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SOME MAJOR ISSUES FACING THE WORLD ECONOMY
OVER THE NEAR TERM

Notes for remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the XXII Meeting of Governors of
Central Banks of the American Continent
Guadalajara, Jalisco, Mexico
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In looking at the recent performance of the world economy two very distinctive and opposite sets of features emerge. On the one hand total production is rising more vigorously than for some time and inflation, at least among the major industrial countries, has slowed to its lowest rate for many years. However, it is also evident that this clearly favourable pattern of stronger economic activity overall, a pronounced expansion of international trade and declining industrial country inflation is not the complete story, although it is certainly the more important part. On the other side the poor economic performance of the 1970s, above all the severe worsening of inflation and inflationary attitudes worldwide, left a legacy of major imbalances in the world economy. They are still prominent and have affected the performance of both developed and developing countries. They are being overcome, but only very gradually. While non-inflationary economic expansion itself helps to ease them, it is also apparent that these imbalances require concentrated attention from policymakers if the economic recovery of the past two years is to become the broad and durable expansion that we are all seeking.

The impact of the earlier worldwide inflation, and the entrenched inflationary expectations to which it gave rise, shows up of course most clearly in the overhang of debt. The resulting problems are an almost inevitable consequence of the transition from an inflationary world. The decline in inflation has upset the plans of those who had resorted to debt on an increasing scale in what appeared to be a chronically inflationary environment.

The major focus of attention with respect to these debt problems has been on the critical difficulties faced by a range of developing countries starting from mid-1982. We have come a long way since that time in the cooperative and many-sided effort to cope with and gradually improve this situation. Much has been learned about international debt management in the process. Also, we are continuing to develop new approaches to an evolving situation and thereby encourage its orderly improvement, as the recent development of multi-year rescheduling agreements shows. It is well recognized, now that the initial crisis phase has passed, that working through country debt problems is going to be a lengthy business stretching over quite a number of years. For the improvements to be more rapid many elements, including domestic adjustment programs, interest rates and world economic expansion, will have to go very well.

The problems of external indebtedness have their parallel within countries. Moreover, internal indebtedness problems are far from being confined to countries with external debt problems. Wherever plans went ahead on the assumption of high inflation and debt finance -- and such plans and assumptions were made widely by governments, businesses and individuals -- debt burden problems have subsequently arisen. In Canada, for example, a great deal of effort has been devoted to redressing financial positions over the past two years, and investment and consumer expenditures have been constrained in order to pay down debts.

But while, as I have already suggested, some degree of debt difficulty was probably unavoidable, these problems have been exacerbated by the way inflation had in the end to be fought. The extraordinarily high interest rates that were generated in international financial markets in the early 1980s, as inflation expectations were confronted by determined monetary policy, brought about wrenching adjustments to balance sheets. Tighter fiscal policies would have helped to avoid the extremes in interest rates. Even though interest rates have fallen since, they are still high relative to industrial country inflation, which is now considerably lower, or to the path of commodity prices, which have stayed unusually weak in this recovery.

The largest part of the economic expansion has come from one source, the United States. Without the strong boost from the United States the world recovery would have been considerably delayed because other countries' domestic expansions have been generally sluggish, although gradually picking up. The high level of interest rates in the United States together with the opportunities provided by their rapidly expanding and dynamic economy have attracted a huge volume of capital, boosting the international value of the U.S. dollar in the process. The resulting improvement in the competitive position of exporters in other countries has allowed them to increase their sales to the United States by spectacular amounts. In this way exchange rate responses have caused the strong economic expansion in the United States to be a major impulse to export-led recovery elsewhere in the world. This stimulus to the world economy has, however, come at a price. The pressures transmitted through world financial markets have meant that other countries have had to contend with the uncomfortable combination of high interest rates and very weak exchange rates for their currencies against the U.S. dollar.

All major industrial countries, and many other countries, have been concerned in recent years to bring their government fiscal deficits under better control. However, it is the fiscal deficit in the United States that has been the major source of concern in regard to the performance of the world economy.

This emphasis on the U.S. deficit should not be taken to imply that other countries do not have equally serious, or more serious, problems to face in the management of their own public finances. The reason for the focus on the U.S. situation is the practical one of size -- the sheer magnitude of the financing requirement that is generated by the world's largest economy and the consequent attraction of large amounts of savings from the rest of the world. The fact that this requirement came together with a strong demand for credit by the U.S. private sector was bound to have world-scale consequences for interest rates, international capital flows and exchange rates.

There is of course room for disagreement over the extent to which the U.S. fiscal deficit is responsible for the high level of U.S. and therefore world interest rates, the extreme movement in the U.S. dollar against other currencies, and the continually widening trade and current account gap. However, the direction in which the U.S. fiscal situation has affected financial markets is clear enough, and the problems posed by this combination of developments sufficiently worrisome, to make action in the fiscal area by far the most sensible first step in trying to bring about the more balanced economic and financial situation that is so important for the rest of the world as well as for the United States.

A particularly disturbing development has been the pressures for increased trade barriers to imports. The drive for increased exports on the part of debtor countries, the problems in industrial countries of adjusting to the shifting patterns of production that accompany world economic development at a time when employment growth has been slow, and the high U.S. dollar, have all generated protectionist demands and a net increase in trade obstacles of one kind or another. The threat posed to the open trading system that has been painstakingly built up over the past few decades is clearly recognized, but it will need a determined commitment to an open world economy to beat back the narrowly focussed but powerful pressures ranged on the other side.

Much of the demand for protection comes from the desire of established industries and communities to preserve traditional jobs. Certainly, one of the disappointing features of the recovery among industrial nations so far has been the persistence of unusually high levels of unemployment in many of them. In the United States, whose vigorous domestic expansion has to date been the main force impelling the general recovery in demand and output, the employment problems that have emerged have largely reflected the loss of competitiveness in some traditional goods-producing industries consequent upon the extreme strength of its currency. Elsewhere, however, particularly by all accounts in Europe, the problem seems more deep-seated. A widely shared view is that it is rooted in the lack of flexibility in labour markets in particular and more generally in the cumulation over a number of years of government-sponsored rigidities in economic arrangements that have hampered dynamism in the private sector. The recovery in Europe has been relatively slow. It is still to this stage being driven largely by export demand although there are increasing signs of renewed domestic momentum. A main policy challenge is therefore seen as one of loosening the rigidities that hamper competition, investment in new fields of enterprise and the adaptation of labour to new economic opportunities. This challenge and the importance of resolving it successfully in order to sustain economic expansion is not of course limited to Europe. I can note that it certainly extends to Canada.

Let me now come to some brief conclusions.

One element that I think stands out from this review is that any actions that lead to an easing of world interest rates would be particularly helpful in the near term. That is why I have stressed the desirability of fiscal action in the United States. Actions to compress the U.S. fiscal deficit, to ease the pressure on its own savings, should also be helpful in easing other imbalances on the world economic scene. Furthermore, policies in other countries would be provided with more room for manoeuvre to help sustain the recovery that has depended to date so heavily on the United States.

I am conscious that in focussing, as requested, on the policy issues facing the world economy, I run the danger of accentuating the negative. Let me therefore in finishing give due emphasis to the absolutely vital improvements that have taken place and that make our prospects so much brighter than they seemed a few years ago. The virulent inflationary pressures of the 1970s and early 1980s in industrial countries have been brought under control, even though not completely subdued everywhere. For the world economy as a whole the most trying part of the economic adjustment needed to provide once more the basis for sustainable economic growth is now behind us. The dividends are beginning to appear. As I pointed out earlier, some of the problems we are facing are a legacy of the earlier period of high inflation and the way inflation was brought under control. What is needed at this stage is to avoid policies that add to the problems that remain so that we can consolidate the recovery, widen it, and create the basis for sustained economic expansion.