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Remarks by

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Economic Policy In The Next Four Years

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It is a pleasure to address the distinguished members of the National Association of Business Economists on the occasion of this seminar on "Economic Policy in the Next Four Years." My remarks today will not be tied to any particular four-year cycle -- economic, political, or otherwise, but they are designed to tie in with the principal theme of the seminar.

The current recovery is now a little over two years old. The overall rate of economic expansion has been well above the average for the comparable period of earlier postwar recoveries. Inflation, however, has not accelerated; in fact, it appears to have moderated somewhat during the course of the recovery. Interest rates have risen, as they typically do during a cyclical expansion, but the percentage increases in both short- and long-term interest rates are not, thus far, out of line with those in earlier postwar recoveries.

While difficulties in individual sectors and regions abound, the performance of the macroeconomy during this recovery has been more trouble free than most of us had expected. The economy and financial markets have been subjected to an enormous amount of fiscal stimulus -- the increase in the structural Federal deficit since

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early 1981 has been of unprecedented dimensions for a peacetime period. But the dire financial consequences of those deficits that many economists and others had expected by and large have not happened.

It would be widely agreed that developments in the international sector have played an important role in this outcome. The exchange value of the dollar has increased greatly; imports have expanded at an unprecedented rate, and the current account deficit has widened dramatically. These events have had important effects on our overall economic growth rate, on the rate of inflation, and on interest rates.

I must confess that I know less about the interaction between domestic and international economic developments than I would like. Perhaps some of you share that feeling. Until this recovery, the need to worry about the interconnections was less acute than it is currently. What I would like to do today is to make a small contribution to improving our understanding in this area. I warn you that I am only scratching the surface of a large and important subject.

A Measure of External Restraint

From the fourth quarter of 1980 through the fourth quarter of 1984, the value of the dollar in exchange markets on a trade-weighted basis against major foreign currencies rose by roughly 65 percent. It did so despite steadily widening deficits in our merchandise trade and current accounts. In real terms, using consumer prices here and abroad as measures of inflation, the increase was about 60 percent.

So large a change in the value of the dollar would seem to have exerted a good deal of restraint on the growth of domestic output. How large might it be? Is there a way of measuring it that would permit comparisons with other familiar measures of stimulus or restraint, such as those employed for fiscal policy?

We all know that to analyze the effects of fiscal policy on the economy and on financial markets, the actual deficit in the Federal budget is a potentially misleading indicator. The actual deficit reflects the effects of the economy on the budget,

as well as the effects of the budget on the economy. Measures of the high-employment deficit, also known as the structural or standardized deficit, are designed to get around this problem.

Similarly, measures such as the current account deficit, or the gap between GNP and domestic aggregate demand, reflect lines of causation running both ways between the domestic economy and the international sector. A measure of external restraint is needed that avoids this problem.

In principle, such a measure of external restraint associated with a change in the exchange rate can be readily constructed. Take an assumed, or observed, change in the real exchange rate and multiply it by estimated price elasticities of demand for imports and exports. The resulting estimates of volume change for imports and exports are then multiplied by the prices of imports and exports expected in the absence of a change in the exchange rate.

The source of a change in the exchange rate is, of course, an important issue to which I will return shortly.

Setting that issue aside for the moment, the exercise just described (or its equivalent performed with the assistance of a model of the current account) yields an estimate of the impact of the change in the exchange rate on the current account deficit, evaluated at predetermined prices, without feedback effects. Thus, it measures the first-round effect on demands for goods and services produced in the domestic economy.

Such a measure of external restraint (or ease) is analogous in all respects save one to the effects on the economy, and on financial markets, of a change in the structural Federal budget deficit. In one very important respect, however, the two concepts differ.

A change in the structural Federal deficit has no direct effect on prices, so that its influence on interest rates, ignoring expectational effects, results from its impact on aggregate demand for goods and services. An exchange rate change, however, directly affects both prices and aggregate demand. There is therefore a direct effect on real money balances that is absent in

the case of a change in the structural budget deficit. Thus, a rise in the exchange rate reduces real GNP through its effect on relative prices of imports and exports. This is the "fiscal effect" of the appreciation. However, since the appreciation also lowers the average level of prices, other things equal, it increases real money balances and through that channel has a stimulative effect on the economy. We may say, therefore, that the measure of external restraint I have described has fiscal effects on markets for goods and services, and also on financial markets, analogous to those of a change in the structural Federal deficit. But exchange rate changes also have monetary effects that need to be carefully considered.

Estimation of such a measure of exchange rate restraint is subject to a particularly wide margin of error. This is true because calculated price elasticities of demand for imports and exports necessarily are based on historical time periods during which the dollar's exchange value changed considerably less than it has in the past four years.

With that caveat in mind, estimates generated by the Board staff's model of the current account suggest that the 60 percent appreciation of the dollar in real terms over the past four years has produced an impact effect on the current account deficit (at predetermined prices and without feedbacks) of approximately \$175 billion.^{1/} Because of lags in the adjustment of trade flows, not all of this impact effect has yet been felt in domestic markets. The part that has already been felt, around \$140 billion, is approximately equal to the increase in the structural Federal budget deficit over the same period.

If one took these estimates of external restraint at face value (and I do not suggest that anyone should), it would mean that the fiscal effects associated with the exchange rate rise had largely offset the effects of the increased structural Federal deficit on economic activity, and also on financial markets.

Taking into account the fiscal effects of the exchange rate change alone, however, would be misleading. The monetary

^{1/}This figure may appear unusually large. However, it reflects estimates of price elasticities of demand of close to unity for both imports and exports, although only about half of a change in the exchange rate is reflected in changes in average import prices.

effects are substantial. The 65 percent increase in the nominal exchange rate that occurred in the four years ended in the fourth quarter of 1984 would ultimately reduce the level of prices by roughly 5 to 7 percent, according to Board staff estimates.

How large an effect this would have on real money balances would depend, of course, on the response of monetary policy. What monetary policy might have been during the past four years had the dollar's foreign exchange value remained unchanged is, I submit, unknowable.

If one takes the growth of nominal money balances as given, however, the anti-inflationary effect of the rise in the exchange rate, through its impact on real money balances, has had a significant stimulative effect on domestic aggregate demand. Estimates derived from the Board staff's multi-country model (MCM) suggest that the monetary effects of the four-year rise in the dollar on growth of the U.S. economy have thus far offset roughly half of the fiscal effects in markets for goods and services. In financial

markets, on the other hand, the fiscal and monetary effects of the appreciation are not offsetting; they are additive. Both act to reduce nominal interest rates.

If the estimate of the fiscal effects of the dollar's appreciation cited earlier is approximately correct, some interesting conclusions follow. First, the effect on economic growth of the rise in the structural Federal deficit was not fully offset by the combined fiscal and monetary effects of the exchange rate change. Second, the impact on interest rates of the increase in the structural Federal budget deficit, on the other hand, has been more than fully offset by the combined fiscal and monetary effects of the exchange rate change.

There may be some of you who hold to the view that large and rising structural budget deficits do not affect interest rates, and that that is why such deficits have not produced the disastrous results widely forecast earlier. To those who are uncomfortable with that hypothesis, I offer you another -- and in my view intellectually more satisfying -- explanation to consider.

Why Did the Exchange Rate Rise?

Let me turn next to the question of what caused the increase in the exchange rate. There are two principal theories: one is that a widening differential between U.S. and foreign real interest rates has been a major factor; the other is that, for a variety of possible reasons, there has been a shift in asset preferences toward dollar-denominated claims at given real interest rate differentials. There is merit in both hypotheses.

Supporting the asset-preference shift hypothesis is the fact that foreign lending by U.S. commercial banks has declined dramatically in recent years, reflecting the international debt crisis. Moreover, a number of Latin American countries have experienced larger capital outflows since 1981 from which the U.S. probably benefitted. There have been some regulatory changes that might have increased the net demand for dollar-denominated assets. The Japanese, for example, have relaxed restraints on their capital markets and on Japanese investors. Additionally, many money

market observers believe that the recent expansion of the U.S. economy contrasts so starkly with the stagnation prevailing in Western Europe that it has attracted sizable flows of funds to our shores.

If such sources of capital inflow helped to account for a rising dollar exchange rate in the face of burgeoning trade deficits, foreign investors evidently held expectations that the U.S. is an attractive country in which to invest, and that the dollar is likely to remain strong for the near future at least. Such attitudes and expectations, however, would also suggest that a rise in real interest rates on U.S. financial assets in relation to those abroad would also be a powerful magnet attracting inflows of funds.

Estimates derived from the MCM, in which the exchange rate is determined endogenously,^{2/} suggest that both hypotheses have

^{2/} The dollar's exchange value, measured against a basket of major foreign currencies is proximately determined in the model as a function of U.S. & foreign price levels, inflation rates and interest rates.

a role to play. Real interest rate differentials in the model explain a little over one-half of the rise in the real exchange rate over the past four years, although the confidence band around that estimate is wide.^{3/} The remainder is unexplained, and might thus reflect shifts in asset preferences at existing interest rate differentials.

^{3/} By one measure, the difference between U.S. and average foreign long term real interest rates had risen by nearly 7 percentage points from its low point in 1979 to its peak in mid-1984. In recent months U.S. real rates have declined about 2 percentage points relative to rates abroad, but the differential remains 5 percentage points above its 1979 trough.

Effects of Endogenous Exchange Rate Changes

For ease of reference, let us call that part of the rise in the exchange rate due to the increase in real interest rates in the United States the "endogenous" part. Endogenous exchange rate changes are likely to be a characteristic feature of future business cycles, and they will have a bearing on the cyclical movements of some significant economic and financial variables. When the dollar's exchange value responds sensitively to cyclical changes in relative levels of interest rates here and abroad, cyclical movements in prices and interest rates are dampened. The dampening of interest rate swings also implies a moderation of cyclical changes in money velocity. Assuming a given growth rate of the money stock, that also means smaller cyclical swings in nominal GNP.

The more difficult questions to answer pertain to the effects on nonfinancial variables. Obviously, smaller cyclical swings in interest rates mean less cyclicality in housing and other credit-sensitive sectors of the economy. "Crowding out" during the expansion phase of the recovery partly takes the form of reduced net exports, as has been the case during the current recovery.

What is not so clear, however, is how the total magnitude of crowding out is affected. Thus, although nominal GNP will increase less during a recovery because of an endogenous rise in the exchange rate, prices will also rise less, so that the effect on real GNP is indeterminate.

Simulations done with the MCM provide some insight on this question. They suggest that the rise in real GNP over a period of several years coming from, say, an increase in private spending propensities is reduced if the exchange rate is driven up by rising U.S. real interest rates. That result stems from the fact that over a period of several years, the negative fiscal effects of dollar appreciation outweigh the positive monetary effects in markets for goods and services^{4/} The principal effect of an endogenous rise in the exchange rate, however, is to alter the form of crowding out, rather than its overall magnitude.

^{4/} This conclusion would not necessarily hold for all models, or even for a particular model over different time periods. For example, in the Board staff's MPS model, the interest elasticities of investment are much higher than in the MCM model. As a result the monetary effects of an exchange rate change dominate the fiscal effects in goods markets even over very short time periods. In the MCM, moreover, the monetary effects increase gradually over time and eventually become as large as the fiscal effects.

Looking to the Future

Let me turn now to what the line of analysis I have pursued might suggest for the course of the economy and economic policy in the years ahead.

The current account deficit in 1984 apparently was around \$100 billion. Most projections anticipate still larger current account deficits in 1985 and 1986. In subsequent years, it is possible that changes in relative economic growth rates here and abroad might help to reduce those deficits somewhat. Realistically, however, it seems unlikely that external balance can be reestablished at any time in the foreseeable future without a substantial decline in the real value of the dollar in exchange markets.

Current account deficits remaining near current magnitudes would imply substantial increases during the years ahead in nonresident net claims on the U.S. relative to foreign GNP and foreign wealth. Portfolio balance considerations suggest that, at some point or other, future increases in such holdings will be resisted by investors unless real interest rates in the U.S. rise further relative to those abroad.

Based on that line of reasoning, forecasts of an imminent fall in the value of the dollar have been common for at least two and a half years. Those forecasts have been decisively wrong, evidently because there has been a large and continuing shift in preferences for dollar-denominated assets, relative to assets denominated in foreign currencies, at given interest rate differentials.

I have no idea how long it will take for the rise of our external debt to begin exerting downward pressure on the exchange rate. But when I contemplate the fact that the United States may have already become a net international debtor,^{5/} that our country is borrowing abroad at a rate of \$100 billion a year or more -- which in ten years would increase our net international debt to \$1 trillion or more -- I wonder if we may not soon be approaching a day of reckoning.

^{5/} Official measures of our international assets and liabilities suggest that, at the end of 1984, the United States was still a net international creditor. However, to the extent that statistical discrepancies in balance of payments accounts during recent years may largely reflect unrecorded net capital inflows, the United States may already have become a net international debtor.

Imagine, if you will, what it would mean if restoration of balance in our external accounts required a reduction in the real value of the dollar to its level four years ago. We would then be facing a source of external stimulus whose fiscal effects in markets for goods and services, and in financial markets, might be larger than those stemming from the increase in the past four years in the structural Federal budget deficit. The monetary effects of a decline in the dollar would offset the fiscal effects in goods markets, but would add to the fiscal effects in financial markets. That is because prices would be driven up by the fall in the exchange rate, real money balances would decline, and interest rate pressures would intensify. Net exports would be crowded in, and credit-sensitive sectors of the domestic economy would be crowded out. If the structural deficit in the Federal budget were still rising when the dollar began to fall, the impact on the economy, and financial markets, would be that much larger.

I do not hold to an apocalyptic view of economic prospects for the years ahead. A significant decline in the dollar is probably necessary and desirable to help restore external balance, and to ease the strains on agriculture and other sectors suffering from strong price competition from foreign producers. But an abrupt decline may be avoidable if the U.S. follows sensible macroeconomic policies. In this respect, there is little room for complacency. Reduction in the structural deficit in the federal budget is badly needed for reasons unrelated to potential developments in the international sector. But the possibility that the dollar could fall substantially over the next few years adds urgency to the discussions of deficit reduction presently underway in Washington.

Possible future developments in the international sector have implications for monetary policy as well as fiscal policy. One sometimes hears statements that monetary policy has more room to be expansive now, since inflation is under good control, or that monetary policy should be easier because the exchange

rate is so high. There is a germ of truth to such arguments, but danger lies ahead if they are taken too literally.

Let us remember that weakness in the domestic economy stemming from a rising exchange rate tends by itself to create a more expansive monetary policy, by reducing prices and raising the the stock of real money balances. Let us remember also that the anti-inflationary benefits that we have enjoyed from the dollar's rise over the past four years may prove to be transitory to the extent that reestablishment of external balance requires a decline in the international value of the dollar.

Progress against inflation over the past five years has required a tough battle. The costs have been very high. The problem is not yet behind us; price stability has not yet been achieved, and developments in the international sector during the years ahead seem likely to create renewed difficulties in keeping inflation under control. We in the Federal Reserve would be well advised to keep that in mind in our current decisions on monetary policy.

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