saving -- lower capital inflows could force a decline in our investment and impair the long-term growth of the American economy.

The Strong Dollar

These large net capital inflows into the United States have produced an extraordinarily strong dollar. Although the dollar has receded somewhat in the last month, it is still, on a trade-weighted basis, about 80 percent above its 1980 average in nominal terms.

The exchange value of the dollar today is determined far more by capital movements than by trade balances. Many factors have contributed. The restoration of America's economic vitality and leadership on the world scene has had an important effect on investment decisions. Our economic success -- and our bright prospects -- cause investments in dollar assets to be judged more attractive and less risky than others despite the dollar's high value. The dollar market also offers the widest selection and greatest liquidity. And dollar assets are serving not only as a store of value, but as a political safehaven as well.

Exchange markets reflect all these considerations, particularly as they contrast with the poor growth performance in Europe, the financial problems of the developing world, and the large excess of saving over domestic investment in Japan.

The net inflows of foreign capital, and the resulting high dollar, have certain advantages. By reducing the cost of imports and forcing domestic suppliers to compete more effectively, the strong dollar has helped restrain inflation in the United States. The net capital inflows have helped moderate interest rates as well. Abroad, the growth of American imports and slower growth of American exports have stimulated export-related jobs and generated economies of scale for foreign producers. The high value of the dollar also makes offshore procurement, tourism, and American foreign direct investment in other countries all less expensive.

But the extraordinarily high dollar also has important disadvantages:

-- It reduces the competitiveness of our exports and the potential for their growth. Even though our exports have increased and the United States is still the world's largest exporter, our share of the world market for exports of manufactured goods in volume terms is estimated to have declined by 25 percent since 1980.

-- Because of increased domestic demand, economic activity in the United States has not yet been appreciably restricted. But that may change.

-- The dollar's strength is causing painful structural adjustments in many of our export-related industries; it is altering the character of the American economy in a basic and, in my view, undesirable way. Lower costs in other countries -- due to exchange rates -- are leading many American firms to locate abroad production facilities that would otherwise be competitive in the United States. Such decisions to locate or expand abroad would be both difficult and costly to reverse if the dollar's exchange value came down.

-- The large decline in the value of other currencies against the dollar has also eroded the value of existing foreign investments, sales, and earnings denominated in foreign currencies.

-- In the meantime, the growth of our imports is spurring protectionist demands for tariffs, nontariff barriers, and export subsidies. Whatever short-term relief for specific industries such measures might provide, the overall long-term cost to the mettle of the American economy, to the American consumer, and to the world economy would be devastating.

Let us never forget the catastrophic effects of protection in the 1930s and the exhilarating impact of more open trade in the decades following World War II.

The Trade Account

This leads me to the most visible international consequence of the strong dollar: its role in our huge and growing trade deficit, which reached a record $123 billion in 1984.

Despite the strong dollar, our exports in fact grew last year by 9 percent to a total of $218 billion -- demonstrating the underlying strength of the American economy and reflecting adjustments in efficiency occurring within the market place. Nevertheless, the growth of imports overwhelmed the growth of exports, increasing 24 percent in volume terms and 26 percent in value terms. ~~Over half of the $85 billion deterioration in the U.S. trade account since 1980 has been attributed to the strong dollar.~~

I have already mentioned the growing demands for protectionism. The Administration is resisting these pressures, and I will have more to say about our approach to trade policy in a moment.

But one point is crucial here: We should not delude ourselves into thinking that a lowering of foreign barriers will have a decisive or even substantial impact on the trade deficit.

We can break the back of the trade deficit only through a combination of, first, a stronger worldwide recovery, and second, a strengthening of other currencies in relation to the dollar, as the performance and prospects of other economies improve and as these prospects are recognized by the markets. Even with movement on these fronts, the effects on the trade deficit will be gradual.

With depreciation of the dollar, U.S. imports would become more expensive and there would be some increase in inflationary pressure, at least initially. The growth of imports should slow down, but probably with a lag. Purchases of raw materials, energy products and petroleum, specialized capital goods, and many consumer goods do not respond quickly when their prices rise.

The growth of our export sales will depend on several factors: on our ability to remain competitive; on a faster pace of economic recovery in other nations, notably Europe; on the success of adjustment efforts in developing countries; and on long-overdue action by Japan to open its markets.

Exports to the developing countries, particularly to those in Latin America burdened by debt, will still depend upon their ability to expand their exports to pay for our goods. This means our markets and those of other industrialized countries must remain open to their products. And many American exporters have already lost major foreign markets, recoverable only with a major effort.

The U.S. Federal Deficit

I have discussed the large net capital inflows, the strong dollar, and the huge trade deficit. It is no coincidence that these imbalances are accompanied by huge federal budget deficits.

As long as there are ample unused resources in our economy, the federal budget deficit does not cause major immediate problems for the United States. But current deficits are simply not sustainable indefinitely. These deficits can become a habit and weaken an essential discipline over federal spending and over the size of the federal government. They drain off national savings, leading to increased reliance on foreign capital or curtailment of needed investment. And as our expansion begins to stretch our resources, continued large deficits pose an increasing danger to that very expansion.

We can all continue to debate what combination of policies is best designed to deal with all the imbalances I have discussed -- budget deficits, large capital inflows, the dollar at financial highs, and trade deficits. But a consensus has emerged that action to reduce the federal budget deficit is an essential part of our response. The President has shown the way with his proposals and in his negotiations with the Congress. Special interests must give way to the general interest.

Control of government spending, coupled with vigorous growth, must be the key to our effort. We must cut spending in a way that does the least harm to the economy's investment and growth potential and to basic national security. But significant cuts must be made now. Tax rate increases are not the answer. To the contrary, the recent Reagan tax cuts, like the Kennedy cuts two decades earlier, have stimulated investment, fueling the recovery and contributing to the future productive potential of the economy. In fact, further tax simplification and reform could be very helpful in reducing tax-induced distortions in economic activity and in stimulating additional growth.

Other Industrialized Countries

So far I have focused primarily on the American economy.

But in our interdependent world, the impact of domestic policies and performance on the economies of other nations is a two-way street. Other countries face challenges in their own domestic policies. They, too, must meet their challenges if the world economy is to correct the imbalances that cloud our common future. The imbalances can do harm also to important political relationships. We all have a job to do.

The major industrialized countries are recovering from the 1980-1982 world recession at different rates. Whereas the United States, and to a lesser degree Japan and Canada, have expanded vigorously, Western Europe still lags. Average real growth in the four major European economies (Germany, France, the United Kingdom, and Italy) accelerated in 1984, but only to a year-over-year annual rate of 2.4 percent. This rise represented less than half the average of the American, Japanese, and Canadian rates. The Japanese and Canadian expansions, however, have depended heavily on the stimulus of exports to the U.S. market. The increase in Canadian exports to the United States amounted to over half the increase in Canadian GNP in current prices between 1982 and 1984, while the increase in Japanese exports to the U.S. market was over 10 percent of the increase in current-price GNP over the same period.

The slowness of recovery in Europe results from conditions that stifle investment, particularly structural problems in labor markets and government disincentives to adjustment and growth. The rigidities in European labor rates and conditions also tend to bias investment toward capital-intensive technologies -- further inhibiting the growth of employment. There has been essentially no net job creation in Europe since 1970, compared with the American record of over 26 million new jobs during the same period. Over 7.5 million net new jobs have been created in this country since the trough of the recession in 1982.

Expressed as a share of output, gross investment in Europe has declined steadily since the first oil shock in 1973 and is now well below its share in the 1960s. Since investment opportunities in Europe have been less attractive than elsewhere, capital has flowed elsewhere. Much of the capital has come to the United States, either as investment in U.S. assets by foreigners, disinvestment by American investors abroad, or a reduction in the previous rate of foreign lending by U.S. banks. At the same time it is estimated that half of Western Europe's growth in 1984 came from export sales to the United States. These exports amounted to $75 billion or nearly 22 percent of total U.S. imports last year.

Capital outflows from Europe and a dependence on exports to the United States -- like the other imbalances I have mentioned -- cannot be expected to continue indefinitely. Other OECD governments must find ways to stimulate growth-oriented investment, thereby making their investment opportunities attractive to domestic and international capital. At stake is an efficient allocation of global resources -- a system which responds to economic potential. This will require sound economic policies and hard political decisions -- but the result will be sustained growth, job creation, and a brighter economic future.

Japan is a special case. The $37 billion U.S. trade deficit with Japan, as we all know, is a source of intense friction in our bilateral relationship and the cause of much of the growing demand for protectionism in this country. But the more meaningful measure of Japan's external imbalance is not our bilateral imbalance but Japan's overall trade surplus, estimated at $44 billion in 1984.

The Japanese could reduce their trade surplus with the world by pursuing policies to offset the impact of their high savings rate.

Gross private saving in Japan is over 30 percent of GNP, about 50 percent higher than the average of the other OECD countries. This high rate of saving means low consumption. The excess of production over private and public consumption is not being used in domestic investment. It therefore appears as net exports. Or, to put it another way, under current conditions Japan relies on a large excess of exports over imports to maintain full employment.

Opening up investment opportunities within Japan would be one way to use such resources and reduce the pressure to export. The needed decisions are more difficult for Japan politically than economically. The structural rigidities in the Japanese economy restrict access by even Japanese firms and investors. If the Japanese Government would improve incentives and reduce restrictions that currently restrain domestic and foreign firms from investing in Japan, all nations, especially Japan, would benefit. Steps are already underway to liberalize the Japanese capital market, so as to channel Japanese savings more efficiently to both foreign and domestic uses, and to widen the financial opportunities facing Japanese firms. As this proceeds, and as the international role of the yen expands, we would expect the value of the yen more fully to reflect the strength of the Japanese economy.

On the trade side, the removal of barriers to the sale of foreign goods and services in Japan would expand market opportunities for foreign suppliers, increasing Japan's imports. Prime Minister Nakasone's recent speech, and the Japanese Government's package of measures to lower trade barriers and encourage imports, are a laudable and encouraging beginning. More specifics must come.

All these steps would help defuse protectionist pressures in other countries. But Japan must deal with its savings-investment imbalance if its chronic imbalance in trade is to be corrected.

The Developing Countries

The external accounts of the developing countries, like those of the European countries, help make up the mirror image of ours. The United States takes nearly 60 percent of all manufactured exports of developing countries to the industrial world. At the same time, our capital inflows from the developing nations are in part the result of American investors bringing their money home, or of American banks reducing their foreign lending, as opportunities in those countries appear less attractive.

Despite the progress made since the 1982-1984 debt crisis, many developing countries still face the need for fundamental changes in their economies and economic strategies.

Several high-debt countries have successfully tackled the job of stabilizing their economies. They have cut public-sector spending to more nearly match their resources, priced currencies to reflect better their market value, and set interest rates to encourage saving. They now face the need to get away from massive price subsidies or public-sector dominance of investment resources and economic activity.

~~The emphasis should be on the positive. Austerity is not an end in itself. For difficult adjustments to be undertaken and sustained, a country's citizens must be able to see real prospects for future growth. Economic expansion, fueled by increased investment and exports, is the only way these countries can raise living standards for their people.~~

This is a theme that applies to many of the issues I have discussed today. Adjustments such as these are more difficult politically than economically -- requiring new ways of thinking even more than they require resources.

The cuts we must make in our own federal spending are painful, but they are justified because they safeguard the continued growth of the productive, private sector of our economy. The structural reforms in Europe that will ensure an attractive investment climate for domestic savings and international capital are necessary to restore Europe's own growth and technological advance. For the Third World, structural adjustment is the key to economic development.

The developing countries will clearly need financing as they go through this process. But where will this financing come from? No one can realistically expect that official development assistance, bilateral and multilateral, is likely to expand; the net flows are already very large -- around $34 billion from official donors. And it is a fact of life that commercial bank lending will not return to the high levels of the past decade. Even increases from current levels are unlikely until developing countries improve their creditworthiness and offer productive investment opportunities. In any case, most developing countries already have more debt than they can readily handle.

There is no escaping this hard conclusion: Domestic saving and private foreign equity investment will be the main sources of funds available to finance development and stimulate growth.

Development and growth will come only to countries with sound domestic policies that stimulate domestic savings, promote trade, and attract external resources:

-- India is a striking example of a country that finances 92 percent of its investment needs from domestic savings. India's recent growth has been impressive and its prospects are bright.

-- Protectionism in the developing world can be a further drag on growth. The barriers to trade among developing countries are a hindrance to Third World expansion, and the barriers to outside trade and investment also retard development.

-- The value of foreign equity investment cannot be measured by the volume of funds alone. Foreign investors often bring technological and management skills that cannot be easily obtained in other ways. The enterprises of such investors tend to grow more rapidly and export more of their output than the economy as a whole. Moreover, there is no conflict between what needs to be done to stimulate foreign and domestic investment; both respond to a stable and predictable regulatory environment and to an expectation that they will be treated fairly.

Many developing countries seem reluctant to encourage foreign investment. It is their decision to make. But a number of countries have shed once fashionable mythology and recognized the opportunity. Now, after consistent application of sound policies, they are reaping the benefits.

International Trade

For developed and developing countries alike, economic growth clearly depends also on the continued openness of the world trading system, and indeed on a further liberalization of world trade. This is a collective international responsibility.

Protectionism is not the remedy to an illness. It is, itself, an illness. It is a hidden tax on the consumer, often an extremely regressive tax. Hold onto your pocketbooks when politicians start trying to "protect" you against buying what you want to buy. Even in the relatively open U.S. market, one estimate is that U.S. protectionist policies cost American consumers directly almost $60 billion in 1980. That was over $250 for every man, woman, and child in the country. Protectionism keeps prices up, reduces living standards, and stifles growth.

Trade promotes the flow not only of goods and services, but also of ideas. All countries benefit from the further division of labor that permits a broadening of the international marketplace. Those developing countries will grow the fastest that reduce impediments to trade and exploit their comparative advantage. Nor can developed countries repeal the laws of economics and defy the principle of comparative advantage; they must be prepared over time to phase out industries in which they are no longer competitive.

The ninefold growth in the volume of international trade since World War II reflects the success of the world trading system. During this period, world trade increased considerably more than world production. In the pre-war period, by contrast, protectionism and a decline in world trade thrust the world into depression. A new initiative is needed to sustain what has been achieved.

The United States has proposed -- and strongly urges -- a new round of multilateral negotiations early next year to liberalize trade, particularly to eliminate non-tariff barrriers such as quotas, voluntary export restraints, and subsidies. We want the GATT to extend its coverage to trade in services, agriculture, and high technology and to strengthen its system of safeguards and dispute settlement.

Progress in these areas will provide new opportunities and new markets, bringing tangible benefits to both developed and developing nations. It will also contribute to the fight against protectionism. In the absence of progress on the multilateral front, pressures for protection and a retreat to reciprocal bilateral arrangements will mount.

From a global perspective, a splintering of the multilateral trading system into a multitude of bilateral arrangements would be a backward step. Bilateral free trade agreements, however, such as we have negotiated with Israel and have offered to discuss with other countries, need not have this result; they can stimulate trade and strengthen the multilateral system. Free trade agreements are sanctioned by the international rules and involve a tighter trade discipline; they can promote freer trade than the multilateral system is currently prepared to accommodate. Our hope, nonetheless, is that the example of greater liberalization -- and the recognition that the United States can pursue another course -- will help motivate a larger group of nations to tackle the job of expanding trade on a global basis.

But we cannot forget our responsibility here at home. We in the United States are today more affected by the health of the global economic system than we have ever been before.

And as the world's largest economy, we cannot escape the reality that any protectionist action here can do enormous harm to the global economic system. So in our own long-term self-interest, we must remain loyal to our long-standing tradition -- our proud commitment to free and open trade.

A Program for Sustained Global Growth

Let me conclude with a message and a program that emerge from my analysis. The message is twofold: First, the main objective, and the key to success, is to accelerate growth in the world economy. That's what this is all about. And second, growth in the world economy is the result of interaction among sound national policies. That is the most important common ingredient in the policy steps that nations must take to correct the imbalances I have discussed.

Together, these steps are a program of international action to protect the current recovery and move us decisively onto the path of sustained, non-inflationary growth.

First, for our own part, and even for purely domestic reasons, the United States must -- and will -- substantially reduce its federal spending and deficit.

Second, the West Europeans should adopt policies that reduce the obstacles to change and innovation, that attract capital, and that stimulate domestic investment.

Third, in addition to opening its markets to foreign products, Japan should reduce the impact of its high rate of domestic saving on its trade surplus. This could be done by a combination of steps, including liberalized capital markets that internationalize the yen, and measures to stimulate investment in Japan by Japanese and foreigners alike.

Fourth, the developing nations, especially those heavily indebted, should continue to make the structural adjustments needed to stabilize their economies, reduce the economic burden of government, expand their trade, and stimulate growth. They should encourage domestic savings and foreign equity investment.

Fifth, all nations should support freer international trade and prepare for early commencement of a new international trade round. We must reject a surtax on imports; other countries must contain political pressures that threaten trade.

Finally, our approach to the strength of the dollar should concentrate on the fundamental market forces at work.

Intervention in exchange markets addresses only the symptoms of the dollar's strength -- and not at all successfully. An easy monetary policy, undertaken in an illusory effort to reduce interest rates, would only re-ignite fears of inflation, raise interest rates, and weaken economic prospects. Instead, we should maintain consistent, non-inflationary growth in monetary aggregates to accommodate economic growth while continuing the trend to lower inflation.

This program of action calls for many hard decisions. But they are the right decisions. We stand at the threshold of what can be, if all governments meet their responsibilities, a long period of global economic expansion and a new era of unprecedented prosperity.

The benefits that economic growth can bring to all the world's people transcend the purely material -- though for the world's poor and hungry, this alone would be a monumental blessing. A strong and growing global economy will help advance all of America's most fundamental goals: a world of cooperation, peace, stability, and progress, a world where human rights are respected and freedom flourishes. We have great opportunities to help build such a world, but we will succeed only if we have the will and the wisdom to recognize the dangers and confront them.

We know what must be done. But we must act on that knowledge if our hopes for a better world are to become a reality.

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