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INTERNATIONAL ECONOMIC SCENARIOS

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Panelists:	CARL E. BEIGIE*
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This session will feature a discussion by a panel of economists covering likely economic scenarios in the short- and long-term from an international point of view. It will include a provocative look at the possibilities for United States (U.S.) economic development in the 1990s and the consequent effects on international conditions.

MR. DOUGLAS W. PARKIN: In examining some aspects of international economics today, at least two areas are of particular interest to actuaries:

1. The internationalization of financial markets--we already have an international debt market, and similar stock market developments cannot be far behind. Any actuary who is concerned about the asset side of the balance sheet will be watching these trends with interest.

2. In North America, freer trade between Canada and the U.S. is being actively discussed following the "Shamrock Summit" held in Quebec City on March 17th of this year. Estimates of Canadian interest rates, demographic trends and other relevant data must consider U.S. policy and experience.

I was recently asked to complete a questionnaire giving my forecast of inflation, real interest rates and real wage increases in Canada for the next fifty years. The letter of request said in part: "Your experience with economic data and forecasting, and your insight into the long-run trends that persist in your projections in spite of short run cycles and disturbances is not readily available to actuaries." I didn't know whether to be flattered or insulted so I have not yet responded! I have asked our panelists to look to the longer term, however, and I am sure we will all gain from their experience and knowledge.

* Mr. Beigie, not a member of the Society, is Director and Chief Economist with Dominion Securities Pitfield Ltd.

** Mrs. Bigsby, not a member of the Society, is Senior International Economist with the Royal Bank of Canada.

PANEL DISCUSSION

Our first speaker will be Mr. Carl Beigie, Director and Chief Economist at Dominion Securities Pitfield Ltd. Mr. Beigie is a Professor in the Faculty of Management Studies at the University of Toronto, and Associate Professor of a similar faculty at McGill University in Montreal. He was born in Cleveland, Ohio and became a Canadian citizen in early 1981. He received his formal education at Muskingum College in New Concord, Ohio and at the Massachusetts Institute of Technology where he carried out graduate studies in economics. He has worked for the Irving Trust Company on Wall Street where he was Assistant Vice President and International Economist. During the 1970s, he became widely known in Canada through his work with the C.D. Howe Institute. He was the Institute's founding Executive Director and later became its President. During the 1981-82 academic year he was appointed Claude T. Bissel Visiting Professor of Canada-United States Relations at the University of Toronto. He is the author of numerous articles covering a broad range of Canadian, U.S. and international policy topics. His most recent writing has focused on inflation, Canada-U.S. relations and the role of government.

Mr. Beigie will focus on the economic outlook for the U.S. in light of the current international scene.

Our second speaker will be Mrs. Elisabetta Bigsby. Mrs. Bigsby is the Senior International Economist at the Royal Bank of Canada, where she leads a group of ten economists involved in international risk analysis, forecasting of foreign exchange and the world business cycle. She is a graduate of the University of Genova, Italy with degrees in Economics and Commerce. Before joining the Royal Bank in 1977 she was involved in industrial location analysis for the Italian Employers Association. Her current position involves extensive travel to all parts of the world.

Mrs. Bigsby will discuss international economic developments with particular emphasis on the debt problems of developing countries.

MR. CARL E. BEIGIE: The world economy today continues in a state of fundamental disequilibrium. This is characterized by several factors:

- o High unemployment.
- o Sluggish economic growth.
- o Large budgetary deficits.
- o Significant international payments imbalance leading to great distortion of exchange rates.
- o Financial vulnerabilities of countries as witnessed by the difficulties experienced by some savings and loan institutions in the U.S.

The origins of this particular disequilibrium period date back to the mid 1960s. Once unleashed, inflationary excesses exposed the fragility of attitudes and institutions that had been evolving in the world economy since World War II. The key characteristics of these attitudes and institutions were complacency and excesses.

I am increasingly struck by the fact that the disequilibrium we are still experiencing around the world has had economic effects not unlike those of the Great Depression of the 1930s. Indeed I refer to the 1970s as the Great Inflation. The causes and cures of disequilibrium, however, differ between the two periods. We got ourselves out of the Great Depression through demand stimulus--World War II and the increase in economic activity it gave rise to. Restoring equilibrium to the world economy following the Great Inflation will be a much more complicated task requiring imaginative new approaches to policy tactics and an overall policy strategy within which these tactics will be placed.

One common feature of both of these periods is pessimism. I have come to conclude that much of the policy commentary on such matters as growth, productivity and unemployment is marked by an excessive degree of pessimism based on a failure to recognize that where we are today is not where we have to be in the future. Pessimism proved to be misplaced during the Great Depression and it should, with proper conduct of economic policy, prove to be misplaced at the present time.

Cures for fundamental disequilibrium begin with a vision to see the problem clearly and, at least as important, the political will to do something about it. In my judgment President Ronald Reagan had both when he came into office in 1981. His basic plan was really quite simple in its general approach. First, he supported Chairman Paul Volcker at the Federal Reserve in introducing significant degrees of monetary discipline to stop the basic inflation rot in the U.S. economy. Second, he quickly moved with Congress to provide fiscal stimulus in the form of lower taxes and increased military expenditures which more than offset the reduction in nonmilitary spending. This stimulus served to ease the inevitable downturn in the U.S. economy following the exercise of monetary discipline, and to speed up recovery from that downturn. Third, and conveying the most important message for Canada, he increased flexibility at the microeconomic level by dealing with specific firms and institutions. Change in response to the world economy was encouraged through market adjustments implying deregulation in its broadest sense.

As an economist, I feel that President Reagan's policy mix produced excellent results up until early 1983. Inflation was reduced after the initial increase caused by monetary discipline, and growth was restored. The confidence of the general public was strengthened to an exceptional degree, witnessed most dramatically last summer at the Los Angeles Olympic Games.

However, beginning in early 1983, President Reagan made a fundamental mistake which contradicted the logic of his own programs. As the private sector (business, consumers and so on) recovered and expanded its demand for financial credit, consistent logic would have dictated a corresponding decrease in public sector credit demand accomplished by reducing the U.S. budget deficit. He did not do this, and over the past two years the result has been a very curious mixture of three main factors:

- o A continuation of high inflation-adjusted (real) interest rates.
- o A truly massive U.S. trade deficit.
- o A very strong U.S. dollar which is most curious given the first two developments.

In recent weeks the U.S. economic momentum has slowed noticeably because of a combination of:

- o The impact of high interest rates on borrowers' willingness to obtain loans for the purpose of continuing rapid expenditure growth.
- o As a result of Mr. Reagan's tax policy and his impact on the confidence of the American people, there was a significant adjustment to the stock of investment goods that businesses were prepared to purchase, and in the durable goods (automobiles, ranges and so on) that consumers were prepared to purchase. That stock adjustment has now been largely, although not totally, completed and the U.S. is currently feeling the consequences of the extremely fast growth that was achieved in 1983 and the first half of 1984.
- o Finally, and of great significance to the current weakness of the U.S. economy, there is the pressure of imports from the rest of the world arising from the very high value of the U.S. dollar in the international marketplace. This has resulted in a leakage out of the system of the incomes generated buying foreign goods instead of continuing the process of expansion within the U.S. economy. This is particularly true of the impacts observed in the manufacturing sector as opposed to the nonmanufacturing sector of the economy.

This slowing in the pace of U.S. economic growth has resulted in lower interest rates because of reduced growth in private sector credit demand <u>not</u> because of any serious easing, to date, of public sector credit demand--in terms of an actual reduction in the U.S. budget deficit. When the U.S. rate of economic growth begins to recover, interest rates will rise once again, although not as high (I hope) as they were earlier, due to two factors:

- o It is my expectation that monetary discipline will be maintained and will continue to moderate inflation fears. If Mr. Volcker breaks this path of discipline, forget my forecast of continuing relatively low inflation.
- o It is the case that growth cannot surge again because new tax stimulus (such as that provided by President Reagan in 1981, 1982 and 1983) is very improbable today given the large U.S. budget deficit. Lest I give you too negative a slant on this, there is an

opportunity for the U.S. to benefit from an improvement in its trade account during the next expansion, rather than the steady and significant deterioration we have observed in the past two or three years.

In my view, a meaningful deficit reduction in the U.S. budgetary position remains an urgent priority. I might suggest that although the U.S. deficit reduction comes first, Canada must follow quickly and significantly thereafter. Deficit reduction is necessary if we are to bring about lasting interest rate relief and lasting interest rate relief is what is needed to boost investment. Investment, in turn, boosts production and increased production leads to higher real incomes and finally to job creation. But, as we have seen in the last two weeks in this country, deficit reduction is tough when the economy is weak, yet it is nonetheless crucial that it be done. The problem experienced with the Canadian Finance Minister Michael Wilson, on May 23rd, 1985, is that measures taken to attack the "structural" or long-term deficit tend to worsen the short-term "cyclical" deficit. Thus we end up doing well overall in the long term while causing short-term political pain. This is one reason it is absolutely essential for a government to move early in its electoral mandate when faced with a difficult task. I have come to conclude that there is only one way around this "mañana" problem. By that I mean the "We'll take care of it tomorrow" attitude, and then, when the economy is going well, the "Why worry about it, everything's O.K." attitude. The only way around this is to cut back on permanent spending and achieve permanent tax reduction, and don't forget that the more we cut down on spending the less necessary it is to raise taxes. As we take these kinds of steps it would be appropriate for government to introduce temporary measures to stimulate investment that is productive and increases the potential to produce in the economy in question.

This is where we are. Now let me talk with you for awhile about where we might be going. In my judgment the fundamental issue comes down to a very simple one. The starting point is this.

In recent years the U.S. has received, in effect, a massive amount of foreign aid. You may or may not accept this statement as factual, I know President Reagan doesn't see it this way, but this is an economic statement, not a political one. That foreign aid came in the form of large flow of imports into the U.S. that was nowhere near matched by the exports that the U.S. was able to produce and sell.

But that is not really a major issue. In terms of its demand for imports the U.S. was, as Canada will certainly attest, a major engine of growth in an otherwise weak world economy. The ultimate issue, and fundamentally important in terms of where we are going in the future, is how this--effectively--foreign aid was used by the U.S. What I want to do is talk about two scenarios. They are extreme and I'm being a little bit pure on each side, but we can talk about shading these scenarios later.

One scenario is that the U.S. took the aid and built up a significant deterioration of its international net worth. The U.S. has accumulated large liabilities relative to the international assets that is acquired over the last several years. Just as an example, the U.S. built up $200 billion in its net international investment position between 1917 and the end of 1982. This year, as Mr. Volcker has told the Americans time and again, that international investment position will be wiped out. At current trends, and if nothing else happens, the U.S. will be a net international debtor by the end of 1986 with those debts exceeding in magnitude the cumulative international debt of Mexico, Brazil and Argentina.

Fine. What did the U.S. do in return? If it used that transfer to accelerate the pace of investment in the U.S. above what it otherwise would have been, then we are about ready to embark on a very, very exciting period into the future. The reason is that the investment allowed by this access to foreign resources imported into the U.S. will help bring about a continuation of relatively good economic growth. That growth will raise taxable incomes and, with relatively modest action by the U.S. President and Congress, it will bring about a gradual elimination of the internal budget deficit. This will lead in turn to a significant further reduction in interest rates back to what was normally the relationship between interest rates and inflation--low inflation of the kind we are currently experiencing.

As the U.S. continues to grow, however, it will grow at a slower pace. The growth in demand for goods from the rest of the world will slow down. On the other hand, because of lower interest rates made possible by a reduction in the U.S. budget deficit, growth in the rest of the world will gain momentum. As these countries grow, they will want to import the goods that the U.S. investment will enable them to find in the U.S. market. Thus, U.S. exports will benefit.

Let's look at what happens under this very happy scenario which I surely hope will come to pass as the correct assessment of the future. The U.S. international trade deficit will gradually be restored to a position of balance without a major depreciation of the U.S. dollar's relative worth in the world commodity market. In short, the first scenario would give us a gradual restoration of the world economy to full equilibrium. This situation would enable us to get the same full benefits from a resolution of the Great Inflation disequilibrium that were possible when we finally got out of the disequilibrium of the Great Depression.

The second scenario is that these imports were mainly used by the U.S. to finance increases in both private and public consumption, including consumption for purposes of military preparedness. It is not the role of a Canadian, which I now am, to be pontificating on the U.S. approach to armament. Living here under the umbrella of defense provided by the U.S., I frankly think we have no business passing judgment. As an economist, however, I do feel that it is appropriate to ask whether this preparedness has been paid for by the U.S. or whether, to the long-term detriment of the U.S., it has been paid for through a major increase in the U.S. net international indebtedness.

If that's what has happened in recent past, and we look to the future on the basis of this scenario, then I come to the conclusion that the budget deficit will definitely not be cured through growth alone, despite what the supply siders say. Thus, unless major action is taken by the U.S. President and Congress, that deficit will result in high inflation-adjusted interest rates persisting over the cycle on into the indefinite future. Unfortunately this means progressively slower growth in the U.S. economy rather than progressively better growth prospects. Import growth in this scenario will slow eventually, quite possibly augmented by a move to protectionist policies by the U.S. government. In this situation, the rest of the world will remain very sluggish in its overall growth performance. Even if other countries were to expand more rapidly than this scenario suggests, U.S. export growth would not be sufficient to cure the U.S. external trading deficit until the U.S. dollar depreciates very significantly in relation to other currencies (although not the Canadian dollar) around the world.

The U.S. dollar's attraction, in my judgment, has been the result of winning a reverse beauty contest rather than any outright attractiveness of its own. When the dollar loses its glamour, the fall could be quite significant. In this kind of scenario there is a constant risk of resorting to inflation to solve problems not addressed by political will.

I am personally very skeptical that the U.S. has done as much investment restructuring as is required to ensure the happy first scenario. The necessary actions to avoid the very unhappy second scenario are these:

1. The U.S. President must compromise as necessary with Congress to insure that the deficit-cutting action now being actively debated within both houses succeeds. President Reagan says that the tax reform he is proposing will be revenue neutral; that is, what he takes by removing tax loopholes, he will give by reducing marginal tax rates, which I think is good sense in terms of tax policy. Although this tax reform is important, in relation to the deficit-cutting measures that the country is going to have to take, I regard it as secondary. For the skeptics, let me just comment on the notion that low interest rates today have effectively removed the real burden of the deficit. Wait. As soon as the economy comes back, those interest rates will rise again. I have no doubt in my mind about that whatsoever.

2. Canadians are going to need a much more meaningful deficit-cutting move than we've had to date, but that's secondary in the world scene.

3. There must be tax cuts to stimulate most of the other OECD countries, that is, the other advanced economies of the world. As President Reagan and his advisors have pointed out, marginal tax rates are holding back economic expansion, particularly in Europe.

I don't think much of economic forecasts today. I tell you as an economist and as a practicing forecaster that I must forecast psychology and, more importantly, I must forecast political decision making. This is true far more for getting results approaching correct forecasts than for traditional business cycle analysis. I wasn't trained as a psychologist and I wasn't trained as a political scientist. I guess. So does every other economist in the business. I will tell you what to watch for if you want a happy scenario:

o Deficit-cutting action--that will make you happy over time.

o Watch for a continuation of monetary policy discipline. Mr. Volcker is being accused of increasing the money supply too rapidly. In my judgment, this is a very narrow view dominated by an overly narrow interpretation of what monetarists say. The speed with which money turns over in the U.S. economy has slowed down dramatically thus far in 1985 and it is appropriate that Mr. Volcker should be putting more money into the economy at this time. When money begins to turn over more rapidly again, as it will, Mr. Volcker must reduce the rate of growth in the money supply. If he doesn't, watch out!

o Watch carefully what happens to wage settlements. It is true that the U.S. is weak primarily because of weakness in the manufacturing sector, but stimulating the economy in an effort to speed up the manufacturing sector's prospects also speeds up demand for the other more healthy sectors of the economy. I feel that there is increasing likelihood we will see relatively large demands (in relation to productivity) for increases in the services sector.

o Watch out for dramatic changes in the exchange rates around the world. Money markets and exchange markets can move dramatically in response to psychological changes, and if that happens it could lead to some considerable disruption in terms of the financial market disequilibriums we have. Mainly that could lead to yet another source of potential inflation problems.

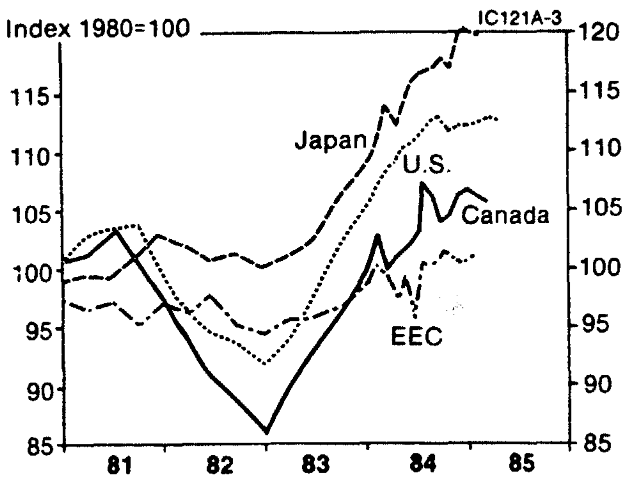
o Finally I close by saying to all countries--Canada, the U.S., and the rest of the world--that the fifth thing to watch for is protectionism. I said, and I fundamentally believe, that the basic course President Reagan brought to the U.S. economy when he came to office was a sound one. With regard to that third principle of increasing the flexibility of the economy in response to unavoidable international market changes, he concluded that for the most part, market responses had to be relied on. Protectionism, even a little bit, would be a refutation of that basic principle. That's where I start to get extremely concerned because, let me just say in conclusion, that what turned a recession in 1929 into a depression in the 1930s was a resort by nations to export their problems through a host of protectionist policies.

MRS. ELISABETTA BIGSBY: I plan to illustrate some of the disequilibria Mr. Beigie has been talking about, to lead us into a discussion of the international debt problem.

The international debt problem may appear somewhat remote, but it really isn't. A lot of the turbulence we have witnessed, and will continue to witness to some extent, in international capital markets and in international foreign exchange markets has certainly been sensitive to the international debt problem. The need for financing on the part of the U.S. and the need for financing on the part of a large number of developing countries are certainly two of the greatest conflicting forces that we are going to witness for some time.

Just to illustrate where we are and where we can expect to go, we have here a demonstration of what Mr. Beigie has been talking about:

Industrial Production



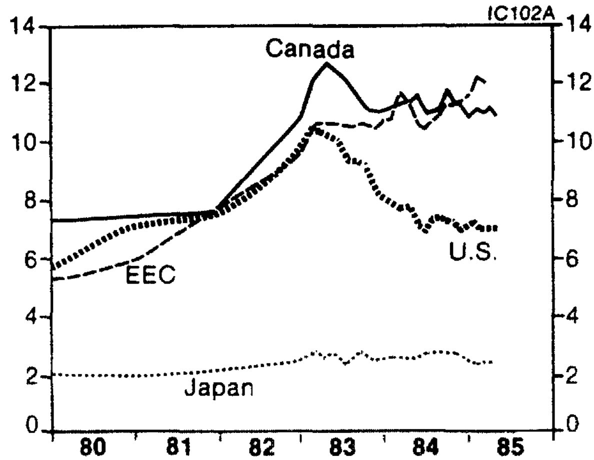
Source: IMF, The Royal Bank of Canada, Economics Department

Here you see the strong recovery in the U.S. followed by Canada and Japan, although the recovery in Japan started from a higher base and wasn't as strong as in North America. Then you see this very disappointing line representing the European Community which, on average, hasn't really grown that much over the recovery that followed our most dramatic recession.

Now this is going to be a problem in the future, particularly because unemployment, which has come down quite substantially in the U.S. (although perhaps not in a fully satisfactory fashion) and has come down in Canada somewhat, has come down not at all in Europe. Despite the so-called recovery it remains menacingly high. Now in this unemployment situation is the seed of social pressure for European governments to release their efforts to bring about fiscal discipline.

We have just heard how important fiscal discipline is going to be for the U.S. and Canada. Europe has been fairly successful in implementing fiscal discipline. It would be just devastating if now that they're on the verge of establishing themselves in the right direction, they

Rate of Unemployment



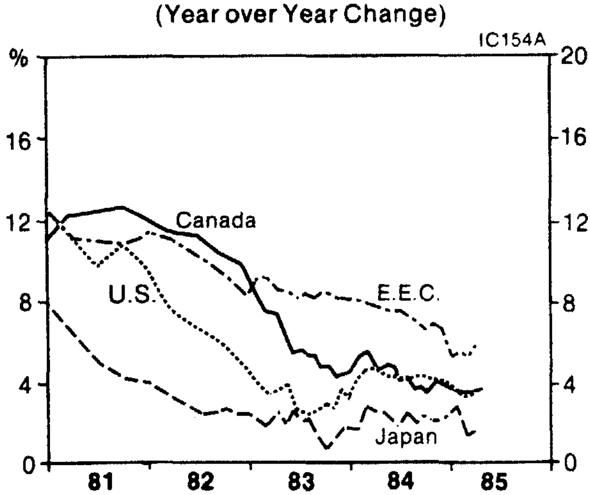
Sources: OECD, Eurostat, RBC

abandoned all of this because of very strong but presumably temporary social pressures to relieve the unemployment problem.

Luckily we no longer have an inflation problem and I think that when we go into the forecast of what I expect to happen to interest rates and foreign exchange movements, we will not have an inflation problem in the foreseeable future.

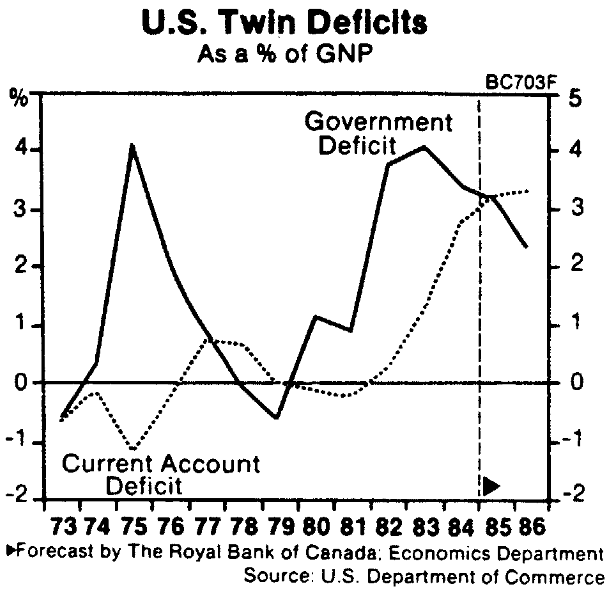
Consumer Price Index

(Year over Year Change)



Source: IMF, The Royal Bank of Canada, Economics Department

This fantastic recovery in the U.S. has obviously been the result, at least in part, of the formidable fiscal stimulus that has been provided by the Reagan Administration. As you can see here, the U.S. government deficit has been happily shooting upward, mirrored of course by the current account deficit which you see basically following the same upward line.



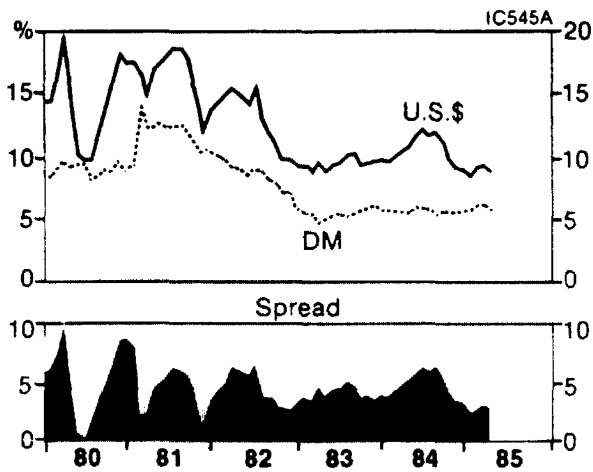
Now this is a clear indication of a fundamental imbalance in the U.S. economy, which has not been reflected, as it should have been, in the value of the U.S. dollar. It was not reflected in a dramatic fall of the dollar some time ago for two fundamental reasons:

1. The U.S. economy was growing so strongly and for so long that it was providing the only interesting field for investment all over the world. Hence foreign capital kept pouring in.

2. The other reason, which is more speculative, is that interest rates in the U.S. have been extremely attractive up until very recently.

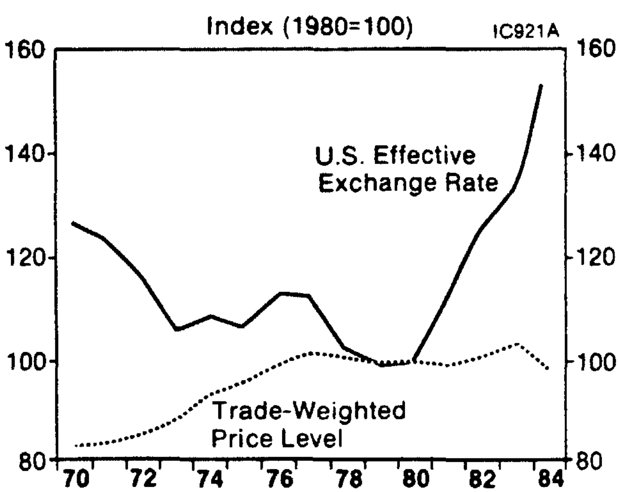
We are all very familiar with the OPEC Conference that went on a couple of days ago with Yamani trying to bring down heavy crude prices and trying to support the price of oil at its current very low levels, but for Europe, if you look at the line representing the U.S. dollar quoted in the basket of European currencies, oil certainly has not become cheaper. This is probably one of the reasons why the European recovery has been so slow. Europe has never had the benefit of cheaper oil prices which the U.S., and to some extent Canada, have had.

3-Month Eurodeposit Rates



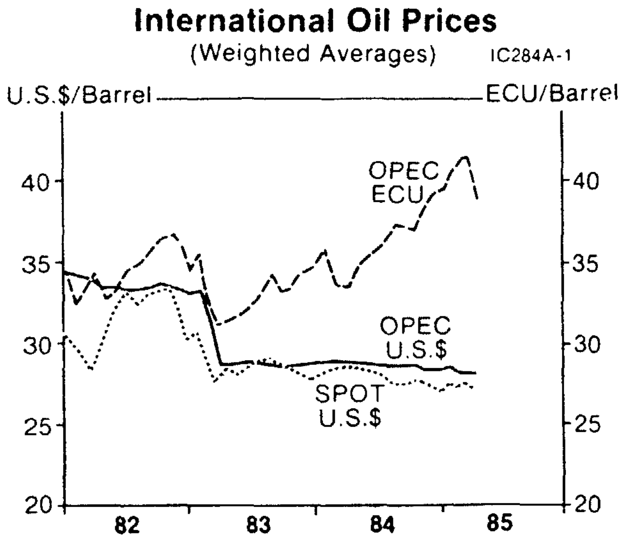
Source: The Royal Bank of Canada, Economics Department

U.S. Dollar* Relative Prices*



*Trade-Weighted

Source: The Royal Bank of Canada, Economics Department



Source: The Royal Bank of Canada, Economics Department

This very argument has brought about a collapse in the OPEC cartel. You can see that the production of OPEC went from over 30 million barrels a day in 1979 to 17 in 1984, and their share of the market was reduced by about one-third. This is due to the fact that the recession cut consumption and the high cost of oil led Europe to continue to cut consumption and to look for substitution. Also, the fact that oil prices were so high during 1979 and 1980 induced a lot of formerly marginal oil producers to put fields into production thereby increasing the non-OPEC share of production.

Now the high dollar has had another very similar effect on commodity prices in general. This is really the first major industrial world recovery (although primarily based on the U.S. recovery) where commodity prices have not responded to the increase in demand. You see that they moved up a little bit in 1983, but they haven't had the strength of demand to continue to support them since that time. This is due in part to the high cost of commodities if quoted in anything but U.S. dollars, in part to the high level of interest rates which has discouraged very strong restocking or stocking, and in part to the developing countries which, being plagued by a fairly significant international debt problem, have increased their supply of commodities in an effort to increase their export earnings.

I would like to look at this international debt problem in more detail. The very root of the international debt problem is the gap you see opening up after 1981 between the rate of accumulation of foreign debt and the rate of accumulation of exports for the developing countries. Up until 1981 you see that the two lines move roughly one next to the

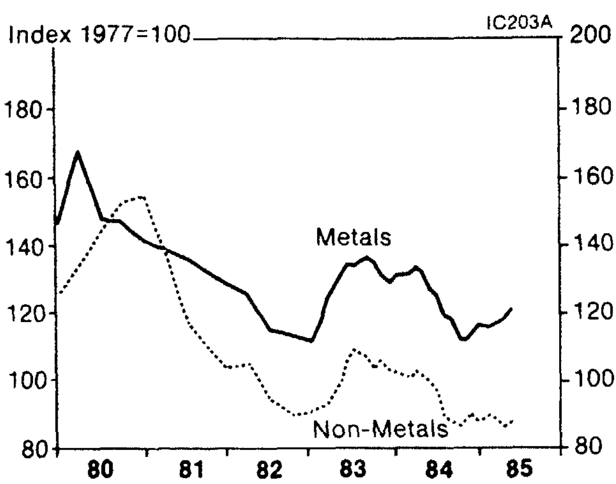
OPEC

IC282A

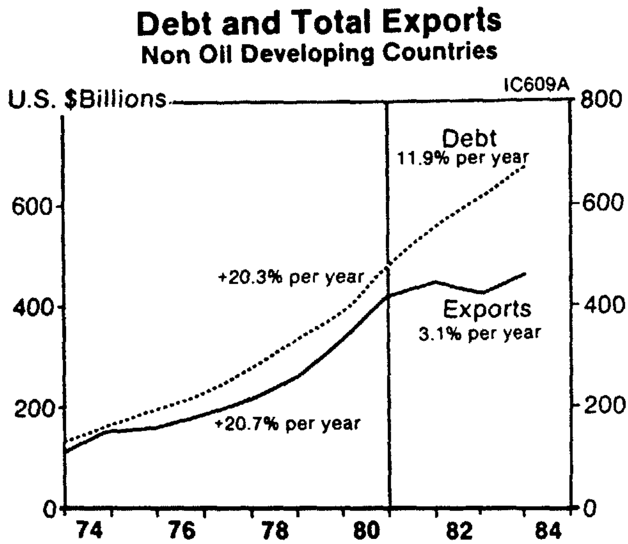
	1979	1980	1984
• Oil			
- Production (MM B/D)	30.7	26.6	17.2
- Capacity Utilization (%)	88	81	61
- Market Share (%) of "Free World"	59	55	40
• Current Account Balance (U.S.$ Billion)	65	111	2

Source: IEA, CIA, Wharton OECD

Commodity Prices



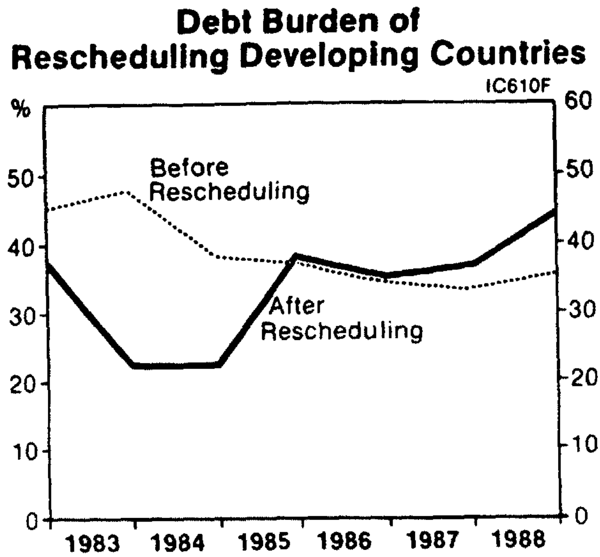
Source The Royal Bank of Canada, Economics Department other and, as every individual knows, the greater your earning power, the more debt you can take on. So up to that point everything was all right. Starting in 1981, exports plummeted because of the recession, the high level of interest rates, and the collapse in world demand. They declined and, up through the first part of 1984, they failed to recover. Meanwhile the debt continued to accumulate.



Sources: International Monetary Fund, The Royal Bank of Canada, Economics Department

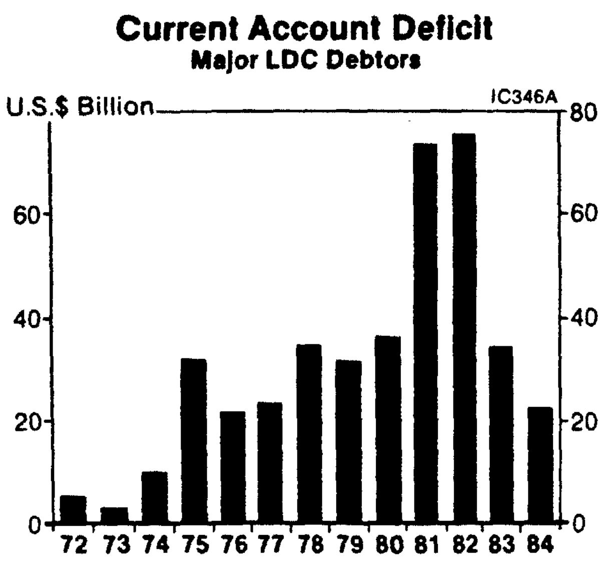
This has been a problem which has been talked about by every newspaper more or less rightly or wrongly, and which is going to stay with us for quite some time. The first solution to the debt problem was created in the wake of the Mexico crisis when Mexico, which owes about $90 billion, said, "I'm sorry, I can't pay." This was a short-term solution in which the burden of debt servicing was lowered quite dramatically in 1984 and postponed to some other time (you see the decline in the solid line). This was fine at that stage--you have a crisis, you deal with that crisis as effectively as you can in the short term. The problem with this approach was that the debt servicing kept mounting in the future, and, in fact, while the original debt line declines, the solid one begins to go up.

Meanwhile, a lot of things have happened. The developing countries have adjusted very dramatically: their external deficits have declined quite substantially and their export growth, largely thanks to the U.S. recovery, was formidable in the second part of last year. That even allowed for a renewed growth in imports so that these countries could resume some sort of positive domestic growth after about two years of very severe belt-tightening. It's interesting that in North America and in the industrial world in general we find it so difficult to go through

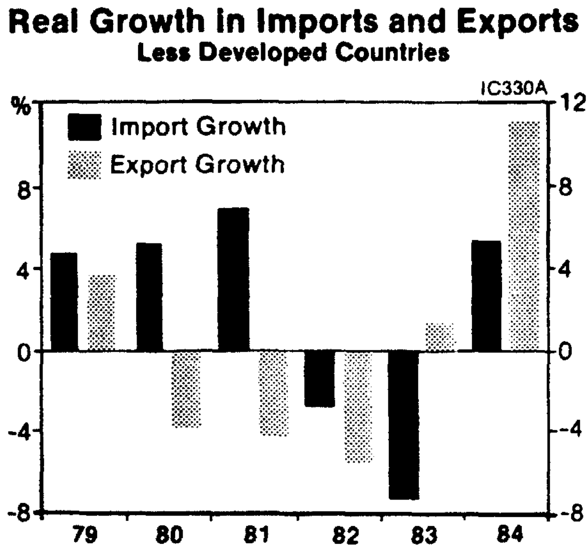


Source: The Royal Bank of Canada, Economics Department

the adjustment imposed by some budget cuts and, as you know, they become very unpalatable for the mass of voters. A number of other countries have to adjust significantly more sharply than we have had to or are about to have to.



Source: IMF, The Royal Bank of Canada, Economics Department



Source: Wharton

There is still some progress to be made, however. While a major adjustment has occurred externally, the internal situation of these countries still needs quite a bit of work as you can see from this illustration of inflation levels.

Inflation
(Percent)

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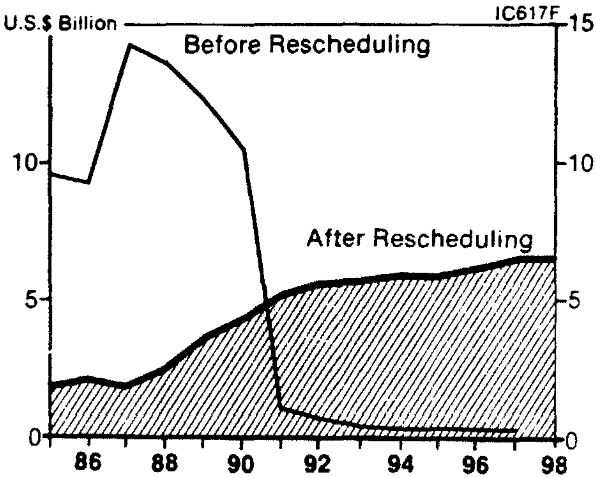
	Mexico	Argentina	Brazil	Venezuela
1971-81	17.8	138.1	42.9	9.2
1982	58.9	164.8	98.0	9.7
1983	101.9	343.8	142.0	6.3
1984	60.0	609.0	196.0	17.5

Source: IMF

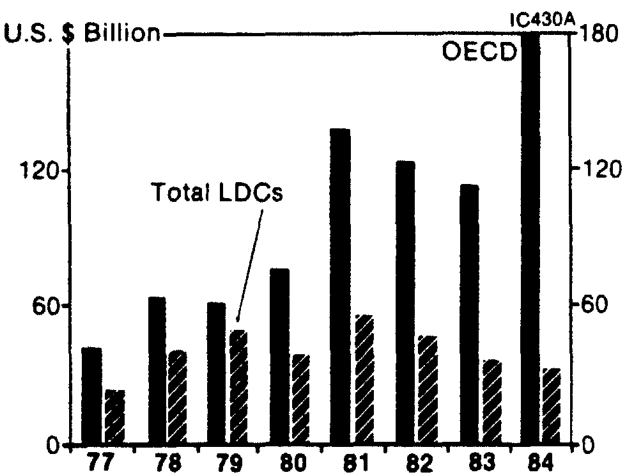
We have continued with the rescheduling, trying to smooth out the repayment process of this fairly substantial foreign debt. We have also continued to provide financing, not to the extent that was the case in 1980 or 1981, but sufficiently to enable countries to finance trade and to more or less continue in their normal international operations.

Mexico
Public Sector Debt Repayments



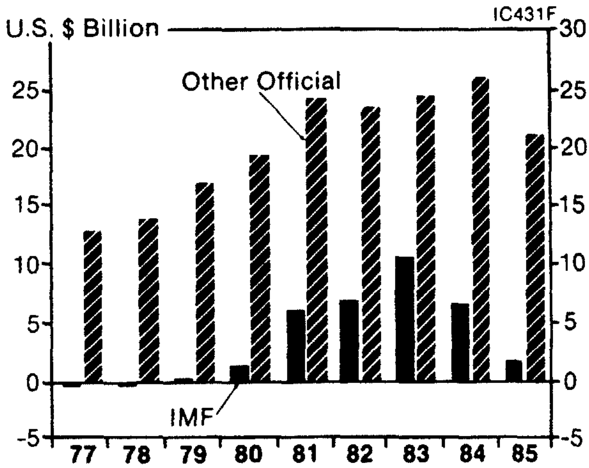
Source Mexico: Secretaria de Hacienda y Credito Publico
As quoted by the Financial Times of London (England)

Funds Raised on
International Markets



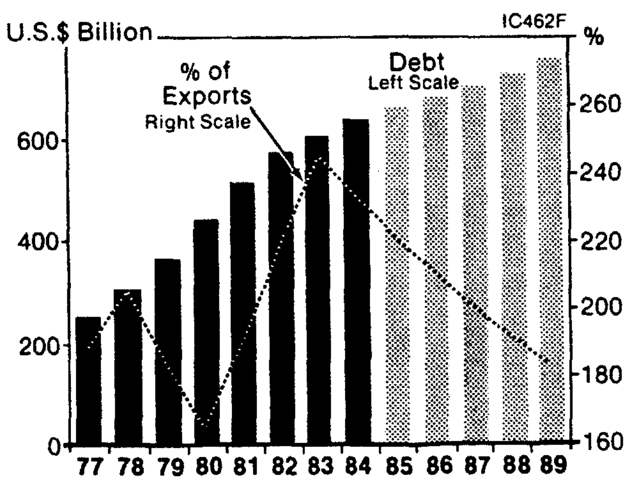
Source OECD Financial Statistics

Official Net Long-Term Lending to Non-Oil LDC's



Source: IMF, World Economic Outlook

Total Foreign Debt
Major LDC Debtors



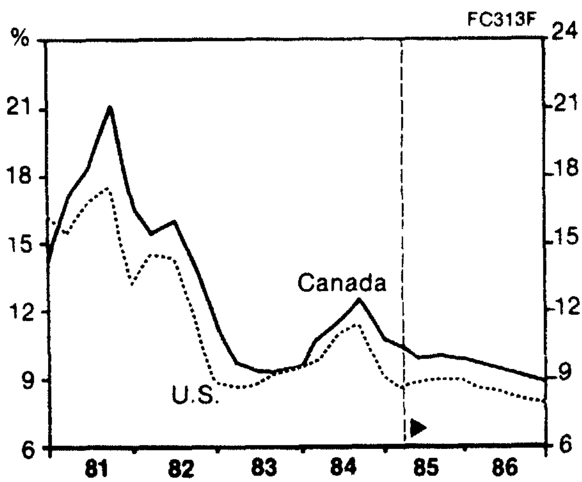
Forecast by The Royal Bank of Canada, Economics Department

Source: IMF

Official lenders have taken up a major lead in this process and have made a considerable amount of resources available to the developing countries. The result is that although in absolute terms the level of debt has not declined (and it will indeed continue to increase), relative to the exports of these countries it has begun to decline. We expect that it will continue to decline if the nondevastating scenario that Mr. Beigie described happens to be the correct one.

So, where are we going? I will actually provide an interest rate forecast which differs somewhat from Mr. Beigie's, because I think that some sort of fiscal discipline will be implemented in the U.S. If we have deficit cuts in the order of $50 billion, as appears to be the case, and then some more over the foreseeable future, along with the recovery that surely will resume but will certainly not see the heights of 1984, there should be enough room even within controlled monetary expansion to allow for some easing in interest rates. That does not mean that in the very short term, before the effects of deficit reduction are felt, there might not be a slight uptake in interest rates which I don't think should be dramatic. After that we should really see a slight decline through the foreseeable future.

3-Month Commercial Paper Rates

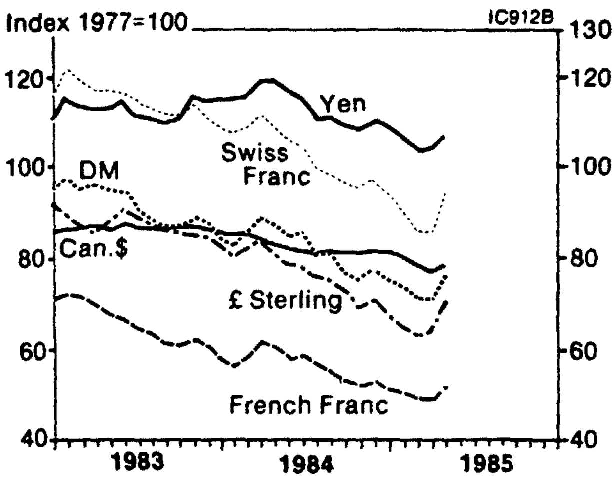


▶ Forecast by The Royal Bank of Canada, Economics Department

Source: Bank of Canada

In line with that we should also see a reversal of the strength of the U.S. dollar which has already begun. In fact, up until March 1985 every overseas currency continued to drop relative to the U.S. dollar. However, as the attraction of U.S. interest rates is no longer there and the attraction of a much stronger U.S. economy relative to overseas economies is no longer there either, we should see a reversal of these flows and an easing of the U.S. dollar.

Exchange Rates vis-a-vis U.S.$



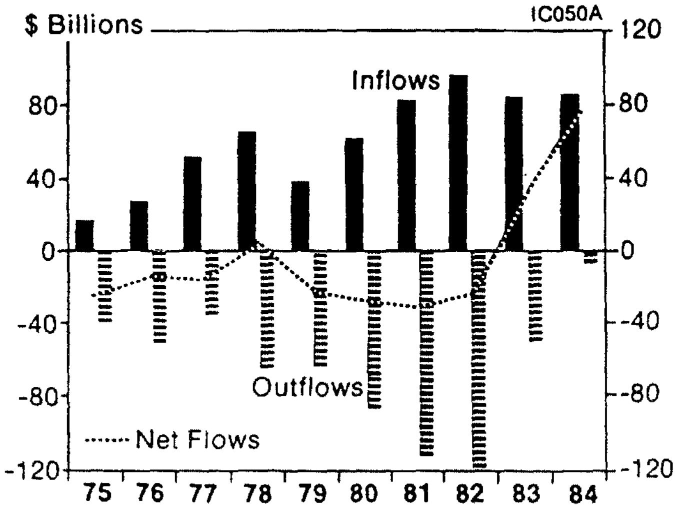
Sources: IFS, The Royal Bank of Canada, Economics Department

Following is an illustration of the amount of money that went into the U.S. Up until 1980 the outflows (foreign investment, loans abroad, or whatever) significantly exceeded the inflows. Then as the tight monetary policy began in 1981, you see inflows as well as a decline in outflows in 1983 and 1984. Everybody wanted to buy dollars and did.

The problem is that this kind of significantly widening and forever deteriorating current account deficit along with no longer attractive interest rates cannot continue much longer. It seems the situation has already started to reverse itself. Thus on average (and this is just a trade-weighted forecast of the U.S. dollar against all major overseas currencies) the dollar should continue to correct itself downward.

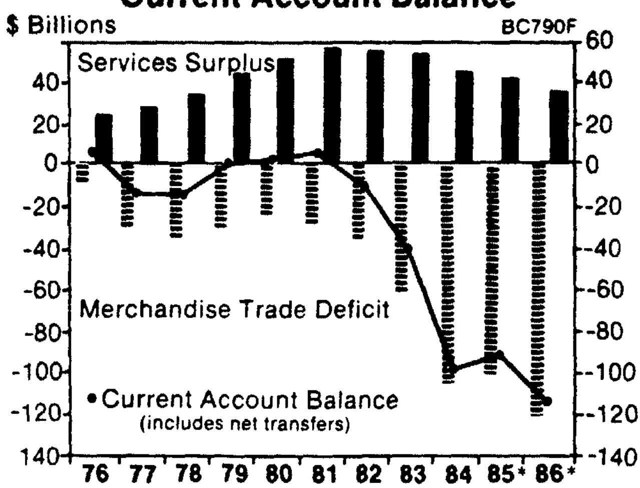
In line with that correction, I think that although we will lose the stimulus in terms of export growth provided by this very strong import demand in the U.S., other countries should have the benefit of lower interest rates because they no longer have to defend their currencies against the U.S. dollar. The U.K. has interest rates of about 12.5 percent, which it certainly doesn't need relative to its current level of inflation. Germany has interest rates between 6.5 and 7 percent and it certainly doesn't need that relative to an inflation rate of 2 percent. Japan is in the same situation. Thus some sort of internal consumer and investment spending in the European and Asian countries should pick up part of the slack that we so much fear will be a result of the U.S. slowdown. I think, even in other areas of the world, Asia-Pacific should continue to grow in dynamic fashion and even Latin America, in line with the improvement of the international debt problem, should show some recovery.

United States Capital Account



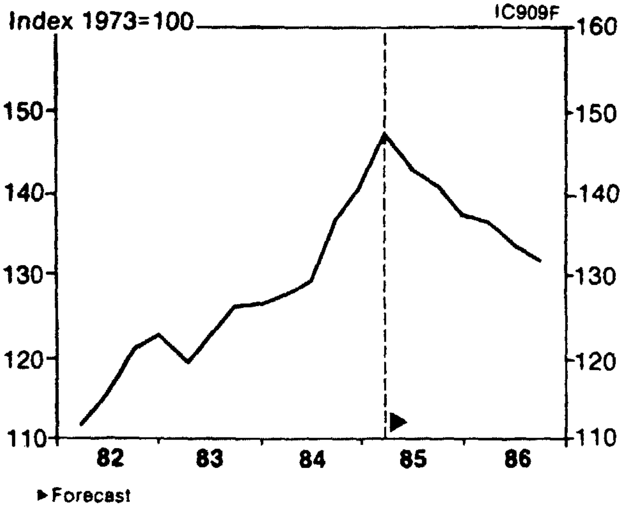
Source: U.S. Department of Commerce

United States Current Account Balance



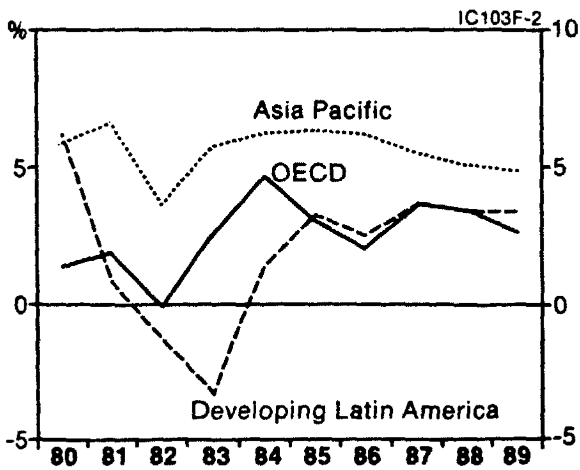
*Forecast by The Royal Bank of Canada, Economics Department
Source: U.S. Department of Commerce

U.S. Dollar Trade-Weighted Exchange Rate



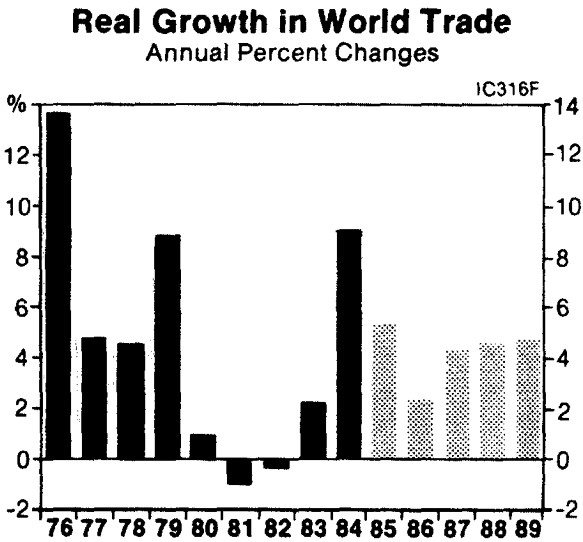
Source: The Royal Bank of Canada, Economics Department

Real GDP Growth
(Percent Change)



Source: Wharton; The Royal Bank of Canada, Economics Dept.

This whole forecast is predicated on a fairly big "if." Following is a graph of the real growth in world trade which has been responsible, in part, for the recovery seen in many areas of the world in 1984. Nobody expects world trade to continue to grow, in real terms, at 9 percent a year, but it would be nice. It is attainable that world trade continues to grow around 5 percent through the next decade. That would exceed the rate of growth of industrial countries by some amount and provide a general stimulus to the world economy.



Forecast by The Royal Bank of Canada, Economics Department

Source: U.N.

The major threat to this scenario occurring is, of course, the resurgence of protectionism. The U.S., which is known for being a fairly free trade country, has growing pressures for protectionism and Europe certainly does too. Japan says it has a very liberal economy, but this is not true. Of course all of these barriers to imports in the industrial world limit the potential for growth in developing countries.

Just to focus on Canada and the U.S., we know that the U.S. position is one of requests for freer and freer trade (so far) and that's a position that Canada fully supports. Ideally, both countries would like to see a new round of international trade negotiations aimed at bringing down all kinds of barriers worldwide. Failing that, Canada's position is for a bilateral free trade agreement with the U.S. This was, of course, consolidated in the summit meeting between President Reagan and Prime Minister Mulroney in Quebec City in which they decided to stop protectionism, reduce trade barriers and look for areas of future progress. I do hope that they don't stop looking, and that they indeed find and implement them.

Trade Policy

MC006-1

- Government trade paper
  - promote early GATT negotiations
  - U.S. bilateral trade options
    - continue as before
    - negotiate on a sectoral or functional basis
    - seek a comprehensive agreement
    - negotiate a framework agreement

- U.S. protectionism
  - lumber, copper, fisheries
  - steel, textiles, sugar

U.S. - Canada Summit
Quebec City, March 17-18, 1985

MC034

Declaration on bilateral trade relations:

- Stop protectionism
- Reduce trade barriers
- Reduce investment barriers

Work program:

- Identify areas for future negotiations

PANEL DISCUSSION

MR. PARKIN: May I ask the panelists whether there are any points they would like to discuss further?

MR. BEIGIE: Just one quick point--I thought I was successful at avoiding a forecast! I guess I wasn't. Actually, my firm's interest rate forecast doesn't differ significantly from Mrs. Bigsby's. I've been in this game for a long time and I have just observed how wrong economists have been. Me too--I've been wrong as much as anybody on this. My contention is that forecasts do not have the same basis of validity as they did, say, in the 1960s or early 1970s, for a very simple reason: when an economy is in disequilibrium, it is subject to a lot more disruptive forces than can be predicted through assuming a normal business cycle. This creates havoc in the forecasting community, and my own pitch these days is for people to understand that the forecaster is really out on a limb. My own view is that political risk analysis is really where the game is these days in terms of trying to develop some conceptual basis for figuring out what governments are likely to do when they face the kinds of pressure points that we are all facing in all of our countries at the present time.

MR. PARKIN: Have we any questions from the floor?

MR. PHILIP F. FINNEGAN: I have two questions on the same subject. First of all, for Mr. Beigie, you referred to the dollar winning a "negative beauty contest." I presume you meant it was the least unattractive currency?

MR. BEIGIE: Yes.

MR. FINNEGAN: Second, Mrs. Bigsby, you attribute part of the strength of the dollar to the differential between U.S. and world interest rates and yet, from your own graph, the differential remained almost constant between 1980 and 1984. I wonder to what extent the strength of the dollar doesn't represent the world's view of a very conservative U.S. President and a safe haven for money without regard to interest rate.

MRS. BIGSBY: I quite agree with you that there is a lot of "safe haven" argument behind the U.S. dollar's strength, and therefore general agreement with Reaganomics or the perception of a strong U.S. President. That is certainly the case. As for the interest rate differential remaining constant, which is roughly correct, I don't think the important thing is that it was constant rather that it was positive. At any given time over the past four years and up until fairly recently, anybody who had to make an investment decision would obtain something like 3 to 4 to 5 percent more in the U.S. than they would in any other major currency, save one that was being significantly eroded by inflation such as France, Italy, and to some extent, the United Kingdom. So, the differential doesn't have to continue rising in order to be attractive for foreign investors.

MR. FINNEGAN: Pursuing the argument that the strength of the dollar is based on the safe haven philosophy, the dollar could not start to fall at this point as you have predicted, and really you're basing your trend on a very short-term phenomenon.

MRS. BIGSBY: No, I think that the rising of the currency is due to a combination of factors. One of them is certainly appreciation for political stability or whatever you want to call it, in the U.S. There is also the interest rate differential and there was the strong recovery up until now. It is very difficult to determine the percentage contribution of each of these three factors behind the dollar, and those contributions change almost daily. Give them 30 percent each, for lack of a better understanding of the distribution. As we reconsider the situation every day, we no longer have the strong attraction of growth in the U.S. We are beginning to see the interest rate differential significantly eroded, and we continue to see the political strength. Thus their play may vary significantly. Meanwhile, of course, this accumulation of net debt on the part of the U.S. begins to cause some uneasiness (and I think it's far too early for this) because the easiest way to finance the debt is to print money. The U.S. is in the ideal position because it is the only country whose national currency is the same currency of indebtedness to foreigners. Thus there is a beautiful way out of the situation by printing money, although I'm not suggesting that this will occur.

MR. BEIGIE: Let me just say that I personally am not that pessimistic about the U.S. dollar and indeed you can look back at the chart for 1977 and ask why that is 100.

In many respects I regard the U.S. dollar to have been undervalued significantly in 1977, and my own view, very strongly held, is that if Mr. Reagan were to make the necessary compromises (not only the President, the Congress has to as well) to achieve a meaningful deficit reduction over a period of time, then I personally would suggest that the U.S. dollar is not ugly. The fact of the matter is, however, that there are a number of analysts in the U.S. that are talking about 100 percent devaluation of the U.S. dollar being necessary relative to the Japanese yen and 50 percent relative to the German mark. Now these are some of the top economists, in terms of public exposure, that are in the U.S. Also, I think this is far too pessimistic a view about what I think has been essentially right in President Reagan's basic approach to undoing what the U.S. has gotten itself into the during the 1970s. Let me make just one other comment. One of the reasons I think any analyst of this is nervous is that if the dollar is perceived to start falling, then in order to keep the flow of funds necessary to finance the external trade deficit of the U.S., you are going to have to have a widening of the interest rate differential to take account of the exchange-rate risk that people would be perceiving about the U.S. dollar. That differential would be quite a serious problem. The second thing, and this is where I do get quite negative about Europe, is that I am terribly concerned that there are a number of European countries, especially Germany. who are basically saying: "Our currency has been fundamentally dumped upon and what we're going to do is to make sure our currency rises in value relative to the U.S. dollar before they lower their interest rates more." In this case you could really have a big mess. I've focused on the U.S. because I think they did start the recovery in a way, and have a responsibility for keeping it going more than some of the others, but I think there is an urgent need for the other OECD countries, especially in Europe, to start playing ball too or potentially we're going to be in a real mess.

MR. FINNEGAN: First of all, how do the Germans raise the price of their money and secondly, wouldn't this have disastrous consequences in Germany?

MR. BEIGIE: No, the Germans wouldn't raise it, rather they would allow it to be raised by the market forces. The question is how far do they let the German mark strengthen before they use the opportunity of a stronger currency to lower their interest rates in order to stimulate the recovery of the economy. The German economy, with 10 percent unemployment, is in no great shakes at this time and my point is a simple one. What starts political problems around the world is when nationalism of whatever guise takes precedence over solid economic analysis. If certain European countries feel, in a nationalistic sense, that their currency has got to become stronger because they want to come to the U.S. to travel rather than having so many Americans travel cheaply in Europe, and they put as a policy target getting those currencies strengthened quickly rather than stimulating the growth of their economies through lower interest rates, then you're going to have trouble. I'm not a negative talker but I think troubles are avoided if you anticipate them, and get governments onto them.

MR. WILLIAM D. JACK: I have a question for Mrs. Bigsby. Regarding the chart that you showed on the spread in interest rates, was that the spread in nominal interest rates or real interest rates?

MRS. BIGSBY: Nominal.

MR. JACK: I wonder what the impact would be if it were real.

MRS. BIGSBY: In the earlier part of the chart the nominal differential appears to actually be larger in favor of the U.S., say between 1980 and 1982. If you put it in real terms, the differential would shrink because the German inflation rate was lower than that of the U.S. at that time. I think for the past two years it would make very little difference because Germany has been running between 3.0, 2.5 and recently 2 percent and the U.S. has been running between 3 and 4 percent. That kind of difference can be accounted for by the way you count CPI and so on, thus the two rates were, roughly speaking, identical.

MR. OSCAR ZIMMERMAN: I was wondering if the panelists might comment on what things we should look for on the Canadian scene that might impact the value of the Canadian dollar relative to the U.S. dollar.

MR. BEIGIE: That question gets more into the forecasting game. Our view at Dominion Securities is for a strengthening Canadian dollar primarily arising out of the fact that we think unemployment will stay relatively high in Canada in comparison to the U.S., at a time when there will be modest (not dramatic yet) increases in general inflation rates in North America. Our view is that the U.S. inflation rate will rise by the middle of next year to be at least a percentage point higher than it is in Canada. This will tend to move the Canadian dollar up. Second, from a psychological standpoint, something I think is very serious, is that the deficit reduction package in this government's first budget was not anywhere near what I think it would have been if they were a little bit tougher politically. There were extenuating circumstances that I am prepared to tolerate, but the fact of the matter is that this budget, no matter what else you say, has continued a trend line of moving the U.S. economic policy toward, rather than away from, the kind of basically solid pro-investment policies that President Reagan has pursued. My sense is that one of the reasons that the Canadian dollar was depressed for a long period of time was severe doubt about whether Canada really wanted to participate in the growth race that, I think, Canada almost bowed out of in much of the 1970s. I personally am optimistic about the Canadian dollar. I would watch carefully if the inflation rate did pick up--especially if it was faster than the U.S. rate. I'd be very negative then. Also, if Prime Minister Mulroney did not continue the trend line (which I think there's no chance of--he's firmly on a trend line) then I think there would be a negative effect on the dollar.

MRS. BIGSBY: Mr. Beigie and I must be the only two economists that, put in the same room, actually tend to agree. I quite agree that the Canadian dollar should move up, and I think the one other element that may help it appreciate is the fact that probably through 1984, because the U.S. economy was growing more rapidly than the Canadian economy, a lot of Canadian acquisition and investment was actually down south of the border. This year we at the Royal Bank expect that Canada will actually grow somewhat faster than the U.S. and this, coupled with the new confidence in the changed government and probably the fear of dismissal or significant change, might actually reverse that trend and I think that should help the dollar.

MR. BEIGIE: Let me just add that one of the things that was most intriguing in the chart review was what's happened to world commodity prices. Again just to repeat the point that was made, this is one of the few recoveries in which the commodity price indexes went down rather than up. I want interest rates down and I think they will go down because I think President Reagan will finally act to reduce the deficit. If that's the case you will have better balance around the world in the growth performance of the next several years. Better balance in growth is much more conducive to a good movement of commodity prices which will be particularly important in terms of Canada's economic performance, being such a major commodity exporter.

MR. SAMUEL ECKLER: I'm intrigued and fascinated with these broad brushes--where Mr. Beigie compares the inflation period to the Great Depression and says that both really came about through a fundamental economic disequilibrium. I think he mentioned as well that the disequilibrium of the Great Depression was not solved by Keynesian public spending policies--by the Roosevelt New Deal--but by the breakout of World War II, and really that is a massive government intervention in growing public expenditures. It's not clear to me what that fundamental economic disequilibrium is now. You said there were some similarities in that sense, but if we follow through the solution back in the Great Depression, I think it too would involve massive government expenditures. I'm not entirely persuaded that the great increase in defense expenditures in the U.S. wasn't a big element in the economic recovery that's taken place there. I would appreciate from Mr. Beigie particularly, some elaboration of this thesis that seems so fascinating.

MR. BEIGIE: To me, the solution has been basically achieved. To me the solution this time was a massive declaration of political will to get that fast rate of growth in the money supply down. It hurt, but President Reagan did it, and what is fundamentally at stake is the maintenance of that low inflation rate. Now the issue, in my view, is that you need just the reverse of the Great Depression expansion in demand through World War II. What we now need is to carry forward the internal logical momentum of what President Reagan is saying. He's got to cut the stimulus from the government through the government deficit and allow more of the available resources in the economy to be used in order to find out where business investment should take place to the greatest productivity advantage of the country. Again, all I am really saying is that if President Reagan would practice what he has very effectively preached by getting that deficit down to remove the burden of the public debt on the ability of the North American economy to grow, I think we'd be there. I really do. But as long as we don't do it, we're going to have a continuation of high unemployment, slow growth and unusually high inflation adjusted interest rates. We're not going to be able to see that end result of what I think is really a very exciting future.

A number of people tell my students they're not going to have much in the way of job prospects and they're going to have to share jobs. To me that's sharing misery. That's not, in my view, the long-term, ultimate conclusion of one of the most exciting periods of technological change that's ever taken place. It would take me all afternoon to tell you what I see as possibilities for productive jobs, where you move from people gaining as a result of sweat to an opportunity to gain through the use of their minds, because of this new era that's coming. Everybody's treating it as scary. To me this new world that's here is not scary at all. I think it's just fascinating and that's why I've put so much emphasis on that solution.