THE WORLD ECONOMY AND THE U.S. DOLLAR

Address by
Mr. G.A. Costanzo
Vice Chairman, Citicorp and Citibank
to The Securities Institute of Australia, New South Wales Division,
Sydney, November 9, 1978.

In the world economy international financial systems provide flexibility. The underlying strength of rapidly expanding international capital markets and a steadily rising volume of world trade does the rest. With these contemporary resources the world economy is strong enough and resilient enough to face major adversities, yet perform one "great escape" after another.

To set the stage properly, I shall first characterize the current United States economy, then expand to include other major industrial nations, and finally the developing countries.

With the current global economy in mind — and seemingly in jeopardy — I want to circle back in time for a closer look at the OPEC oil crises. We should be able to calm our present day anxieties by considering how effectively the world economy has dealt with the most severe economic shock of the postwar era.

Comparing the actual impact of sharply higher oil prices with the first catastrophic predictions should also underscore the futility of extrapolating current conditions to divine the future. Economics is not an exact science — governed by immutable laws of nature. Economics is a *social* science — forever buffeted by the shifting currents in human affairs. Although economics has no absolute numbers like the speed of light and no laws as relentless as gravity, there are certain marketplace realities that have persisted long enough to be recognized as working principles.

Economic policies can be devised and pursued that ignore these underlying principles — but not for long. Ultimately, market realities prevail over mismanagement.

The United States economy today is, unfortunately, a case in point. Efforts to direct the economy toward lower inflation and higher growth rates, desirable as these goals may be, cannot succeed in contravention of fundamental market principles. You cannot reduce inflation while expanding the money supply. You cannot promote economic growth while discouraging investment.

In a recent survey of economic forecasts by 40 major U.S. institutions, only three predicted real growth of more than 4 per cent next year. Citibank's forecast of 2 per cent made us one of the least optimistic.

The forecasts for U.S. inflation in 1979, as measured by the GNP deflator, range from a low of 6.5 per cent to a high of 8.1 per cent. Again, Citibank's relative pessimism is evident in our high end prediction of 7.9 per cent. As long as the U.S. continues to increase its money supply faster than production, inflation will keep rising.

To summarize the U.S. economy, then, we are now looking for a third quarter decline in real growth to less than 3 per cent, headed down to 2 per cent next year, extending the slowdown that has been underway since 1976. As a result, real capital spending growth will be negligible in 1979 — perhaps turning negative in 1980. With inflation rising and firmer wage price "guidelines" being phased in, recession is likely to overtake the U.S. late next year or early 1980.

That's the bad news. The good news is that it need not be a deep or lengthy recession, if monetary expansion can be curbed, federal budget deficits trimmed, and fixed wage price controls avoided — in time. What the money, capital, and foreign exchange markets are saying loud and clear is that time is running out — and the market realities will reshape the near-term U.S. economy, if its managers do not.

Though Americans recognize inflation as their number one problem, many no longer believe it can be managed. They have begun to accept it as a fact of life. As Australia's economic managers have proved, however, rampant inflation is *not* a fact of life.

At some immediate cost in slower growth and unemployment, Australia has reduced its unacceptably high consumer price inflation rate of nearly 17 per cent in fiscal 1974/75 to less than 8 per cent in the last fiscal year. And it continues to moderate, proving that inflation can be brought under control by any nation with the courage and determination to do so.

Let me broaden our perspective now to include six major industrial economies — namely, Britain, France, Germany, Italy, Japan and Canada.

The real economic growth rate for these countries averaged 2.9 per cent in 1977, well behind the 4.9 per cent achieved by the U.S. that gave rise to so much discussion of the "locomotive theory" of global recovery. There is considerably less talk of the U.S. economic engine pulling along other economies these days. By 1979, while the U.S. slips to about 2 per cent real growth, the other six countries should average around 4.6 per cent — more than double the U.S. economy's growth in output.

The real point isn't that the other countries have greater productive capacity. They don't. What they have is less tolerance for inflation — which leaves them with higher real growth rates. Since the peak inflation year of 1974, the average inflation rate for the same six industrial countries has declined consistently — year by year. We project a continuing decline. The U.S. inflation rate also dropped for two years, but then reversed and rose for the past two years. We expect it to continue rising.

Widespread inflation throughout Europe in the early 1970s produced high wage demands and low investments, which left a deep-rooted anxiety about inflation that continues to be reflected, with occasional lapses, in continental economic policies.

The U.S. recovery, which took off like a hare with a 7 per cent real growth spurt in 1976, has been slowed to a tortoise by inflation. Meanwhile, slower starters, cautiously managing inflation as they go, are pressing ahead at varying rates.

Among major industrial economies, Japan, France and Canada had strong GNP and industrial production growth in the first half, and look firm for the rest of this year. Despite a slow first half, West Germany is picking up momentum in the last half.

Britain — after a very slow year in 1977, with virtually no real growth, is posting satisfactory gains this year in the 2 to 3 per cent range, with industrial production up in the first half about 3½ to 4 per cent. However, recent signs of a shift back toward monetary restraint make forecasting very iffy.

Italy's very sluggish industrial production in 1977 seems to be picking up on the basis of preliminary first half 1978 figures, but not dramatically so.

Besides having to somehow rationalize widely divergent inflation and growth rates from country to country, the world economy now faces the added problem of having to adjust major current account imbalances among industrial countries. Especially troublesome is the sharp contrast between the sizable U.S. *deficit* and the abnormally large *surpluses* of West Germany, Japan and Switzerland. The estimated combined surplus of these three countries this year is about $27 billion, while the U.S. deficit should be around $19 billion. Clearly a more balanced adjustment is required by all four countries if the global economy is to function effectively.

The reluctance of West Germany, Japan and Switzerland to allow domestic demand to grow and begin reducing these surpluses has the added disadvantage of retarding growth in the non-oil developing countries.

Historically, and by their nature, developing countries require high growth rates. To achieve that, they customarily encourage foreign investment and borrow — sometimes heavily — in the international capital markets, using such credits to expand their own productive capacity.

They traditionally maintain current account deficits which they endeavour to manage with prudent internal policies that promote exports while minimizing imports. Because the industrial nations are their biggest customers, developing countries thrive when their customers thrive and continue buying. Thus, the economic development of these countries is closely and historically related to the economic vigour of industrial countries.

At this point we have to return in time to 1973 to see what disrupted the established pattern of third world development and has led some industrial countries to feel that they must continue to protect themselves with large current account surpluses. The event was, of course, the abrupt raising of the price of crude oil shipped by OPEC countries.

With economic vigour in the oil dependent industrial world threatened, the stage was set for a massive economic collapse of the world economy. We were told that all industry would grind to a halt, the international financial system would fold, and a bottomless world-wide depression was inevitable.

Because the non-oil developing countries were least able to pay high oil prices, their fragile economies were supposed to perish first.

In short, we were asked to believe that OPEC's price action had instantly invalidated all the market disciplines and economic principles that have governed commerce between nations for centuries.

The immediate result was a sharp build-up of revenues in the current accounts of oil exporting countries — the so-called "oil surplus". In 1974 it totalled $65 billion.

Alarmists immediately projected this surging growth to a cumulative surplus of about $650 billion by 1980 — and as much as $1.2 trillion by 1985.

What actually happened? Three years later, in 1977, OPEC oil export revenues were 22 per cent higher than in 1974. But OPEC spending for a wide range of imported goods and services increased many times faster. The OPEC current account surplus fell from $65 billion in 1974 to less than $30 billion in 1977, and to about $10 billion this year — which is substantially less than the combined current account surplus of Germany, Japan and Switzerland. Even with various belt-tightening measures taken by OPEC members and allowing for possible upward adjustments in oil prices, the oil surplus seems likely to hold at the $10 billion level through 1979, then slip to perhaps half that amount in 1980. This means that the cumulative oil surplus, by 1980, will not be $650 billion, but less than $200 billion.

OPEC oil revenues that could not be usefully spent on imported goods and services have been reinvested in the economies of other nations — developed and developing. Some of this was done directly through Government-to-Government grants, some indirectly through banks.

The non-oil developing countries responded to post 1973 market realities by cutting back on non-oil imports, expanding exports and restraining expenditures on non-essential domestic programmes. Export earnings in these non-oil countries, which were supposed to lead the parade to extinction, shot up from $67 billion in 1973 to $132 billion last year. In the process they added some $23 billion to their total international reserves.

The scaling down and recycling of the oil surplus dramatically and convincingly demonstrates the new strength and resiliency of the postwar global economy. As Mr. Johannes Witteveen, former Managing Director of the International Monetary Fund, noted recently, "the world situation has changed remarkably since then. The problem of the oil crisis has been overcome in large part, and rather better than we thought possible at the time."

One major reason for that, surely, has been the extraordinary flexibility and sophistication of the global financial system. Another is the vastly expanded pool of international capital that is available on a non-political basis to assist economies stunned by major shocks that in an earlier era might have been fatal.

As recently as fifteen years ago there were virtually no private international capital markets open to developing countries. Today, more than $100 billion of private credit is extended annually — one-fourth of it to developing countries. This is not just recycled Petrodollars. These funds flow from many sources. In 1977, $46 billion came from developed countries, $13 billion from OPEC, and $13 billion from the developing countries themselves.

It seems to me that those who predict future disasters for the world economy, whether based on failing confidence in the U.S. Dollar, the prospect of another recession, rising protectionist sentiments, the maldistribution of current account balances, or any other adverse development, would do well to measure that threat against the overally challenge of the oil crisis. Then consider how that challenge has been met, and overcome. Finally, consider that the interdependent world economy has emerged from that crisis, not weaker, but stronger.

I know that the subject uppermost in your mind is the U.S. Dollar and I guess the question at this point is what the fore-going trends, visible on the world scene, mean in terms of the U.S. Dollar?

First of all, I want to point out that the trade deficit in the United States arose in 1977 and that trade deficit was against a background of a growth of the U.S. economy — a rather rapid growth — rapid recovery — from the deficit of the 1975 recession, where the U.S. economy for a period of 1975/76/77 was growing at rates of 6% to 8%, and even in 1977 it averaged around 5% while the rest of the world — the rest of the industrial countries — were growing at rates of less than 3%. Using hindsight, if we had asked ourselves what the implications of that situation was, I think you would have had to conclude that a sizeable trade deficit by the United States was very much on the cards, and that is precisely what happened. Now, as I just indicated, I think that the major change that is underway is that the U.S. economy is pushing its full capacity and due to that factor and also due to an increasing rate of inflation, the U.S. economy is slowing down. In the first half of this year economic growth continued very strong — in the first half of this year we averaged probably in the area of about 6%, and the third quarter of this year the latest predictions indicate that maybe we will continue to grow at about 3½%, and as I indicated to you we see something like 3% in the last quarter this year and 2% as we get into 1979.

Now as we look out, as we say, in the rest of the industrial countries, the pattern is the other way around. The growth gap which was in favour of the United States has probably been eliminated at this point in time. I would say that the growth rate in the other major industrial countries is slightly in excess of that in the United States, and as we get into 1979 and 1980 then we are going to have a turn around. It's as I indicated to you in the prediction there, that against that 2% growth rate in the United States the other major industrial countries are going to be growing at a rate of something like 4½%, in other words, twice the growth rate of the United States. As we look further out in 1980 we see the U.S. economy in a recession, albeit a shallow recession, with negative growth rate of about 1%, while the other major industrial countries will continue to push ahead at a rate of about 4½% again in 1980.

Now, I think in that kind of a situation it is reasonable to assume that at least the fundamentals are going to be moving in favour of the Dollar as we get into 1979 and 1980, and in fact I think that such studies as have been made are predicting just that. I think you may be aware, the U.S. Treasury is predicting that our current account deficit will decline in 1979 from the $19-20 billion being forecast for 1978, that the deficit will be in the $12-$14 billion range in 1979 and probably go into equilibrium in 1980. The OECD is even more optimistic, they are predicting a cut-back from $20 to $10 billion in 1979. The IMF has recently come out with the results of its study and is predicting that the U.S. current account deficit in 1979 will decline to 7.5 billion. So I think that with this divergence in growth rates now, the pendulum should begin to move in favour of the U.S. from the point of view of the imbalance in the current account balance. And in fact, I think that this has been lost sight of in all the emotionalism and loss of confidence of recent months, but if you examine the statistics carefully I think that there is evidence that our current account deficit has actually been improving since about February, 1978. The improvement hasn't been dramatic enough to make the market alter its particular view of things, but I think it has been happening and I think it is reasonable to assume this will go on — this kind of improvement. We'll see more of this in the coming months.

The other fundamental factor that one has to bear in mind is that there has been now a substantial depreciation of the Dollar against those of at least the other major industrial countries, and the United States is no doubt highly competitive in export markets today. It takes some time before we get that effect, but I think enough time has gone by and trade statistics will begin to reflect that in the coming months. We are primarily — except for agriculture — in the manufacturing areas. We are a high technology exporter and there is a long lead in terms of deliveries, etc. but I think that there is clear evidence that our exports are on an increase and in fact the recent months would indicate that our exports are rising at a rate of about 20% per annum, while our imports have been rising at about 10%. So these two curves are beginning to move in the right direction. Against those two positives there is the negative longer term factor, and that is the inflation rate. I did not give you any encouragement that we are going to get our inflation rate down in the near future. Our inflation rate at the present time is running at about 8% and our own prediction is that that inflation rate will continue to increase in 1979, maybe to 8½%-9% before we turn into recession in early 1980 and that curve begins to turn down. Well that 8% or 9% compares with rates of inflation in Germany that are now running at 2% or 3% and might just possibly run a little higher than that in 1979, but nevertheless there is still a very substantial inflationary gap against the United States. But at the same time, I think with the depreciation that has already taken place, that kind of inflation gap is accommodated, has already been discounted, so that I don't think that the inflation factor will affect immediate results of what is going to happen to our current account, let's say over the next year or two. A longer term point of view is if that continues, obviously it will bring about some erosion in the strength of the U.S. Dollar.

Now, I guess the question then is how do we get from here to that more favourable environment, which hopefully is out there as we get into 1979? The problem that has been facing us is that there undoubtedly was a severe break of confidence in the U.S. Dollar in October, and I guess you would have to trace that to certain disappointment with our Energy Bill that finally came through. It had been compromised to a certain extent and the real question was as to how much bite was left in that. At the same time I want to add quickly though, that sometimes we think that the significance of that bill has been grossly exaggerated. The administration itself, in trying to get the bill passed, put a great deal of emphasis on its tremendous importance in terms of the U.S. Dollar, etc., and I think that this factor exaggerated the markets. When we didn't get a strong Energy Bill the markets reflected that immediately. In addition to that, the markets were waiting for Mr. Carter's Anti-Inflation Programme and everyone expected that there were going to be wage and price guidelines. We've had enough experience with wage and price guidelines and wage and price controls around the world to know that those kind of measures don't have much credibility left in terms of fighting inflation these days. There were some hopes that there would be other announcements which would get to the fundamentals like the budgetary deficit and monetary policy, but the message really had nothing of that sort in it and so the markets reacted very negatively and certainly in the latter part of October in the Exchange Markets the Dollar was being very heavily sold.

Now, at the present moment I think the U.S. administration has done what it had to do in terms of trying to restore the confidence, at least bring us away from this crisis in confidence that occurred, and I think that the measures that were announced were about all that were possible in that kind of situation. It is clear that the U.S. administration now does intend to intervene in the markets to try to prevent a further slide in the Dollar, but at the same time I think the markets also realise that without some changes in fundamentals that money can last only a certain period of time and will then be exhausted. I suppose the markets don't have to be reminded that $30 billion roughly, was used in intervention in 1977 without too much impact on the depreciation of the Dollar.

But there were two other parts, however, in the recent message, that I think are encouraging and the markets will be watching very closely for follow through. One was the increase in the re-discount rate by 1 percentage point from 8½%-9½% and while that per se is not something that bites because commercial banks generally do not borrow and the central banks have little impact in the actual monetary aggregates, on the other hand, it did signal that the administration was willing to live with a high interest rate structure. The other measure was the increase in reserve requirements which took about $3 million out of circulation and this also signalled that the administration now was prepared to accept a tighter monetary policy. This runs very much counter to what the administration policy had been up to that point and it appears — from a first reading at any rate — that the events of the market place have forced the administration to take the kind of measures it was reluctant to take at an earlier date. This will be watched very closely and I would say, probably the most important thing to watch is the course of money supply in the coming months. One of the factors that I think has also been responsible in the depreciation of the Dollar was that the monetary targets in the last couple of months have exceeded the announced goal of 6½% expansion in M.1 by very substantial amounts and I think that the markets will be looking to see if indeed the excessive expansion of the last couple of months is going to be reversed. I personally think that it will.

Now once the Dollar is held more or less stable for a few months, then you are likely to reach a stage where the market place will begin to feel that at least the risk of another substantial slide in the Dollar is rather remote. When you reach that point I think you will have capital flows which will begin to take over and the capital flow turnaround can have very important effects in terms of what happens to the U.S. Dollar. As I have indicated to you, if the administration can hold the situation together for a few months, I think we are going to have better trade statistics coming out, and if you get two or three months of good trade statistics, the market psychology will turn around. At this point as I haven't spoken about interest rates it is a good time to do so because I know this kind of audience would be very much interested in that. If the fears of a declining Dollar are minimised, then you face a situation of very high interest rates structure in the United States. As you know, our lending rate at the present time in the United States is 10¾th per cent, which is historically a very high rate for us and we are looking for a continuing increase in interest rates through the end of 1979. As I indicated, we don't see a recession until we get to 1980, so we look for interest rates to increase at least another hundred basis points by that time and would not be surprised to find lending rates in the United States at a 12% area by the end of 1979. Now, with those kind of interest rates and if we get fears of another massive decline in the Dollar out of the way, I think you can find some very substantial capital inflows to the United States. We also like to think that there are some good values in the Stock Markets, so that maybe some of the foreign investors — if the fears on the Dollar can be mitigated — would find the U.S. a good market to invest in. Therefore, I do not exclude the possibility that within 6 or 9 months we might find the Dollar bouncing back some 10% to 15%, not unsimilar to what happened in 1973 and 1974. Remember the first half of 1973 the Dollar lost about 20%, it gained about 10% in the next six months and lost another 10% in the first half of 1974. It was those kind of gyrations that created very large exchange losses for the banks around the world and caused the collapse of Herstadt with all the repercussions that flowed from that. The temptation when something is sliding is to assume that what happened yesterday and happened today is going to happen tomorrow, but as I indicated, there are market forces operating there and my guess is that we have seen the worst of the Dollar and I would not be surprised to see the Dollar bouncing back as I say 10% or 15% in the coming six months.

Beyond that, the thing that we are all concerned about, and I can't tell you there is any clear reading, is precisely how good a job we do in slowing down the rate of inflation.

BOOK REVIEW

INVESTMENT ANALYSIS AND MANAGEMENT

Investments — An Introduction to Analysis and Management, by Frederick Amling, Prentice-Hall, 1978. Pp. 745. $A22.95.

First published in 1965, and last revised in 1974, Frederick Amling's book entitled *Investments — An Introduction to Analysis and Management* has now been revised again to include reward and risk analysis in the decision-making process. This fourth edition covers the breadth of subjects included in that process. It retains much of the description necessary for understanding the subject and now includes an excellent framework for making analytical decisions, particularly in the practical application of portfolio theory and valuation to investment analysis and portfolio management.

The 24 chapters are supplemented with summaries, questions, problems and selected readings. Additionally, the text is abundantly illustrated with graphs, tables, and photos of investment documents.

The author is Professor of Business Finance at the George Washington University, Washington, D.C., U.S.A.

This is one of the finest textbooks in its field which this reviewer has seen. It is magnificently produced, comprehensive, attractive, well-written, interesting, informative and practical. At the price it is a bargain and, for investment analysts and investment houses, well worth acquiring. It should also be ideal for academics and academic libraries interested in the subjects of investment and investment analysis.

E. F. GILLIN