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Adapting to Change in an Interdependent World Economy

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I appreciate the opportunity to exchange views with you today about an economy that is undergoing so many adjustments in its institutions and its place in the world. We witness change and transition in every line of endeavor: business, government, and personal. The need to adjust and adapt is ubiquitous and pervasive; it is also the breeding ground for uncertainty. Although each generation muses about "the best of times, the worst of times," an objective view of the 1970s and 1980s reflects more than mere transition: we live in an era of institutional transformation.

In such a dynamic economic environment, monetary policy builds upon the lessons of its long historical experience here and abroad. But that policy cannot be cast in a rigid mold that would prevent the central bank from supporting and facilitating legitimate financial growth and progress in institutional adjustment. However, policy flexibility does not mean surrendering control over the pace of monetary and credit growth compatible with disinflation. There are a thousand ways to rationalize easy money, but all of them fail the test of the overriding public interest in a stable price level.

This is also a time in our history in which the media are ever present, virtually setting the agenda of our discourse. Thus, it is vital that we step back from time to time from the flood of information -- and misinformation -- and review the progress we have made, having been fully informed about the risks and costs incurred.

That review shows that our financial system has evolved with unprecedented speed to such fundamentals as disinflation and global competition, to floating exchange rates and massive oil shocks, to extreme exchange rate volatility and what has been called "the leveraging of America." Our banks first recycled the petrodollars, then managed the less developed country (LDC) debts. As a society, we have coped with the dislocations in agriculture, energy, and manufacturing.

Recall for a moment the world of your undergraduate days at this institution. In those dear days, you at least knew what a bank was. Money was definable -- simply something you kept running short of. In 1985 there is serious political discussion about defining a "bank" and heated economic debate as to which ingredients properly go into the potpourri labeled "money."

Among other dramatic changes, we have seen an accelerated evolution from a manufacturing-extractive-agricultural economic base to a further emphasis upon services. We have reversed the inflationary momentum built up in the 1970s, although the process of disinflation has led to severe strains in our domestic economy. We suffered the worst recession, the highest unemployment, and the most severe financial strains since the 1930s. But we succeeded in dramatically reducing the inflation rate, laying the foundation for the economic expansion that has now been under way for almost three years.

Where are we today? Employment and output growth have slowed markedly since mid-84, despite declining interest rates and rapid money growth over the past year. As a result, some have questioned the very efficacy of monetary policy. Monetary policy <u>has</u> been effective in keeping aggregate demand growing at a healthy pace. Spending by households and businesses has continued to expand at rates that would, in normal circumstances, reduce unemployment and increase profits.

But circumstances have not been normal. An increasing amount of domestic spending has gone to buy foreign products. As a result, the trade deficit has grown to unprecedented levels. Despite the recent announcements that our merchandise trade deficit declined to "only" about $10 billion in July and August, both the trade deficit and the current account deficit this year will set new records. In part because of these large and growing external deficits, the effect of monetary stimulus has been dissipated, producing the paradox of healthy growth in spending but only sluggish growth in production.

Several policy actions have been proposed to bring down the trade deficit. One is for the Federal Reserve to follow a significantly more expansionary monetary policy. But aggressive, inflationary growth of money and credit to bring down the dollar's exchange rate would not enhance the position of U.S. firms in world markets. A lower external value of the dollar would be offset by inflated domestic costs. The trade deficit is in part a function of a high real dollar exchange rate. Monetary policy is only one of several factors -- and not the most important in the long run -- that influence real exchange rates.

The real exchange rate is the nominal -- or market -- exchange rate adjusted for differences in inflation across countries. It measures the real terms of trade for products we import and export, which depend on such real economic factors as productivity, consumer preferences, and the proportion of income saved. Any beneficial impact of an overly expansionary Federal Reserve policy on the trade deficit would be short-lived without accompanying changes in these fundamental economic factors.

In the final analysis, a country's trade balance reflects domestic spending and saving decisions. The primary reason the Japanese run a chronic trade surplus is not their stringent import restrictions but that the Japanese people save much of their income. Similarly, a major cause of the growing U.S. trade deficit in recent years, in my judgment, is that we are a society of high consumption and high government spending relative to our meager pool of private savings. This is one reason growing federal spending, which raises government credit demands, is so worrisome.

The importance of domestic saving and spending decisions for our current account deficit and foreign indebtedness is straightforward. Borrowing from abroad -- as reflected by an inflow of foreign capital -- is the other side of the trade deficit. If recent trends continue, we will soon become the largest debtor nation in the world. Why? Because domestic borrowing -- by the government to finance the excess of spending over tax revenues and by the private sector to finance consumption, business investment, and housing -- exceeds our low domestic saving. We live beyond our means, importing to live so well and increasingly dependent on foreign financing. As a result, foreign investors have taken on increased importance in keeping credit flowing to our economy.

One major result of the growing trade deficit and the pain it has inflicted on major sectors of our economy has been a growth in protectionist sentiment in the country. More than three hundred bills have been introduced in Congress to raise trade barriers. Although understandable from a political standpoint, the growing protectionist fervor is profoundly disturbing. The economic and political advantages of free trade are more than an academic theory. The prosperity in the U.S. and world economies in the postwar period is in no small part due to liberalized international trade. In an increasingly free trade environment, Europe and Japan have been rebuilt, America has enjoyed rising living standards, and the LDCs -- despite some recent setbacks -- have built some foundation for sustained economic growth, but only providing the environment for free and fair trade is maintained and enhanced. Although I recognize the frustrations caused by such a strong dollar and its contribution to the inability of many American companies to compete effectively in world markets in recent years, the worst possible public response would be an increase in trade barriers. Instead, we should work toward lowering trade barriers both here and abroad and toward eliminating the internal and external imbalances manifested in the uneven economic expansion around the world.

International trade and capital flows have, of course, played an increasingly important role in the behavior of the U.S. economy and financial markets. As a result, the Federal Reserve has given more attention to international and exchange market developments in policy deliberations, as Chairman Volcker noted in our mid-year report to Congress and, indeed, as is evident in the records of policy actions from recent FOMC meetings. In an interdependent world, policy makers here and abroad must take account of the broad range of effects their fiscal policy and their monetary policy actions have -- especially when domestic and international imbalances are so closely related.

What are the prospects for redressing our internal and external imbalances? The outlook seemed bleak early this year . Pessimists argued that the President and Congress were hopelessly gridlocked over the budget deficit;

the dollar was at levels that promised no respite from our massive trade imbalance; and protectionist sentiment was growing exponentially.

But recent developments have been encouraging. After a process of negotiation and compromise, a deficit reduction objective was passed by Congress and signed by the President. According to the Congressional Budget Office estimates, this agreement will lead to significant reductions in the budget deficit over the next few years. More needs to be done, and the Congress continues to explore ways and means to curb spending growth over a multi-year horizon.

In part because of the improved deficit outlook, the exchange value of the dollar has descended from levels reached earlier. Even before the descent in the last three weeks, the dollar had declined about 15 percent on a trade weighted basis from its peaks in February. The marked adjustment of the dollar to more realistic levels reflects in part some convergence in economic growth rates between the United States and our major trading partners. Our sluggish growth has been accompanied by prospects for slightly more rapid economic growth in Europe. If European economies emerge from their extended period of lethargy following the worldwide recession of 1981-82, growth rates among major industrial countries could converge further. The United States then would no longer be considered the only major haven for international investment.

The enhanced prospect for redressing our internal and external imbalances without resorting to self-destructive protectionist policies was reflected in the communique issued by the "Group of Five" industrialized nations after their September 22 meeting. At the initiative of the United States, the finance ministers and central bank representatives for England, France, Germany, Japan, and the United States met three weeks ago to discuss issues of mutual concern. Discussions have continued this past week in Seoul. The announcement issued after the G-5 meeting noted the efforts to promote convergence of economic policies and performance among major industrial countries. More importantly, the representatives also reaffirmed their commitment to home-front policy actions that would reinforce the recent progress.

The press has focused on the exchange market aspects of the G-5 meeting. Much has been made of the language in the communique recognizing that exchange rates were not reflecting underlying economic realities. Subsequent reports have closely monitored the dollar sales by central banks in Japan, Germany, and other countries. The media have also reported the rumors in financial markets about the amount of exchange market intervention. It is understandable that exchange market intervention, which is both visible and dramatic, has received the most scrutiny.

But the increased role of intervention since the G-5 meeting is not to me the most significant outcome. More important, in the final analysis, is the explicit recognition of interdependence among our nations. As is made clear in the communique from the G-5 meeting and in dispatches from the meetings in Seoul, political sovereignty does not imply economic independence. We are all part of an integrated world economy. This, to me, is the important message of the "state of play" in international negotiations.

What are the concrete implications of this message? They are that all of the involved countries must redouble efforts to pursue policies that will contribute to balanced, sustainable, and noninflationary growth in the world economy.

For the United States, a most important contribution would be to insure continued progress toward fiscal responsibility. We simply must find ways to further reduce the federal budget deficit. Less attention has been devoted to the possible relationship of tax reform and simplification to continued foreign investment in the United States. Finally, the favorable impact of improved fiscal and tax policies can be reinforced by the Federal Reserve's continued pursuit of a monetary policy aimed at sustainable growth and continued progress toward price stability.

As the United States makes progress toward correcting our internal imbalances, our trading partners could complement our actions by adopting policies that reinforce the convergence of economic growth rates and redressing the trade imbalances. The strengthening of other currencies relative to the dollar provides greater scope for our European allies to pursue more expansionary domestic policies with less risk of reigniting inflation. There is already some evidence that our friends in Europe are taking advantage of the opportunity afforded by the decline in the dollar. In Germany, for example, monetary growth has recently moved above the midpoint of the long-run range established by the Bundesbank.

The reaction in foreign exchange markets indicates that the statement of intentions by the G-5 countries has been taken seriously. The dollar has declined about 7 percent in the last three weeks. Together with earlier declines, this development implies that the foreign sector's drag on the U.S. economy could lessen. As a result, the gap between growth in domestic production and spending could begin to narrow.

Moreover, some recent data suggest that the U.S. economy has strengthened slightly after remaining in the doldrums for several quarters. The unemployment rate has moved slightly below the 7.3 percent level where it had been stuck for most of the year. The survey of purchasing agents showed gains in production for September. The most encouraging news has been the three months of solid gains in the index of leading indicators. One last positive note: because of the decline in the value of the dollar, less of the growth in domestic spending will go for imports.

However, no single economic sector yet shows promise of playing the role of accelerator. Housing has not responded as much as was expected to the decline in mortgage interest rates -- in part because of an offsetting tightening of credit standards by FNMA, mortgage lenders, and mortgage insurers. Inventory investment is unlikely to contribute much. Disinflation is the order of the day; "just in time" inventory management has replaced "buy now." Nor is a boom in consumption spending likely. Consumers have to be enticed to counters and showrooms with concessional financing or pricing. Saving rates look unsustainably low, and consumers' debt has been rising faster than their financial assets.

On balance, I think the chances are good that the slight pickup in GNP growth implied by the 2.8 percent flash estimate for the third quarter could be extended for the remainder of this year and beyond. A return to higher levels of sustainable economic growth following a period of sluggishness has ample precedent in previous U.S. expansions. Obviously history has a way of straying from previous paths, but it may be comforting to recall that slow growth need not be a precursor to recession.

Even so, the U.S. economy can't be counted on to function as the "locomotive" for global economic progress. Smaller increments in exports from Europe, LDCs, and elsewhere will continue. The effects on the LDCs' ability to earn the foreign exchange with which to service their external debt could be particularly troublesome. The meeting in Seoul recognized the role of other developed countries -- markets expanding rapidly enough to pick up the slack of slower growth in U.S. imports.

Another potentially troublesome effect of the decline in the value of the dollar could be some additional inflationary pressure in the short run. Our imports will be more expensive, and domestic producers will be under less pressure to keep prices and wages down. The effect on inflation of the dollar decline can easily be exaggerated, though. Moreover, in my view, continued declines in the dollar at a moderate pace would not have a large short-run effect on inflation. Based on historical relationships, a 20 percent depreciation would raise the inflation rate by an average of 1 percentage point over the next three years. But I expect the impact to be smaller this time around because profit margins have been unusually wide for many foreign firms that have new, expanded distribution systems in place in the United States. Because these firms will be reluctant to give up market share, they may not raise selling prices this time around as much as historical relationships suggest. In addition, the disarray in OPEC portends further declines in energy prices. Most importantly, the Federal Reserve remains committed to a monetary policy that will lead to further progress toward price stability.

It may be a peculiarly American trait to focus so much public discourse upon our difficulties and risks of failure. My argument today is that a balanced view is necessary if we are to continue in the interest of consumers the revolution in our institutions in such a changing world. Let us recognize that the trend over the past decade has been toward a healthy "return to basics." Your organization may have divested companies unrelated to your core business. There are some signs of more cooperation between management and workers. Productivity is no longer a four letter word.

We continue to face major adjustments and significant risks, both here and abroad. Monetary policy can and will contribute to stability and growth by avoiding rigid adherence to policies dictated by yesterday's institutions and environment. In today's world, the Federal Reserve's methods of conducting monetary policy must be pragmatic, considering a wide range of indicators from commodity prices and exchange rates to the monetary aggregates and interest rates. Whatever indicators we use, though, the goal remains the same: contributing to further disinflation and building upon our progress to date -- which has been achieved at considerable cost in these difficult times.