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I shall ~~try~~ in this discussion to cover three related sets of issues. First, recent underlying trends common to Western Europe and the United States. Second, a few of the major economic problems before us. And third, the issue of leadership in our societies and in the world economy.

Recent Trends

Without attempting to be exhaustive, I would suggest three trends which contribute to the complexity of contemporary economic problems.

The first trend relates to the intensive push and pull among political pressures which has resulted in a marked change in the economic characteristics of our societies in recent years. The so-called single interest pressure group has made development of a national consensus especially difficult. A certain "refeudalization" of politics has taken place, as individuals -- perhaps reacting to the bigness and distance of government -- seek to amplify their voices through participation in these groups. The ability of governments or broad political parties to balance competing interests, and aggregate them into policies which have the support of a substantial percentage of the electorate is correspondingly diminished.

The industrialized democracies, in this respect, share a common dilemma. On the one hand our democratic tradition demands that our institutions be sensitive to a wide variety of interests. On the other hand, because individuals increasingly express themselves on many issues not through elected district or state representatives who can at that level aggregate them, but rather, as part of specifically focused, nation-wide constituencies, democratic governments find it difficult to formulate and implement broad policies which serve the long-term national interest.

These pressure groups, as well as individual citizens, have become adept in using the system -- the bureaucracies, regulatory bodies, the legislatures, and, most strikingly, the courts -- to block or at least substantially delay policies which they find distasteful. In this post-Vietnam, post-Watergate era, the political dissent of the 60s has been translated into the economic dissent of the 70s. Thus, while we have become in one sense more democratized through greater access to the instruments of power, we have in another sense become considerably less so. It has become difficult to mold, or even identify, a "will of the majority" and even more difficult to convince individuals and groups to compromise with, or bend to meet, the democratic consensus.

The <u>second trend</u> relates to the ends to which the aforementioned pressures are directed. The economic success of the industrialized democracies since World War II has resulted in new types of economic demands being placed on governments. The progress of the last 25 years -- most clearly manifest in the dramatic improvements in living and working conditions -- has brought the average American and European a life-style which a generation ago would have been considered a prerogative of only the very rich.

Because of this success, the emphasis of government economic policies appears to have shifted. In earlier years the achievement of rapid economic growth was a strong unifying objective behind which broad political coalitions could rally and to which narrower interests were generally subordinated. Today the goal of economic growth is often <u>indirectly</u> dominated by social, environmental, and distributional goals. I stress the word "indirectly" because, except for a relatively small number of people or groups opposed to further economic growth, few want to believe that the measures <u>they</u> advocate will reduce economic growth, just as few want to believe that the single action <u>they</u> support will contribute to inflation. But many actions taken by governments, however virtuous the motive, tend cumulatively to reduce productivity, place a drag on growth, and contribute to inflationary pressures.

These same social and equity concerns lead toward policies which attempt to minimize, or protect citizens from, risk-- be it from a nuclear reactor, the noise of the Concorde, or competition from imports. The strong desire to preserve what we have, frequently undermines our willingness to accept the kinds of changes which would produce greater economic well-being in the long run but with painful adjustment or risk to certain individuals or groups. The trade-off of less risk for less growth may be entirely appropriate in many circumstances. Given, however, the difficulty of identifying the long-term economic costs of each risk-averting decision when that decision is made, I have to question whether we are fully conscious of the implications of this trade-off.

Economic policy-makers must therefore cope with a growing section of the population which is interested in preserving the status quo along with another substantial portion which believes that improvements in quality of life are costless -- that society has little need to make hard choices or set priorities and that multiple demands can be accommodated.

The third trend, which follows from the first two, is toward greater uncertainty and a consequent lack of long-term focus in government policies. The practical economic result of the pressures I have identified is that economic policy tends more often than not to be erratic. Leaders frequently adjust policies to accommodate popular sentiment.

New legal or social considerations are constantly being injected into our economic planning. As leaders or institutions attempt to satisfy political or social sentiments of the moment, they tend to focus less on the longer-term problems and to ignore the cumulative effects of their actions. A striking example of this trend is found in the many new sources of inflation being built into our economies through policies -- many to be sure with considerable merit -- which respond to relatively short-term pressures. The inhibiting effect on investment in new capacity and jobs of uncertainties resulting from frequent changes in economic rules is another good example. In addition to these economic costs there is also a political cost. While the body politic demands quick responses to current pressures, it tends to judge leaders, institutions, and systems primarily by their ability to resolve longer-term problems such as inflation and growth. Thus, there may be an inverse correlation between efforts to satisfy short-term political pressures and long-term political support.

Let me punctuate this rather pessimistic train of thought by identifying two developments which appear to be moving in the opposite direction, toward a simplification of the process of economic management.

The <u>first</u> is that the popular sentiment for an increased government role in economic affairs seem to have abated on both sides of the Atlantic. The recent economic difficulties experienced by our societies have brought about a rethinking of the proper role of government. Large budget deficits, high taxes, over-regulation, and doubts as to the ability of the government to outguess the market in investment policy have created sentiment in many quarters for a reduction, or at least a standstill, in the current level of government intervention. In Western Europe today, we see less pressure for nationalization, growing disenchantment with state-owned enterprises, and a recognition of the need for a revitalized private sector. In a recent poll in the United Kingdom, 78 percent of those questioned said they were opposed to further nationalization. The recent liberalization measures of Prime Minister Barre in France imply a marked change in attitude in that country. Even the Italian Communist Party has recently expressed disenchantment with state-owned corporations. In the United States, there appear to be strong popular views that a reduction in government regulation and in disincentives to capital formation in the private sector may well help stimulate lagging investment and reduce inflation.

The second countertrend is the greater perception of several national leaders of the political as well as the economic benefits of establishing and adhering to consistent policy directions. Leaders who have adopted consistent economic policies have generated renewed public confidence in their leadership and in the economic systems over which they preside. A few cases stand out. While perhaps greeted with less than total enthusiasm initially, the policies of Giscard and Barre have generated growing public confidence both because of their perceived correctness and because of the apparent determination of the French leadership to adhere to them. The policies of Prime Minister Callaghan and Chancellor Healey, also unpopular in some quarters initially, have led to a long-term strengthening of confidence in Britain and important improvements in the British economy. These policies have led to a firming of economic activity in France and a strong recovery in the U.K. Political stability in both countries has increased as a result.

Four Major Economic Issues

Let me now turn to several issues which, against this backdrop, our societies must address more forcefully. While concern over unemployment and inflation compete for attention, the problem of inflation appears today to have emerged the victor in competition for attention in the US and, I believe, in many of the countries of Western Europe. The problem seems so intractable, it affects all people in any society, and its adverse economic effects tend to divide Western societies. The middle classes who find their savings eroded and their life-styles deteriorating feel that the rich can protect themselves while the poor are protected by government welfare programs. This attitude puts pressure on programs designed to benefit lower income groups.

Many of the causes of inflation are built into our economies through legislation and regulation. The most frequently advocated prescription against inflation, however, appears to be tighter fiscal and monetary policy. While such a prescription is in many cases the right one, it frequently tends to divert attention from the need for governments to be considerably more aware of the inflationary implications of specific decisions in such areas as environmental protection, health and safety regulations, minimum wages, agricultural policy, and import restrictions.

As I noted earlier, it is easy to argue that any given policy in itself is not going to significantly increase inflation. But the cumulative impact of small individual measures can indeed be significant -- and has been. Moreover, as a result of this accumulation of measures, governments' credibility, needed to persuade business to hold down prices and labor to hold down wage demands, is considerably reduced.

Societies will from time to time inevitably decide for entirely appropriate reasons to take actions which are inflationary. But if the inflationary trend is to be reversed, we must be considerably more judicious about the selection and timing of such actions. As a beginning, we should strengthen the presumption against measures which increase inflationary pressures and undertake a more energetic effort to remove previously built-in rigidities.

While such an approach would undoubtedly be burdensome to certain groups, the costs would be smaller for society at large than the ultimate costs of inappropriate actions or of delaying appropriate actions. If and when necessary, action to alleviate the costs to individuals, such as protection of a dying industry, should be temporary and should aim to facilitate adjustment rather than to preserve the status quo. Such an orientation would not only directly reduce inflation but would also establish a longer-term expectation that inflation will decline. I am, for instance, struck by the fact that Germany has a higher rate of money creation and a larger budget deficit as a percentage of GNP than the U.S. at the same time that it has an inflation rate of less than one-half that of the U.S. I suspect that one important reason for this good performance on inflation results from widespread expectations on the part of the citizenry that the German government will act in non-inflationary ways, that labor and business will act in a similar spirit, and that the efforts of all the major actors to hold down inflation will be mutually reinforcing.

The second critical economic problem we need to address is that of energy. Our ability to adapt to the new global energy situation through a reduction in our reliance on imported oil is critical to the resumption of sustained economic growth, as well as to our political and security interests. We have a temporary respite because of new supplies from the North Sea and Alaska, and slow economic growth in many countries. It is, however, no better than being in the eye of a hurricane. Unless we make a more purposeful effort, particularly in my own country, the problem can only worsen dramatically.

While efforts to increase energy production are perhaps the most important element in the solution, I should like to focus on one of the less discussed elements -- energy-saving capital investment. We are seeing some reduction in the ratio of energy to output in our economies. Elementary economics tells us that as energy becomes more expensive we should begin to see a substitution of labor and energy-efficient capital for energy-intensive capital. Recent data lead to the conclusion that this substitution is beginning to take place. Some observers suggest that this is at least part of the explanation for the reduction in unemployment in the United States.

But the adjustment to date has only been partial. The sharp increase in oil prices made part of our capital stock obsolete, causing firms to idle some of their most energy-intensive equipment. Productivity fell as fewer goods were produced by the same number of workers, a development which along with high energy cost per unit of output contributed to inflation. Increased capital costs and low-capacity utilization are holding back the replacement of obsolete and inefficient capital. Uncertainty about energy policies, prices, supply availability, and regulation retards replacement still further.

Higher rates of economic growth in our countries will lead to longer-term conservation by encouraging investment in new capital equipment, even though the short-term increase in oil imports such growth implies draws greater attention. More specifically, however, tax and energy policies aimed at speedy adjustment of capital stock would facilitate increased investment in energy-efficient equipment, thus also increasing productivity and employment and reducing inflation. Also, as I noted earlier, the private sector must have confidence that government policies will be stable and consistent before committing investment funds.

A third problem is <u>youth unemployment</u>. The figures are staggering. In the OECD area as a whole, unemployment rates for those between the ages of 15 and 24 are on average three times as high as overall unemployment rates. The unemployment rate in this country for black teenagers is nearly 40 percent. The social costs of this situation are enormous because unemployed young people -- especially blacks and other groups already disadvantaged -- feel they have no place in society, fall further and further behind others who get entry-level jobs, and come to altogether reject the society that spurned them. The seeds of rage are building in our society as this rejected group becomes larger.

While no easy answers exist, the problem is serious enough that we should reassess many aspects of our economies which have long been taken for granted to identify solutions. For instance, many countries, in pursuit of their social/economic priorities, have instituted various systems of taxes on employment which, in some cases, may be counter-productive. For instance, in attempting to assure adequate retirement and other benefits through social security and equitable wage levels through the minimum wage, labor costs may be ratcheted up to the point that they reduce employment opportunities. Similarly, increasing job security, through laws which make it so difficult to lay off workers that firms are reluctant to hire new ones, can similarly frustrate the specific goals these programs aim to achieve.

Fourth is the problem of adjustment to imports from the developing countries. Manufactured goods -- both labor and capital-intensive -- have been rapidly replacing raw materials in the export profiles of the more advanced developing countries. Since 1955 manufactured goods as a share of developing country export earnings have expanded from 10 to 40 percent, and significant further growth is anticipated.

To put this development in perspective, roughly 23 percent (nearly $34 billion) of total US imports in 1977 came from non-OPEC developing countries. The comparable figure for Western Europe is about 10 percent. Nonetheless, concern is high on both sides of the Atlantic about the rate of penetration of imports in key sectors, provoking charges that developing countries have an "unfair advantage" in labor-intensive manufacturing.

To better understand this problem, a few facts are worth noting. First, while imports do, admittedly, displace workers in sensitive industries, the amount of displacement is considerably smaller than that which results from productivity improvements, competition, and industrial consolidation within our countries. A study of the German economy, for instance, has shown that, in the manufacturing sector, growth of productivity during the 1962-1975 period displaced 48 workers for every one displaced by imports from developing countries. The fact that job displacement results in productivity improvements and to improved consumer welfare and lower rates of inflation is clear. Imports do likewise, although their displacement effects are more noticeable than their benefits.

Second, imports from developing countries represent only a small portion of total supply (imports and domestic production) in importing countries. Even in the area of clothing, where import penetration has been rapid, developing countries supplied only about 7 percent of US consumption in 1976, up from less than 3 percent in 1970. In other developed countries the figures are comparable.

Third, in spite of the rapid growth of imports of manufactures from developing countries, both the European Community and the US continue to run large surpluses in trade in manufactured goods with these countries. In fact, the buoyancy of developing country economies, made possible by substantial borrowing in international capital markets, helped maintain demand for developed country products during the last recession. Together the developing world provides the most dynamic market for our exports. In this decade, for example, sales of US goods to developing countries grew by 22 percent per year as compared to 15 percent growth in US sales to developed countries. Today our manufactured exports to the LDCs exceed our combined manufactured exports to Europe and Japan. A restriction on imports from developing countries is, in effect, tantamount to a restriction on our exports to developing countries.

Fourth, the problem has taken on a particularly emotional dimension in some countries in Western Europe. Many Europeans fear that Europe will be unable to compete with the US in future growth sectors such as computers and aircraft while traditional capital-intensive industries such as steel, paper and chemicals will continue to suffer from overcapacity and labor-intensive industries such as footwear, consumer electronics, and textiles face increased competition from the developing nations.

The response of the industrialized democracies to this challenge can essentially be met in only one of two ways -- through appropriate adjustment or through increasing protectionism. Adjustment will entail some dislocations, which specific groups will clearly, and in their view legitimately, resist. Protectionist measures to help such groups may enjoy short-term popularity and will be hard for governments to resist. We may not notice the consequent loss of high wage exports' jobs which would result from a reduced ability of developing countries to buy from us. We would probably think even less about the jobs that could have been created but never were because we did not seize the opportunities which appropriate adjustment and trade expansion create. Individuals may argue, as I noted earlier, that actions to protect their interests will have only minor inflationary consequences even though taken together they contribute significantly to inflationary pressures and expectations.

The alternative path is what has come to be known as positive adjustment. At the June OECD Ministerial meeting and again at the Bonn Summit the industrial countries went beyond their pledge of previous years to avoid trade restrictions. They agreed on guidelines for positive adjustment which recognize that defensive measures designed to maintain existing employment or to preserve existing productive capacity in inefficient industries tend over time to reduce productivity and to inhibit sustained non-inflationary growth. The OECD countries agreed that a more positive approach should be based, to the extent possible, on market forces to encourage the movement of labor and capital to their most productive uses. In those rare cases where protective actions can be justified, the actions are to be temporary, progressively reduced, and linked to plans to phase-out obsolete capacity. Emphasis is to be placed on positive measures such as training, improved labor mobility, and work replacement in order to facilitate adjustment to shifting demands, technological progress, and changing patterns of trade.

The concept of positive adjustment is unlikely to take firm root in developed countries, unless similar actions are undertaken by developing countries. It is difficult to ask the citizens of the industrialized countries to undertake painful structural adjustments which provide new export opportunities to the developing countries unless the latter are also willing to open up their markets. A number of developing countries which have been particularly successful as exporters unnecessarily restrict imports. This feeds pressures for protectionism in developed countries and discourages positive adjustment. It is also very much in the interests of developing countries to rationalize their own domestic policies. Those that have, for instance, adopted appropriate exchange rate policies, undertaken rational pricing policies, and directed resources to industries that have a comparative advantage are the more efficient and dynamic international competitors.

The Politics of the World Economy

Let me now turn briefly to the politics of international economics. Shared responsibility for the management of the international economy is increasingly important as domestic economic management becomes more and more dependent on the world economy and vice versa. The Bonn Summit underscored the emergence of Germany and Japan as countries willing to play a greater leadership role in the world economy. While we tend today to assume that our countries will cooperate in difficult economic situations, that was not always the case. During the inter-war period, leaders of many major economic powers attempted to solve their domestic problems at the expense of other countries. Seated around the table in Bonn, however, were a group of leaders much more cognizant of the interests they shared because they had recognized the cost of unilateral actions in an interdependent world and the critical impact of the international economy on their own nation's economic well-being. None of these leaders, I believe, has illusions that his country could achieve prosperity at the expense of others. All of the leaders projected an economic sophistication and expertise resulting from the experience which heads of state and government have accumulated through the joint debate of difficult economic issues. The leadership of the industrial democracies is today more international and more economically experienced than at perhaps any time in this century.

Another element which contributes to the strengthening of shared responsibility, and which is too often taken for granted, is the existence of the European Community. Imagine, if you will, the difficulties of managing recent events if there were no Community and individual European countries went off in different directions or worked at cross purposes. The framework of the Community imposes a requirement to work out common or relatively consistent policies. While that effort is not entirely without friction, the degree of difficulty is minor compared with the trials of managing differences in the absence of the Community. Although Americans from time to time complain about Community policy in one area or another, there is little doubt that economic cooperation <u>within</u> Europe gives a desireable consistency and stability to US economic relations with Europe.

Our Atlantic economic relationship is only one dimension of the global economy. Both the EC and the US have an increasingly dynamic economic relationship with Japan. While Japan has long been content to simply react to events in the world economy, we are now seeing a greater willingness on the part of Japan to assert its interests. Although it is not easy to break the pattern of hundreds of years, Japanese leaders are making the effort to open up Japan's relatively closed economy. In the area of trade, Japan has come a long way in the direction of liberalizing imports. And while more progress is called for in some areas, Japan has moved in directions more comparable with the open economy so essential to its long-term prosperity, and to dispel criticism that it enjoys access to other markets while unfairly impeding access to its own. The process will not be furthered by the strident criticism or demands for punitive action all too often heard in some quarters of Europe and the US. The strongest possible collaboration between the EC, Japan and the US is a prerequisite for a prosperous and orderly world economy in coming years.

We must also deal with an increasingly assertive Third World. Only at our peril can we avoid including the major OPEC and Third World trading nations in important global decisions. Patterns of cooperation between developed and developing countries are less advanced than those which have been nurtured for years among developed countries in the OECD and elsewhere. We must therefore fashion new modes of consultation to insure that we better understand the perceptions of developing countries, that they better understand our own perceptions, and that common objectives can be more easily identified.

Conclusion:

Having spelled out a number of broad observations on the direction in which our economic and political systems are moving and having noted the problems on which I believe we should concentrate as well as the importance of international cooperation in resolving those problems, let me conclude on an optimistic note. The industrialized democracies have gone through an extremely difficult period. During this period we have managed not simply to avoid a deterioration in international economic cooperation, but to actually strengthen it significantly. Greater cooperation among senior monetary officials, more extensive use of the OECD, the creation of the International Energy Agency and the institution of economic Summitry are four important examples of such improved cooperation.

We have also begun to adopt our domestic policies to meet new demands and new conditions. While in many cases far greater effort is necessary, in the areas I have mentioned and others, progress has been made in increasing growth, lowering rates of inflation and reducing payments imbalances between OPEC and non-OPEC countries. In addition, our societies have continued to press forward the frontiers of modern technology in such areas of solar energy, computers and genetic research. We continue to set the standards for human rights, for respect for the dignity of the individual and for the free competition of ideas.

It is important to remember that while our societies clearly have problems, we have also demonstrated resiliency and a capacity for self-correction. In a world trying to improve the quality of life for all mankind, to solve major technological problems, and to achieve sustained prosperity, it is the industrialized democracies which have demonstrated repeatedly that they can find the answers.

Given effective and purposeful leadership and cooperation, a greater understanding of the interrelationships among the various problems we face and a clearer policy focus on our priorities, we will continue to find the answers.