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Monetary Policy: Its International Dimension

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Currency Options Symposium

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This is a most appropriate time to meet and exchange views about experience gained in world financial markets. Spencer wrote of "the ever whirling wheels of change," but neither he nor any other social commentator at the time could have foreseen the diversity and change in the financial markets in which you participate, which have been transformed by the electronic revolution.

In this sense, you are revolutionaries. Your innovations have helped eliminate most geographical limits on financial markets. Governments and other analysts find it increasingly difficult to keep track of international capital movements in this fluid global market, as trillions of dollars flow across national boundaries each year. Even the residual in our balance of payments accounts is measured in the tens of billions of dollars.

Global markets for capital and for goods have long been the ideal of economists, who argue that mobility of productive factors together with free trade lead to the efficiencies flowing from optimal resource allocation. However, these ivory tower theorists aren't subject to the rigors of competing in this period of transformation. Neither are they subject to the risks to the safety and soundness of the domestic and international financial systems brought in the wake of financial change.

Monetary policy, too, is affected by the financial revolution. Monetary policy both here and abroad has a long history of pursuing the dual goals of sustainable domestic growth and a stable domestic price level. An additional goal of some central banks in certain periods has been a stable exchange rate. While central bankers emphasize the need for various types of stability, the revolution in financial markets requires that we take account of changing patterns of behavior, which have altered such fundamental economic relationships as money demand. In a shifting financial environment, no mechanical rules can determine with any degree of certainty the rates of growth in monetary and credit aggregates consistent with our ultimate policy goals. This is not to say, however, that we should ignore the lessons of history -- excessive monetary growth that is allowed to continue ultimately leads to inflationary pressures. The heavy foreign demand for dollars does not vitiate this principle. Therefore, I advocate flexibility in the conduct of monetary policy, but I oppose "easy" money. Inflation is too cruel a tax to risk the consequences of overly rapid monetary growth based on an assumption that new economic realities have made monetary growth totally meaningless. Until solid evidence is in hand to the contrary, a central bank must continue to presume that excessive monetary growth -- somehow measured -- is a necessary and sufficient condition for inflation in the long run.

Having acknowledged the risk the financial system bears, it is also necessary to put such risk in perspective. We must note the shock absorbers we have in place as well as the shocks themselves. At the top of the list of shocks to which the financial system has been subjected is the LDC debt problem. At the top of the list of shock absorbers is the cooperation among nations and international agencies that has made possible the series of case-by-case rescheduling of debt, and of internal policy adjustments within the principal debtor nations over the last three years. Tonight, I ask you to step back from the flood of specific information -- and misinformation -- and review the overall progress we have made in adapting to change in the financial system, while also maintaining awareness of the remaining risks.

Our financial markets and institutions have adapted to such fundamentals as disinflation and intensified global competition, to twelve years of floating exchange rates and two massive oil shocks, to extreme exchange rate volatility and rapid accumulation of debt -- the "leveraging of America." Our banks first recycled petrodollars from OPEC and since then have managed the problems stemming from huge LDC debt. As a society, we have coped with dislocations in agriculture, energy, manufacturing, and other sectors.

The appropriate analogy for economic developments in recent years may be President Truman's two-handed economist. On the one hand, economic growth has slowed in the United States and elsewhere; on the other hand, the inflationary fever of the 1970s has been reversed. Certain of the principal currencies have overshot any reasonable long-run value reflecting relative production costs. Unemployment in industrial countries -- especially those in Europe -- has remained too high, but the United States has made progress in providing large employment gains despite the disruptions caused by a shift from a manufacturing-extractive-agricultural society to an information-finance-service industrial base. On the one hand, regulators and bankers have better information about loan concentration by countries, tending to reduce risks. But the other hand is exploring currency swaps, interest swaps, floating rate notes, and note-issuing facilities, to name but a few devices that could increase risks unless used carefully. Disinflation has shocked and decimated sectors of our economy like agriculture and thrift institutions, but the United States has persevered through the worst recession, the highest unemployment, and the most severe financial strains since the 1930s.

As an international debtor, we benefit from the unique position of having our obligations denominated in dollars. In this respect, we smile when the dollar declines. But our brows furrow when we recall that LDC debt is also denominated in dollars, because that floating-rate debt is vulnerable to significant future increases in interest rates.

One can use that old cliche, the locomotive, to describe the U.S. expansion and its force in lifting the global economy out of recession. But where are we today? You know that employment and output growth has slowed markedly since mid-84, despite declining interest rates and very rapid money growth. As a result, some have questioned the very efficacy of monetary policy. Monetary policy has been effective in keeping aggregate demand growing, albeit at a sluggish pace. Spending by households and businesses -- and unfortunately, also by the government -- has continued to expand. In past circumstances, this would have reduced unemployment and increased profits. In a normal business cycle, inflation would have increased by now.

But circumstances have not been normal. An increasing amount of spending has gone to buy foreign products. As a result, the trade deficit has grown to unprecedented levels. Note the irony in recent announcements that our merchandise trade deficit declined to "only" $10 billion in July and August. Both the trade deficit and the current account deficit this year will set new records. In part because of these external deficits, the effect of monetary stimulus has been dissipated, producing the paradox of healthy spending but only sluggish GNP.

Several actions have been proposed to bring down the dollar and the trade deficit. One is for the Federal Reserve to follow a significantly more expansionary monetary policy. But aggressive, inflationary growth of money and credit to bring down the dollar's exchange rate would not enhance the position of U.S. firms in world markets. A lower external value of the dollar would be offset by inflated costs at home. The trade deficit is in part a function of a high real dollar exchange rate. Monetary policy is only one of several factors -- and not the most important in the long run -- that influence real exchange rates. Any beneficial impact of an overly expansionary Federal Reserve policy on the trade deficit would be short-lived without accompanying changes in fundamental economic factors.

International trade and capital flows have played an increasingly important role in the behavior of the U.S. economy and financial markets. As a result, the Federal Reserve has given more attention to international and exchange market developments in policy deliberations. In an interdependent world, policy makers here and abroad must take account of the broad range of effects of fiscal policy and of monetary policy in each major nation, because domestic and international imbalances are now so closely related.

What are the prospects for redressing the U.S. internal and external imbalances? The outlook seemed bleak early this year . Pessimists argued that the President and Congress were hopelessly gridlocked over the budget deficit; the dollar was at levels that promised no respite from our massive trade imbalance; and protectionist sentiment was growing exponentially.

Although understandable from a political standpoint, the growing protectionist fervor is profoundly disturbing. The possibility of a trade war is the major risk to global growth. The economic and political advantages of free trade are more than academic. The prosperity and peace in the U.S. and world economies in the postwar period is in no small part due to liberalized international trade. In an increasingly free trade environment, Europe and Japan have been rebuilt, America has enjoyed rising living standards, and the LDCs -- despite some recent setbacks -- have built some foundation for sustained economic growth. For these societies, the old British expression "export or die" is nearly literal.

The enhanced prospect for redressing our internal and external imbalances without resorting to self-destructive protectionist policies was reflected in the communique issued by the "Group of Five" industrialized nations after their September 22 meeting. Importantly, it was at the initiative of the United States that the finance ministers and central bankers for the U.K., France, the Federal Republic, and Japan met with us to discuss issues of mutual concern. Of course, discussions continued in Seoul at the IMF-World Bank meetings last week.

The press has focused on the exchange market aspects of the G-5 meeting. Much has been made of the language in the communique recognizing that exchange rates were not reflecting underlying economic realities. But the increased role of intervention since the G-5 meeting is not to me the most significant outcome, unless you are trading in foreign currency options! More important, in the final analysis, is the explicit recognition of interdependence among our nations, which has been carried on in dispatches from the meetings in Seoul. Political sovereignty does not imply economic insularity. We are all part of an integrated world economy. This, to me, is the important message of the "state of play" in international negotiations.

What are the concrete implications of this message? They are that each of the involved countries hopefully will reconsider policies that could contribute to balanced, sustainable, and noninflationary growth in the world economy. The program recently announced by the Japanese government to stimulate domestic demand in housing and other sectors is encouraging. So are the data suggesting that the U.S. economy has strengthened slightly after remaining in the doldrums for several quarters. Despite this modest pickup, though, the unemployment rate is still near the 7.3 percent level where it had been stuck for most of the year. Most encouraging of all, a deficit reduction objective was passed by Congress and signed by the President. More needs to be done, and the Congress continues to explore ways and means to curb spending growth over a multi-year horizon, an approach unheard of a few years ago.

The exchange value of the dollar has descended from the stratosphere. Even before the G-5 meeting in New York, the dollar had declined about 15 percent from its peaks in February. The marked adjustment of the dollar to more realistic levels reflects in part hopes of convergence in economic growth rates between the United States and our major trading partners.

Why is growth in Europe and Japan increasingly important? Because no single sector in the domestic economy yet shows promise of playing the role of U.S. accelerator. Not housing. It has not responded to the decline in mortgage interest rates -- in part because of an offsetting tightening of credit standards. Inventory investment is unlikely to contribute much. Disinflation is the order of the day; "just in time" inventory management has replaced "buy now." Nor is a boom in consumption or business investment spending likely. Saving rates look unsustainably low, and consumers' and businesses' debts have been rising faster than their financial assets.

On balance, I think the chances are good that the slight pickup in GNP growth implied by the 2.8 percent flash estimate for the third quarter could be extended for the remainder of this year and beyond. It must be recognized that even with a modest pickup in economic growth, the economy may remain below its long-run trend path. Obviously history has a way of straying from previous paths, but it may be comforting to recall that slow growth need not be a precursor to a U. S. recession.

It may be a peculiarly American trait to focus so much public discourse upon our difficulties and risks of failure. My argument today is that a balanced view is necessary if we are to continue in the interest of consumers the revolution in our institutions. Let us recognize the trend over the past decade toward a healthy "return to basics." Many organizations have divested companies unrelated to their core business. There are some signs of more cooperation between management and workers. Productivity is no longer a four letter word.

On a deeper philosophical level there are some scattered indications of a rediscovery of Adam Smith and David Ricardo in Latin America! (No, not the neckties!) Michael Novak wrote in his <u>Spirit of Democratic Capitalism</u> that "the world of ideas was moving to the advantage of totalitarianism." Because he wrote before Latin America moved in the direction of democracy, Novak did not anticipate the shift in LDC thinking. In many third world countries, there is serious political discussion of measures to encourage their private sectors, stimulate domestic investment, and even reverse the flight of capital.

Of course we continue to face major adjustments and significant risks, both here and abroad. Monetary policy can and will contribute to stability and growth by avoiding rigid adherence to policies dictated by yesterday's institutions and the day before yesterday's environment. In today's world, the Federal Reserve will conduct monetary policy in a pragmatic mode, considering a wide range of indicators from commodity prices and exchange rates to the monetary aggregates and, dare I say it, interest rates. With a changing mix of economic indicators though, the goal remains the same: contributing to further disinflation and building upon our progress to date -- which has been achieved at such considerable cost in such difficult times.