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STRATEGIC ISSUES IN U.S. ECONOMIC POLICY

H. Robert Heller

Member, Board of Governors of the Federal Reserve System

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By

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I would like to focus on the current economic strategy of the United States as a free society facing contemporary economic challenges.

My remarks are a natural follow-up to the last two conference sessions on deregulation and budget consolidation. These topics also rank high among the key strategic issues of economic policy in the United States.

Freedom and markets

The overriding economic goal of the United States as a free society must be to preserve and extend freedom in economic decisionmaking. The strategy for dealing with today's challenges must be consistent with this overriding goal of relying wherever possible on individual decisionmaking and free markets to allocate resources.

In an "open" society, with a free market philosophy, the ultimate objectives being pursued generally are not fixed quantifiable goals. Instead, the ultimate objectives are "open-ended," reflecting shifting choices over time made by hundreds of millions of people in the marketplace as well as the decisions of their elected representatives in the ongoing democratic process. Left free to assert itself, the "invisible hand" of the marketplace will guide people's actions toward fostering overall economic welfare as well as their own individual objectives.

We may argue that economic policy influences economic welfare on two different levels: one, economic policy sets the "rules of the game" within which the market forces can assert themselves. Equality of opportunity is one such goal. This economic policy framework molds the environment within which the market forces operate.

Two, economic policy directly influences the broad economic goals of the nation. These national goals

include the provision of public goods and, in a macroeconomic context, sustainable economic growth, price stability and a balanced pattern of international transactions.

I would like to take this opportunity today to examine more closely the four cornerstones of the current U.S. economic policy. First of all, we believe in enhancing the role of free markets in a free society. I will focus on how deregulatory moves in the United States have enhanced the sphere of market forces. Second, it is important to get federal spending and deficits under control, not only to reduce government's role in the economy, but also to facilitate a better balance in our internal and external accounts. That will lead me to the third aspect, namely to meet the challenge to U.S. international competitiveness and the appropriate response of our trade policies. Fourth and finally, I'll touch on how monetary policy can promote a stable environment that allows market forces to work effectively in attaining our nation's goals.

1. Economic freedom and deregulation

The primary reliance on market forces in allocating resources in the U.S. economy dates back to the birth of the nation, as does a basic understanding of how market processes work. After all, the Declaration of Independence and the publication of Adam Smith's Wealth of Nations coincided in 1776. And this year we are celebrating the 200th anniversary of the Constitution of the United States, which enshrined the principles of economic and political freedom, democracy and the rule of law.

In front of this audience I would like to note that the scholarship of economists associated with the Austrian school has contributed importantly to our current understanding of market forces. There was Mises' critique of the efficacy of central planning, Schumpeter's notion of the capitalist "process of creative destruction," and Hayek's concept of market prices as transmitters of pooled localized information in signaling relative scarcities. Haberler, who worked at the Federal Reserve Board in 1943-44, made pathbreaking contributions to the theory of exchange rates and their influence on trade. Machlup's work laid the foundation for recent advances in the theory of contestable markets. Their ideas, like lines from Shakespeare, have become so familiar that we sometimes forget the source.

Furthermore, the value of economic freedom as a crucial aspect of liberty in general has become increasingly recognized in recent years. In no small part this sentiment also reflects the intellectual reverberations of the thought of these Austrian economists.

We in the United States have learned much from these distinguished Austrian economists, and in some ways we have become even more Austrian than you Austrians.

During the last decade, we have tried to expand the sphere of market forces and to narrow the scope of government in the economy. This process of deregulation and privatization has been prompted by the enhanced appreciation of the value of independent economic decisionmaking. By now, this movement has become a worldwide phenomenon that extends even to Eastern Europe and China.

In the United States, major steps have been taken to deregulate airlines, air freight, bus service, trucking, railroads, communications, banking, and finance.

The results typically have been: lower prices for most consumers; increased competition, with many new entrants and some failures of established firms; and more variety in the products and services offered to consumers.

On the other hand, regulations related to health, safety, and the environment grew rapidly in the 1970s and have been maintained in the 1980s. Considerations of market failures and externalities must, of course, be given due weight, though I believe more efficient and less burdensome regulatory approaches could be pursued in some of these areas.

The issue of further deregulation in banking and finance deserves special mention. The European experience suggests to me that the United States could reap considerable benefits from tearing down barriers to interstate banking and allowing a broader range of powers for banks and other financial institutions alike. Of course, appropriate regard for safety and soundness, as in Europe, has to accompany such deregulation. Banking legislation just passed has put some of these issues on hold while Congress re-examines the basic strategy to guide future financial deregulation.

All in all, I see no reason to dispute a comment once made by George Eads, a former member of the President's Council of Economic Advisors. "The weight of economic

evidence has become so great that any economist venturing to support regulation today is apt to find himself in a very lonely position. What only a short time ago was considered heresy now has assumed the status of conventional wisdom."1

1. George Eads, "Economists vs. Regulators," in James C. Miller III, ed, Perspectives on Federal Transportation Policy (Washington, D.C.: American Enterprise Institute, 1975), p. 101.

Federal deficits must be reduced

The direction of U.S. fiscal policy is another key strategic issue that nowadays receives much attention not only in the U.S. but also abroad. We in the United States realize that we face a serious fiscal challenge. It arose because conflicting political goals were not adequately reconciled. A desire to limit tax burdens conflicted with support for a defense buildup and for continued growth in entitlements, such as social security and medical care for the elderly. As a result, federal deficits and borrowing mushroomed to \$221 billion last year.

But we have turned the corner. In the current fiscal year, the federal deficit is likely to fall to about \$160 billion, which represents a 25 percent reduction from last year's record level. While the decline is partly due to a one-time boost of receipts from tax reform, it also reflects determined discipline to permit no increase in inflation-adjusted federal expenditures. In concordance with my previous remarks, I believe it is important that the deficit reduction be achieved by constraining federal expenditures, rather than tax increases. Only in that fashion will the private sector be allowed to flourish.

The prospects for further deficit reductions in 1988 and beyond are favorable. The Congress will consider reinstituting Gramm-Rudman deficit targets with teeth through new provisions that put back tough enforcement measures to replace those invalidated by the Supreme Court. Such constraints may well help to avoid fiscal backsliding. These fiscal initiatives are laudable not only for their own sake, but also for their contribution to solving the problem of our external imbalances, the next strategic issue I would like to address.

3. Trade deficits need to be eliminated

Federal deficit spending contributed to our unprecedented trade deficit, and the massive buildup of federal debt helped push the United States from an international creditor position to an international debtor. So did the attractive investment opportunities associated with our sustained recovery, which will become in two months the longest peacetime expansion on record. During these years, international investors flocked to the United States in search of safe, yet high yielding, investments. Confidence in the dollar, the premier international reserve currency, further boosted demand for dollar assets.

But as the dollar soared well above levels consistent with purchasing power parity, it created problems for U.S. export and import-competing industries that have persisted to date, even in the face of the subsequent dollar depreciation. Consequently, the U.S. trade and current account deficits ballooned. In the process, the United States moved from its peak international net creditor position of around \$140 billion in 1981 to being the world's largest debtor. By the end of last year, we owed the rest of the world some \$265 billion on net, according to official - but admittedly flawed - statistics.

No one can have an inexhaustible credit line with fixed terms, and the same goes for nations. Growth of our external indebtedness at anywhere near the pace of recent years is clearly unsustainable. International investors began pulling back from financing our current account deficits in the spring of 1985. Since then, the dollar has fallen to a more realistic level, and the process of bringing our international accounts into better balance has begun.

With the dollar now at a more sustainable level, U.S. competitiveness has improved and the trade balance has begun to improve in real terms.

But we cannot sit back and let the dollar do all the work to restore our external balance. Both the U.S. government and the American consumer must restrain their spending. U.S. industry must further improve its competitiveness. At the same time, foreign countries need to do their part to ensure a continued expansion of world income and trade.

Every pilot knows that in order to execute a safe turn, one should not only turn the rudder but also adjust the position of the wings, so that the plane does not spin out of control. While today's lower dollar exchange

rate provides some incentive for U.S. and foreign buyers to switch to U.S. products, we should not depend on the dollar alone to restore external balance. If we force all readjustment to come through changes in relative prices, we could suffer higher inflation, continued high federal deficits, lower investment and therefore the potential threat of stagflation. Instead, we have to complement the exchange rate changes with a realignment of our income and expenditure patterns.

The experience of many nations facing external deficits has taught the same lesson over and over: to get external accounts in order, government deficits must be reduced and private domestic saving increased. Thus, one crucial element in our overall strategy must involve more progress in the direction of fiscal restraint. The federal budget deficit must continue to decline through the rest of the 1980s to reach approximate balance in the 1990s.

At the same time, U.S. consumers need to save more. The personal saving rate, which remains near its all-time low, is clearly insufficient to generate the investment funds needed for future growth. Both as a government and as individuals, we must save more in order to get the economy back on a course that is consistent with sustainable growth.

U.S. industry also cannot depend for success solely on a lower dollar. Industry must continue to reduce costs, diversify products, and supply the quality of goods that world markets demand. Clearly, we need to apply some of the same ingenuity demonstrated in our financial sector to our manufacturing.

But for U.S. producers to sell their products in foreign markets, surplus countries have to allow their imports to increase. Otherwise, as the U.S. trade deficit narrows, it will be foreign exports that have to fall. This means that we in the U.S. are not alone in our responsibilities.

The lower dollar will yield further gains in world income only if the surplus countries sustain a healthy expansion of their domestic spending. These days the depreciation of the dollar is causing adjustment problems in the export-oriented sectors of some of our trading partners. To compensate for this slack, demand abroad needs to increase if growth in these countries is to be sustained.

It would be useful if the surplus countries of the world were to emulate the example of Austria's balanced current account.

It is also crucial how this balance is attained. In a world with ample capacity, it would be appropriate for the trade surplus countries to increase their imports - instead of having to suffer a reduction in their exports due to protectionist measures or recession forced upon the deficit countries. Either we will grow together or we will shrink together.

With appropriate macroeconomic conditions worldwide, there is every reason to be optimistic about the future.

But in addition to pursuing appropriate macroeconomic policies to bring about better external balance, it is equally important to do everything possible to enhance the functioning of free markets in the international trade sector.

By some measures trade is freer now than in the 1960s. Tariff rates have fallen in the industrial countries over the last 20 years from an average of 15 percent to about 3 percent today. But every force seems to generate a counterforce, and every action an opposite reaction. Non-tariff barriers have become much more prevalent. By these measures free world trade has suffered serious setbacks, with many countries using insidious policies of restrictive monitoring, exclusive standards, and of administered prices and quantities. In many respects, such policies are a far worse form of protection than tariffs because they completely contravene the market mechanism.

A high percentage of both U.S. imports and exports face non-tariff barriers. What is particularly discouraging to Americans is that they seem to face some of the most rigid barriers in areas where they might enjoy a competitive advantage if free market forces were allowed to prevail. This is particularly true for agricultural exports to Europe and Japan.

Trade legislation now before the U.S. Congress could move the United States in a protectionist direction. This legislation flies in the face of an economic strategy that would allow market forces greater scope. The last thing we should do right now, given difficulties overseas of adjusting to the lower dollar, is to provide an environment where foreigners feel righteous about closing their markets. But frustration with the slow turnaround in our trade imbalance is clearly mounting and the focus of political action is

directed toward the countries with the largest trade surpluses.

One area where the U.S. enjoys considerable competitive advantage and where trade barriers tend to be high is agriculture. The United States has offered a strategic proposal that would bring agricultural trade under the GATT rules and thereby foster free trade. The U.S. plan for freer agricultural trade advocates the elimination of distortions and regulations from the agricultural markets and returns this market to the principles of the price mechanism. An added bonus of the proposal would be its salutary effect on governmental budgets not only in the U.S. but also in other countries that now subsidize agricultural production.

The program envisions a multilateral elimination, over a ten year horizon, of all export subsidies, export barriers, and all other domestic subsidies that affect international trade in agriculture. Farmers would not be left unprotected: provisions for income support would remain. But the artificial incentives that encourage excess production and bias the patterns of international trade would be eliminated. The plan would reduce surpluses of agricultural products, and lower budget outlays -- both those that result from creating the surplus and those that result from storing the surplus. The objective is to allow the market mechanism to work in the agricultural sector as well.

Of course, the United States cannot undertake such a bold move by itself. Just as improvements in external imbalances require the concerted effort of all countries, eliminating distortions to trade patterns needs participation and commitment by all.

4. Monetary stability is essential

I cannot close this talk without a few words about the strategic importance of the Federal Reserve in providing a stable financial environment conducive to economic growth. The surge in oil prices from last year's low level imparted some upward price pressures earlier this year, but if the Persian Gulf situation stabilizes, inflation rates should again move lower on a sustainable basis. In this case also, the United States would do well if it could come closer to the good price performance of the Austrian economy over the last few years.

Several underlying factors affecting inflation seem promising. The monetary aggregates, after growing rapidly in the last two years, have slowed

significantly this year. In labor markets, wage increases have stayed moderate, with the rise in compensation rates running close to 3 percent per year. This represents one of the best performances among all industrialized countries. Finally, our economy seems to be on a more balanced and sustainable growth path, with regional and sectorial imbalances being reduced.

I believe the best way for monetary policy to aid the process of domestic and international adjustment is to provide a stable financial environment that is conducive to sustainable economic growth.

Everyone will agree that a monetary policy that is extremely tight will reduce imports and move the external accounts quickly into balance. But the consequences for investment might impair the growth and restructuring of the industrial base that we will need in order to be competitive in the future. Strains on domestic and foreign debtors also might become more pronounced, and the risk of recession would be increased.

On the other hand, an unduly easy policy that allowed inflation pressures free reign could shatter confidence of domestic and international investors and could cause a precipitous decline in the exchange value of the dollar. Longer-term interest rates could well shoot up under such circumstances, with undesirable effects on economic activity.

The strategic role of a balanced monetary policy is therefore to provide a stable financial environment within which the other market participants - be they located in the public or private sector - can develop their own strategy.

In conclusion, I believe that the basic economic strategy of the United States is correct and provides a sound basis for the future. Reliance on free markets, concerted efforts to reduce our fiscal and external imbalances, and the provision of a stable financial environment are the four cornerstones of this program. I am confident that this strategy will provide greater prosperity for all.