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The International Challenge - How Will America Respond?

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1987 will be a year of important economic decisions, not only for the United States, but for the entire world economy. Our decisions, and how we react to the events now unfolding, will not only determine the economic outlook for the immediate future, but will influence the structure of our economy for years to come.

The Challenges Before Us

In the United States we will have to execute one of the most difficult economic and financial maneuvers ever attempted in our economic history.

We all know that we have to reduce the Federal budget deficit and the trade deficit. There are many alternative ways in which this task can be accomplished. But we cannot be indifferent to the policy mix chosen because the way in which the goal is accomplished will in itself have a profound impact on our economic welfare.

We will have to accomplish the dual task of reducing the Federal and trade deficits without stifling economic growth or rekindling inflation.

And we will have to do so without doing harm to a fragile world trading system and world economic growth.

The task will be challenging indeed because it involves a sharp reorientation of our entire economy.

It is also a complex task that will require detailed and close cooperation and coordination among the Congress, the administration, and the Federal Reserve.

The task will also affect the economic life of virtually every American. Businessmen will have to reorient their investment and production plans; workers will have to change jobs; and the spending and saving patterns of most Americans will be affected.

Finally, we will have to take the international repercussions and feed-back effects of our actions into account.

These are the issues before us and the issues that I wish to address today.

We Have Much To Be Proud Of

Let me begin with the good news, because there is much that we can be proud of. During the past five years, all of us have built a solid record of accomplishments.

The current economic expansion is now 50 months old. By that it is the second longest peacetime expansion on record. During this expansion over 12 million new jobs have been created and the employment rate is now at a record high.

The stock market has experienced an enormous boom, with the Dow Jones Index tripling in value and reaching almost daily new record highs.

At the same time, the inflation rate has been reduced from over 13 percent in 1980 to a mere 1.1 percent as measured by the change in the consumer price index last year.

Considering that stagflation was the economic malaise besetting the country only six years ago, we have every reason to be proud of our accomplishments.

But at the same time, two large imbalances have mushroomed, and they threaten the viability of our economic expansion. You all know that I am talking about the deficits in the Federal budget and in our trade accounts. What makes the problem more complex is that these two problems are interrelated and must be attacked in a coordinated fashion.

Our ship of state must change course and we must do so while changing the trim of the boat and the set of the sails simultaneously. Doing all that without loosing momentum and while competing against many other nations at the same time will be no mean task.

I guess Dennis Connor and his America's Cup crew knows that as well. The only difference is that they had the benefit of being able to practice many thousand times before the actual maneuver. We as a nation have never faced a similar task before and we will have to get it right the first time.

Inaction on Budget Deficit Might Endanger Stability

The Federal budget deficit amounted to $221 billion last year. The magnitude of that number is rather difficult to comprehend. Only when we realize that the annual Federal deficit amounts to just about $1,000 for every man, woman, and child in the United States are we able to realize the enormity of the problem. A typical family has to save $4,000 every year just to finance the excess of Federal expenditures above current receipts. That is in addition to the taxes that we are paying already.

Taking stock of the deficits accumulated so far presents an even more worrisome picture. The total Federal debt amounts now to over $2 trillion and is growing at a rate of about 10 percent per year. The debt is equivalent to almost $10,000 per person and represents the mortgage that each of us will have to service in the future. I am sure that we all agree that a further increase in that burden is unwelcome.

All political parties agree that the deficit should be reduced as speedily as possible. But there is wide disagreement regarding the best method: some politicians advocate tax increases, others spending decreases. Some prefer cuts in social spending programs, others cuts in defense spending.

It stands to reason that the problem should be attacked from several fronts, but the emphasis should be placed on spending reductions rather than tax increases. Tax increases would undoubtedly curtail private spending. But they would also leave less money for saving and investment. This might endanger the current expansion.

A tax increase would also represent a further burden for American producers and workers. It might well reduce our international competitiveness by making it more costly to produce in the United States.

The prospects for a reduction in the Federal deficit are good. The Gramm-Rudman legislation has outlined an ambitious program, but it will take much determination to stick to it.

The administration is projecting a deficit of $173 billion for the current fiscal year. This is a reduction of almost $50 billion from the deficit experienced last year.

Most importantly, the growth rate of federal spending is declining sharply and is projected to be only 2 percent this year. In inflation-adjusted terms, Federal spending should be roughly unchanged.

It is vitally important that we continue on this path to reestablish fiscal discipline and make further meaningful progress in reducing the Federal budget deficit.

Abandoning our resolve to make substantial progress on the Federal deficit might shake the hard-won confidence of domestic and foreign investors in our future financial stability. And it certainly won't make life at the Federal Reserve any easier.

Switching to Export Growth

Of course, lower growth of Federal expenditures would also lower our overall economic growth rate in an accounting sense. It is therefore important that we use the resources set free in the most productive manner possible.

The obvious answer is to employ these resources in the export sector. This will have the dual advantage of reducing our trade deficit while allowing us to maintain our growth momentum.

I am not telling you anything new if I tell you that our exports have been stagnating. But the magnitude of the problem is nevertheless shocking. Our physical export volume is essentially unchanged since 1980, and our dollar receipts from exports are now at the same level as they were in the early eighties.

The deterioration has been across the board: we are exporting less agricultural goods, less crude materials, and less manufactured goods.

Our balance on goods and service as well as our current account balance still showed a surplus in 1981. But because our imports mushroomed by about 50 percent since 1981, our annual deficit runs now at a rate of $150 billion.

Now there is an opportunity to turn this situation around. But it will not be easy to do so and exports will not increase automatically. It will take the concerted efforts of all of us to make this export drive succeed.

The German mark and the Japanese yen have appreciated sharply in value against the dollar over the last two years, and

American exporters have therefore become more competitive. According to most calculations, American producers are no longer handicapped by the high value of the dollar and are now in a position to compete in these important markets.

I have just returned from a trip to Germany, and I found that the Germans are spending money again. Total domestic demand is currently expanding at an annual rate of about 4 percent.

The good news for us is that the German import volume is increasing at about twice the rate of domestic demand.

The bad news for German producers is that domestic production is expanding at an anemic rate in the neighborhood of 2 percent. This is an obvious source of concern to German policy makers and might lead them to take some of the actions so long advocated by the international community.

But who is benefitting from the German buying spree? Unfortunately it is not mainly us, but the Japanese. German import volume from the U.S. is now growing at about 7 percent per annum. However, Germans are now actually spending less on American goods than in 1985. But because the dollar has fallen so much in value against the mark, American exporters are receiving more dollars than before. But these dollars are worth less in world markets.

At the same time, German spending for Japanese imports is surging at a rate of almost 20 percent. In many ways, this is surprising. After all, the Japanese yen has remained roughly stable versus the German mark, while the dollar has become less expensive. On a simple price basis, the American exporter should hold the advantage. But the Japanese make up for this by a carefully designed marketing strategy, much determination, and total commitment to quality. They just try harder. Their success validates the appropriateness of that strategy.

The problem may be compounded by the strong European presence of many U.S. multinational corporations. The giants of American industry, like IBM, GM, Ford, and Coca Cola all produce many of their products locally in Europe.

Europeans like to drink Coke and Americans like to drink Perrier. The irony is that this has a negative impact on the U.S. trade balance because Coke is widely produced abroad and Perrier is imported. Of course, if one focuses on profits, a very different picture emerges -- but the profit remittances unfortunately do not impact the trade accounts, but only the current account in the balance of payments.

I believe that the export challenge must in large part be answered by America's mid-sized and small manufacturers. We must learn to market our fine furniture, leather goods, textiles, and apparel abroad.

Export American textiles and apparel, when many our domestic manufacturers are in distress and continue to ask for protection from foreign competition? It may come as somewhat of a surprise that Italy and Germany are the world's largest exporters of textiles and apparel. They achieve this not by competing against Korea and Hong Kong in T-shirts, but by selling world class labels like Gucci, Pucci, Bennetton, and Addidas. That's where the profits can be found.

Your industrial structure and product mix here in the South Eastern states is uniquely suited for foreign markets. It is up to you to make the most of it.

Protectionism Is Not the Answer

What is the alternative to more exports? It lies in rectifying our trade imbalance by cutting imports. Some suggest that this is easy to accomplish. All it takes are a few protectionist laws, and imports will come to a standstill.

Even if that were true, protection would have immediate adverse consequences abroad. Not only are foreigners likely to retaliate in kind, but their export industries will slow down sharply and a global recession might result. This would also make it impossible for us to succeed in our export drive. We would all wind up as losers.

The game plan is thereby clear: reduce the growth in Federal spending and substitute export growth as the new driving force of the American economy.

Price Discipline is Key to Success

All that cannot be accomplished if we do not maintain tight price discipline in our country. Without discipline on the price front, it will be impossible to compete effectively abroad and we will endanger our domestic expansion.

Some of the favorable price developments of 1986 were due to the sharp decline in oil prices early in the year. Now we must maintain and consolidate our hard-won domestic price stability and do everything possible to avoid backsliding.

Developments in the wage sector have been very supportive of a lower inflation rate. Last year, wages and salaries increased by only 3 percent, and union compensation by only 2 percent. All this has been very helpful.

Much of the fall in the value of the dollar has not been reflected in higher import prices because foreign producers cut their profit margins in order to maintain market share. Now the point has been reached, where import prices are increasing at an annual rate of 7 to 8 percent. Because the foreign trade sector is relatively small, the direct price impact on the American inflation rate has been minimal.

But recently some American producers have taken this opportunity to increase their own prices by almost as much as their foreign competitors. The American automobile industry is a case in point. This development is unfortunate for three reasons: first of all, the action of price-matching by American firms contributes to domestic inflation by generalizing the import price increases to the domestic sector. If every American producer were to behave in this fashion, a sharp increase in domestic inflation would result.

Second, if American producers match the price increases of their foreign competitors, there is little reason to expect that they will regain lost market shares here at home. Again, the automobile example is instructive.

Third, rising domestic prices mean that we will fritter away the gains in international competitiveness that resulted from the dollar depreciation. It will therefore be more difficult to increase our exports.

If inflationary forces were to be rekindled in the United

States, we could easily enter a new vicious circle where dollar depreciation results in greater inflation which in turn necessitates a further depreciation. Everybody would wind up a loser!

It is therefore vitally important that American producers hold the price line and utilize the opportunity that presents itself now to increase their market share versus the foreign competition. Our new-found competitiveness can then help us to gain market share in foreign markets.

The Task Ahead

The overall strategy is clear: reduce the Federal deficit and increase exports to maintain the growth momentum. But this strategy can be successful only if we maintain price stability at home.

I can assure you that we at the Federal Reserve will do our best to provide a stable monetary and financial framework for the execution of that game plan. The rest is up to you!