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THE MONETARY POLICY DILEMMA: SHORT-RUN BAND-AIDS VS. LONG-RUN CURES

Thank you for the opportunity to initiate this academic year's financial executive speaker's series. It is always a pleasure to share ideas in a university setting.

Today, I would like to focus on a pressing dilemma currently facing monetary policymakers in the U.S. The general acceptance of the notion that "money matters" has been a mixed blessing. On the one hand, changes in the money stock are now commonly considered to have significant effects on aggregate demand. Hence, monetary policy has become an important component of macroeconomic stabilization policy. On the other hand, the demands on monetary policymakers to "do something" can easily get out of hand. That is, monetary policy can be expected to attempt tasks that it cannot hope to accomplish.

Specifically, policymakers are frequently asked to increase certain real variables such as real output (income) or employment, and to decrease others, for example, the real interest rate. While changes in the rate of money growth can influence real variables, this impact lasts but a short time; it is strictly ephemeral.

Now, there is nothing wrong per se with trying to do "well" in the short run. The dilemma for policymakers is that focusing on short-run temporary solutions misdirects monetary policy from addressing problems for which it can provide lasting solutions and may even create other problems in the long run.

Let us consider the most visible example of this dilemma facing monetary policymakers today. The "overvalued" dollar and the resulting rising U.S. trade and current account deficits over the past few years are widely believed to be jeopardizing the present expansion. Indeed, the Plaza Agreement of the G-5 just about a year ago labelled the external imbalances among the major industrial countries as destabilizing. This concern has generated calls for further depreciation of the dollar engineered, in part, by the Fed following an easier monetary policy to drive down U.S. interest rates. Now, not only will this action fail to heal our trade wounds in the long run, it may not even do much good in the short run. To see why this is so, despite public clamor for monetary easing, a brief, and I hope painless, discussion of the causes of trade imbalances is required.

What's Behind the U.S. Trade Deficit?

Our trade deficit (or to be more accurate, our current account deficit) can be viewed in two different ways. First, it indicates that we are spending more abroad than we are earning from sales abroad. The second way to look at the deficit is to consider its mirror image, our capital account surplus which indicates a net inflow of foreign capital

into the United States. Traditionally, the capital account has been viewed as passively adjusting to finance current account deficits or surpluses. Consequently, attention has been focused primarily on the relative demands for or supplies of goods and services across countries as major determinants of the current account balance. As capital markets have become increasingly integrated, however, investors' efforts to earn the highest available risk-adjusted return have reversed the presumed "cause and effect" between current account and capital account movements. The current account can now be thought of as passively adjusting to reflect the net capital flows. This adjustment occurs primarily through exchange rate movements; however, it also results in changes in relative prices and income levels across countries.

The extent to which capital flows dominate trade flows is exemplified by a recent survey conducted by the Federal Reserve Bank of New York, the Bank of England, and the Bank of Japan. This survey indicates that in any two weeks, foreign exchange transactions in London, Tokyo and New York equal the annual value of world trade in goods and services.

If, then, we view the current account balance as simply mirroring an independently-determined capital account balance, the primary forces behind our current account deficit must be those that influence domestic saving and investment. Why? Because foreign capital flows into the United States when domestic investment exceeds the sum of private domestic saving and total government saving. Only under these circumstances will the current account be in deficit.

This particular framework of analysis forces us to address directly the role of the federal government deficit in the trade problem. A government deficit indicates negative government saving. But a government deficit is neither necessary nor sufficient to produce a current account deficit. Norway and Denmark are currently running current account deficits while having government budget surpluses. Alternatively, numerous industrial countries, including Japan, Germany, the United Kingdom, the Netherlands and France have current account surpluses and government budget deficits. In these countries, domestic investment is too low to induce an inflow of foreign capital even with their governments absorbing domestic saving.

Does this mean that the persistent federal government deficit in the United States over the past four or five years has not adversely affected the U.S. current account balance? Not at all! The current account deficit rose from a relatively negligible \$9 billion in 1982 to \$118 billion (or nearly 3 percent of GNP) in 1985; it is running at a \$137 billion annual rate during the first half of 1986. What happened? First, the current U.S. economic expansion began at the end of 1982. Rapid growth of private domestic investment has been a key force behind the expansion, contributing twice as much to U.S. real GNP growth as compared with the average postwar expansion. Rapid growth in investment, accompanied by high prospective real rates of return on investment, attracted foreign capital into the United States.

Furthermore, this investment-led expansion generated much faster growth in U.S domestic demand vis-a-vis its trading partners. From 1982-85, U.S. domestic demand growth has been three times larger than that in Western Europe and 75 percent larger than that in Japan. This marked increase in U.S. investment growth and in the growth of U.S. domestic demand have played major roles in creating our capital account surplus and current account deficit.

As an aside, while U.S. domestic demand has slowed markedly during the past 18 months, in real terms it was only slightly less than that in the rest of the Organization for Economic Cooperation and Development (OECD) last year. U.S. demand for imports, unfortunately, is more responsive to changes in income than is foreign demand for U.S. exports. In more technical terms, the U.S. income elasticity of demand for imports is larger than the foreign income elasticity of demand for U.S. exports. Consequently, other things the same, our trade balance worsens when we grow as fast as our trading partners. For income effects to make a positive contribution to resolving the U.S. trade deficit, real growth abroad must exceed by some considerable margin that in the United States. And, according to recent forecasts, real domestic demand is expected to grow about as fast in the United States as in the rest of the OECD this year and next.

Second, the federal government deficit has not followed its typical cyclical pattern. In 1982, the federal deficit was absolutely large, but relative to GNP it was about as large as in 1975. Both these years marked the troughs of recessions. In the past, federal deficits usually

fell as the economy expanded. During the current expansion, however, this counter-cyclical movement has not occurred. In fact, for the first half of this year, the federal deficit was 5.3 percent of GNP, totally unprecedented for this stage of the business cycle. With the strong rise in domestic investment and the huge federal deficit, it is not surprising that U.S. private saving alone has been insufficient to satisfy the domestic demand for credit. We have had to tap the savings of the rest of the world.

A third factor has been the debt-servicing problems of the developing countries. These problems arose in 1982 and resulted in major reductions in the flow of savings and credit to these countries from industrial nations. By 1985, bank loans to developing countries from industrial nations were only 20 percent of their level in 1981. The LDC debt problem made the U.S. economy a "safe haven" for foreign savings. The funds previously channelled to LDCs were redirected into the U.S. capital market. In 1982, U.S. banks lent \$111 billion abroad; in 1985, they lent only \$0.7 billion abroad. Increased preference for dollar-denominated assets by U.S. banks as well as foreigners showed up as an increased net inflow of foreign capital. This placed additional upward pressure on the foreign exchange value of the dollar and caused further deterioration of the U.S. current account balance.

To summarize, the U.S. current account deficit over the past four years is primarily the result of robust U.S. investment growth (reinforced by persistent federal deficits), high real returns to foreign investors, and the relative security of dollar-denominated assets. These

factors collectively have forced up the value of the dollar, contributed to faster demand growth in the U.S. than abroad, and boosted U.S. demand for imports.

What's a Monetary Policymaker To Do?

The dilemma facing the monetary policymaker should now begin to become more clear. The trade deficit is a real phenomenon; that is, it is determined by real variables -- real output growth, real interest rates, real exchange rates. For monetary policy to have a lasting impact on the trade balance, it must be able to have a lasting impact on these real variables. Unfortunately, changes in the rate of growth of the money supply -- the only variable over which the monetary policymaker exerts control -- have no long-run impact on real output, real interest rates, or real exchange rates. This ineffectiveness property is often called the "neutrality of money." The money supply is a nominal variable and, hence, has long-run impacts only on other nominal variables, such as nominal income, nominal interest rates, or nominal exchange rates.

In the short run, however, money growth is not neutral and changes in money growth can affect real variables. This brings us back to the proposition made by some people that the Fed should cut the discount rate, thereby seeking to drive down U.S. interest rates and lower the foreign exchange value of the dollar. Associated with this policy action would be an increase in the rate of U.S. money growth relative to that in other countries. In the short run, the increased flow of dollars will push the nominal exchange rate down. In the longer run, rapid money

growth in the United States will ultimately produce more rapid inflation in the United States relative to the rest of the world. But the ensuing inflation develops with a lag, whereas the impact on the nominal exchange rate occurs immediately. Thus, in the short run, the real exchange rate (i.e., the nominal rate adjusted for price level differences across countries) also falls.

Ultimately, however, domestic prices eventually rise and so does the real exchange rate. Thus, in the long run, the nominal exchange rate will depreciate only enough to offset the higher rate of U.S. inflation relative to that in the rest of the world; the real exchange rate will remain unchanged. On net, then, the monetary stimulus has had no lasting beneficial effect on the real exchange rate; it has, however, a nasty impact on the U.S. economy -- increased domestic inflation. Similar arguments can be made about the short-run vs. the long-run relation between changes in the rate of money growth and both real output growth and real interest rates.

There may also be other short-run effects of such a policy action that tend to offset any beneficial impact of temporarily lower real exchange rates. For example, the easier monetary policy intended to result in a lower foreign exchange value of the dollar might simultaneously lead to stronger real growth of domestic demand. In view of the relatively strong income elasticity of U.S. imports cited earlier, the trade deficit problem might in fact be exacerbated.

Finally, there is an issue of stability, or perhaps I should say potential instability, associated with the large current account and capital account balances. Markets, both for foreign exchange and for U.S. government securities, tend to react very quickly to expectational shifts, particularly those arising out of monetary policy actions. Accordingly, a policy action perceived to carry with it a significant risk of future inflation could cause an immediate and abrupt adjustment in nominal market prices. This, in turn, could disrupt the pattern of international capital flows on which we have become so dependent to meet our savings gap and have very negative consequences for real economic activity in the short run.

To summarize briefly, our trade deficit is not a problem which can be addressed effectively by monetary policy actions. The trade deficit is a problem created by real changes that reflect domestic savings/investment imbalances worldwide; monetary policy actions have no lasting effects on these real influences whatsoever. Directing monetary policy at futile attempts to resolve the trade deficit, however, jeopardizes the one objective that monetary policymakers can achieve — maintaining price stability. If we are to achieve this, monetary policymakers will have to withstand the public clamor for short-run policy band-aids that have no chance at all of providing long-run cures to trade problems.