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# Policy Responses to International Imbalances


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I am pleased to have the opportunity to speak to you this morning on the problems and policy implications of today's international imbalances, as reflected in trade and capital flows and in exchange rate movements. Earlier in the economic expansion, the U.S. current account deficit and the capital account surplus had important benefits. U.S. demand for imports provided a market for foreign goods, including those of developing nations, and thus helped to stimulate economic recoveries abroad. Capital inflows put some downward pressure on U.S. real (or inflation-adjusted) interest rates, helping to maintain domestic output of capital goods and housing. The strong dollar helped to restrain inflation in the United States.

More recently, the problems of external imbalances have become more apparent. First, employment and output in sectors most vulnerable to foreign competition, especially manufacturing and farming, have been adversely affected. Second, contemporary strains on these sectors, although dating back many years, have contributed to political pressures for protectionist trade legislation. Such action in the U.S. could lead to retaliation from abroad and thereby must be considered a threat to the health of the world economy. Finally, the counterpart of our trade deficit has been heavy borrowing from abroad, to the point where the U.S. may now be a net debtor nation. This situation could mean reduced spending on consumer goods in the future in order to repay and service the debt, and it makes the U.S. economy vulnerable to any possible shifts in foreigners' preferences for U.S. financial assets.

It must be clear that movement toward an ultimate solution is urgently needed. Unfortunately the tools of monetary policy are not well suited to address these multifaceted imbalances, although the recent "rebasing" of M1, an ex post adjustment to rapid M1 growth, avoids exacerbating international problems. Substantial reductions in federal budget deficits would ameliorate the situation, but further progress beyond the recent budget compromise lies in the future.

Another factor that could contribute to reduced imbalances would be somewhat faster economic growth in industrialized nations abroad. Faster growth in their economies and thus in their imports -- stronger economic performance abroad -- could help reduce the rest of the world's current account surplus with this country. Taken as a whole, the industrial countries abroad have experienced relatively high unemployment but have made good progress against inflation in recent years. A reasonable argument has been made that somewhat more stimulative economic policies abroad would be beneficial to the United States, other industrial economies, and the developing nations.

In my presentation this morning I plan to discuss monetary and fiscal policies here and abroad and to assess the merits of international coordination of these policies.

Imbalances

The appreciation of the dollar since the end of 1980 is just one of several manifestations of international imbalances. The dollar's strength has occurred in a U.S. economy characterized by a highly expansionary fiscal policy and a disinflationary monetary policy. U.S. inflation has been brought down faster than falling nominal interest rates: thus real interest rates in the U.S. have been high. For a number of reasons, dollar denominated securities have been highly desirable investments internationally: high real interest rates in the U.S., our initially strong economic recovery, favorable tax treatment of physical investment, and "safe-haven" factors, all have deepened capital inflows. U.S. capital outflows have slowed significantly or reversed. This concentration of factors has thrust to high levels the foreign exchange value of the dollar. The nearly 13 percent decline in the dollar from February to August of this year probably was related, in part, to prospects for lower real interest rates on dollar assets and relatively weaker economic growth here.

Of course, it is widely recognized that the strong dollar has been a principal financial factor contributing to our unprecedented deficits on trade and current accounts. Economic recovery in our trading partners has lagged significantly in timing and amplitude behind growth in the United States: thus their demands for imports also have grown slowly. This has been especially true in the European community, where growth of real GNP has averaged only about 1-1/2 percent over the past three years. The major LDC debtor nations have had to limit growth to move toward financial stability, thus limiting their demands for U.S. goods and services.

Our large trade imbalances have had both beneficial and detrimental effects on the U.S. and world economies. On the plus side, the availability here of both domestic savings (as outflows were curbed) and of foreign savings has meant lower interest rates and less crowding out in interest-sensitive sectors of the U.S. economy, like business investment and housing. At the same time, the sharp increase in our imports has provided the strongest market to the world economy, and especially to some heavily indebted developing countries. Increases in the value of the dollar also have meant lower inflation rates in this country than we would have had otherwise, given the strength of the U.S. recovery in its first two years. Import competition has stimulated management and investor attention to productivity, cost control, and widespread corporate restructuring--a "return to basics."

The minus side is epitomized by impacts on those sectors of the U.S. economy that have been most vulnerable to foreign competition since the 1970s. Whereas growth in jobs in the private service sector has been quite strong, manufacturing industries, which tend to compete more internationally, have decreased their work forces. Industrial production has risen by only 1-1/4 percent over the past year. The agricultural and extractive sectors also have been hit hard, following on the heels of curtailments during recessionary periods in the 1980s.

Years of strains in these sectors of our economy have led to widespread pressures for restrictive trade policies. Although responsive to genuine local economic dislocations and unemployment, protectionist measures pose a threat to our economy and to our trading partners. Serious studies suggest that the elimination of all existing trade restrictions throughout the world probably would make insufficient improvements in our foreign balances. Moreover, actions in this country inevitably would lead to retaliatory actions, and we quickly could find ourselves caught in a sequence of falling demand for goods, rising prices and mushrooming wage settlements. This could be quite costly to the United States and to the rest of the world.

Finally, our external deficits have meant a continuing erosion of the net external financial position of the United States. Department of Commerce data suggest that the United States became a net debtor to the rest of the world in the spring of 1985, from a position of being a $150 billion net creditor at the end of 1982. Thus an increasing burden will be placed on current and future generations to service that debt. This burden will be especially onerous to the extent that foreign funds end up financing current consumption--for example, by the federal government. Moreover, as we come to depend increasingly on selling foreign assets abroad, the economy becomes more vulnerable to any possible changes in foreign preferences for U.S. assets.

Economic Policies in the United States

What can be done in this country to correct these imbalances? Let me begin by discussing the policy I am closest to--Federal Reserve monetary policy. Some of the Federal Reserve's critics argue that we could help greatly in solving these problems by promoting very rapid domestic economic growth and substantially reducing real interest rates from present levels. This approach, it is argued, would make a major contribution to balancing the budget and trade deficits and to reducing the foreign exchange value of the dollar. However, this is an unacceptable course of action because it ultimately would involve the loss of hard-won gains against inflation.

Of course, other critics argue that recent monetary policies do reflect an overly expansionary bias that ultimately will lead to higher inflation. Needless to say, I take a different view of what we have done. One decision concerned the so-called rebasing of the 1985 target range for the narrow monetary aggregate, M1. That aggregate grew at a 10-1/2 percent rate in the first half of this year, well above the 7 percent upper boundary of its original target range. But since nominal GNP rose at only a 5 percent rate in that period, the velocity, or rate of turnover, of M1 declined at a fast 5-1/2 percent rate. With the economy failing to exhibit the normal response to the rapid M1 growth, a new target range of 3 to 8 percent was established and was based on the second quarter 1985 level.

This action resembled one we took in mid 1983, following another period of sharp velocity decline. In 1983, though possibly for somewhat different reasons, velocity also declined and then remained at a more-or-less "permanently" lower level. In both cases, the shift in velocity was due, in part, to declines in market interest rates and possibly to a desire by money holders for greater liquidity. And in both cases, our objective was, in part, to offset the potentially adverse effects of the velocity declines on the economy. The 1983 action was followed by an economic recovery, but no reacceleration of inflation.

By promoting sustainable economic growth, the Federal Reserve can avoid exacerbating internal and external imbalances. But progress toward a lasting solution must be sought in a mix of policy actions. Steps to reduce the federal budget deficit, especially from the spending side, are essential. If you ease the government's insatiable demands for savings and resources, you may apply further downward pressure on interest rates. In turn, lower interest rates enhance the prospects that any further decline in the value of the dollar will be orderly , and contribute to greater external balance.

Economic Growth and Policies Abroad

Consumer price inflation declined to relatively low levels abroad in the past year and one-half, despite the appreciation of the dollar. In the other G-10 countries, consumer inflation averaged about 5 percent in the first half of 1985. In Canada, France, Germany, Italy and the United Kingdom, recent rates of inflation have been lower than rates experienced since the late 1960s or very early 1970s. For Japan, the current inflation rate is lower than any experienced since 1959. In contrast to this favorable inflation outlook, the most recent unemployment statistics reveal double-digit rates in Canada, France, Italy, and the United Kingdom, and only a slightly lower rate in Germany.

Nevertheless, authorities abroad have been reluctant to alter existing economic policies, which have been aimed at disinflation and moderate economic growth over the medium term. They apparently are concerned about the financing of government deficits, about the excessive role of the public sector in economic decision-making, and about the potential that a lowering of interest rates could weaken the value of their currencies and apply upward pressure on domestic prices.

As a percent of GNP, general government budget deficits (including those of central and local governments and social security institutions) in the other G-10 countries are at least comparable and in some cases larger than in the United States. For example, Italy's deficit was over 13 percent of GNP in 1985, Canada's was over 6 percent, and those of Japan, Germany, France and the United Kingdom ranged from 2-1/2 to 4 percent, compared with 3-1/2 percent for the United States. General government expenditures as a percent of GNP show a larger role for government in other G-10 economies than in the U.S. in every case except Japan, where the percentage is about the same as in this country. In 1984, these percentages ranged from a high of 59 percent in Italy, to 45 percent in the United Kingdom, to lows of 34 percent in Japan and the United States.

The concerns of these countries are legitimate, but they should be balanced by an awareness of the costs and dangers of continued high unemployment and continued international imbalances. Moreover, a careful easing of policies in several countries together would be mutually supportive. Tax revenue would be enhanced by a more rapid growth of economic activity, and the value of their currencies would tend to move together against the dollar. Indeed, the prospects of stronger economic growth actually could tend to raise the demand for investments denominated in those currencies. Finally, as mentioned above, the dollar has depreciated some this year.

Fiscal policy currently planned or implemented abroad remains cautious in the foreign G-10 countries, and seems to be directed toward reducing the size of the government deficit as a share of GNP, and in some countries, lowering the degree of government control over economic activity.

Similarly, the overall stance of foreign monetary policy in 1985 has been one of only moderate accommodation. Authorities have sought to support the current economic expansion while at the same time bringing about further reductions in inflation. In each of the countries where authorities set targets for growth of one or more aggregates, the ranges for 1985 were lowered or left unchanged from 1984. In most cases, the actual growth of aggregates through the first half of 1985 has been within, or only slightly above, the target range.

The 3 to 5 percent target range for German central bank money (CBM) in 1985 is the lowest set by the Bundesbank since it adopted an explicit target in 1974. Through July of this year, CBM has grown below the midpoint of this year's target range. However, in response to the lack of vigor in the recovery in real growth and the continued low inflation rates, German authorities have recently indicated a willingness to ease policy somewhat.

The targets for growth of the United Kingdom's monetary aggregates during the current fiscal year are 3-7 percent for MO, defined as currency outstanding plus banks' operational deposits at the Bank of England, and 5-9 percent for the broad aggregate £M3. While growth of MO has been in the middle of its range all year, £M3 growth and that of the other United Kingdom aggregates has been quite rapid. Authorities have stated that significant changes in the pound's foreign exchange value might influence the stance of United Kingdom monetary policy.

The Bank of Canada discontinued the use of a money growth target in November 1982, in large part because of the effects of financial innovation on the Canadian aggregates. Canadian monetary authorities have been guided mainly by interest rate and exchange rate considerations, with particular attention being given to the U.S. dollar/Canadian dollar exchange rate. Over the past year, Canadian short-term interest rates have followed the same general pattern of U.S. rate movements, although Canadian rates have increased relative to U.S. rates on balance.

Although the Bank of Japan announces short-run projections of monetary growth, these do not play a major role as targets for monetary policy. Short-term interest rates are the primary instruments of policy. By this standard, Japanese monetary policy seems to be following the same pattern as the other countries I have mentioned. Policy seems to have been aimed at trying to support moderate economic growth without precipitating a weakening of the domestic currency.

A review of the monetary and fiscal policies of our major trading partners indicates their understandable priority of restraining inflation, maintaining the strength of their currencies and reducing the role of government in their economies, with moderate economic growth also an important consideration. Recent action by the German central bank to reduce interest rates is an exception to this central tendency. But compared with the central tendency, it may be argued that U.S. monetary policy has been somewhat more oriented to sustaining the expansion, with a watchful eye on inflation, and this hopefully may engender more support for somewhat more accommodative policies abroad. The decline this year in the value of the dollar also may permit more expansionary policies abroad. Speaking for myself, discussion among the "Group of 10" countries concerning policy coordination is a constructive step, and this group seems to be an appropriate forum for such discussion.

Summary

The forces and factors determining the trade and current account imbalances of this country are complex: many are long-standing. There are the factors leading to a reduction in our competitiveness in world markets. Other developments here and abroad have altered the position of our farmers in global markets. Our trading partners, included the developing nations, have responded to internal needs and political pressures in ways that have produced trade surpluses for many and have strengthened their currencies. Countries with which we deal in a political/economic way have in place a mixture of fiscal and monetary policies consonant with their national goals and objectives, policies which have contributed to both disinflation and moderate expansion in imports.

In contrast to some nations, the United States has persisted in raising its governmental expenditure levels. Our monetary policy on balance has been carefully oriented toward accommodation at a time of very basic innovation in our financial instruments and institutions. Such evolution or revolution is only commencing in some societies abroad and has not progressed far enough in others to require similar adjustments in monetary policy accommodation.

The U.S. imbalances of a decade-plus have been accentuated by such a substantial strengthening of the dollar since 1980 that it appears to many here that we have suffered a permanent loss of jobs in agriculture and industry. More recently, job "exports" have begun in our dominant services sector. The political result is that trade negotiations must be carried on in assertive, even aggressive ways.

Given the complexity and long-developing nature of the U.S. trade and current account imbalances, only a complex of policy measures --not monetary policy alone -- can be expected to move us toward balance. Indeed, some of the factors, U.S. industrial competitiveness for example, appear to require a long period of painful transition. Under these circumstances, monetary policy has only a finite contribution to make, while protectionist measures carry the seeds of retaliation, and delay the needed adjustments in the allocation of resources in our economy.