U.S. MONETARY POLICY:

The Interaction of Domestic and International Conditions

Remarks by

Frederick H. Schultz

Vice Chairman, Board of Governors of the Federal Reserve System

at the

NAM International Economic Affairs Committee Meeting

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I am pleased to participate in the 1979 meeting of the NAM International Economic Affairs Committee. Your Chairman has developed a challenging list of subjects for your agenda, not the least challenging being the topic assigned to me for discussion, "U.S. monetary policy: the interaction of domestic and international conditions."

It is clear that there remain substantial gaps in our understanding of how the world economy functions. Not infrequently, even in a country such as the United States where statistical information is generally reliable and current, our knowledge of even the present state of the economy is subject to significant uncertainties. One striking illustration was provided earlier this year, when economic analysts generally believed that a recession had begun in the first half of 1979. This did not prove to have been the case. Now, the common view is to assign the beginning of a recession to the fourth quarter of 1979. A slowdown in the U.S. economy does seem to be underway, but it is remarkable that, halfway through the final month of the year, there remains some doubt as to whether the U.S. economy is well into a downturn or still in an expansion phase. Yet economic decisions, both private and public, must be made if only by default, and the challenge is to do one's best on the basis of available information.

The importance of taking full account of information on international developments is becoming increasingly obvious. Recent experience has reemphasized the interrelated nature of the domestic and international economic issues that we face -- in the Federal Reserve System and, more generally, as a nation. The influence of international factors on the economy is demonstrably important, and sometimes, as in the present situation where the balance between supply and demand in the energy sector is so delicate, may be a dominant factor.

The need to consider carefully the international environment when examining the needs of the U.S. economy would exist even if one could identify a single objective at which policy should be aimed. Of course, we have a long list of such objectives, including price stability, high employment and a reasonable balance in our external accounts. At times in the past, and maybe at times in the future, conflicts among our objectives may appear. It is my view that, at least at the present time, this is one problem we do <u>not</u> have. Our overriding concern must be to get the inflationary forces now at work in our economy under control.

We have registered important economic gains in recent years. On the domestic side, many of our recent accomplishments have derived from the long and vigorous economic expansion we have experienced. During the course of that expansion there have been dramatic increases in the number of Americans employed. On the international side, substantial progress has been made in reducing the sizable external imbalances that emerged among the industrial countries several years ago. The large and growing current-account surpluses of countries such as Germany and Japan in 1977-78 exacerbated the already difficult problems posed by high oil prices and large surpluses of OPEC nations. In 1979, the German and Japanese surpluses have disappeared and better balance introduced into the pattern of international transactions of the industrial countries. As one consequence, we have seen more stability in exchange markets. Such progress, as well as our aspirations for the future, would all be jeopardized by a failure to deal with the inflationary pressures that have become so pervasive in the U.S. and the world economy.

Thus, in early October it was clear to the members of the Federal Open Market Committee that both the domestic and international objectives of the United States were firmly interconnected, and that both required firm action in reducing the sources of inflation in our economy. Monetary aggregates and bank credit had been growing very rapidly in the third quarter, and speculative activity was spreading to a number of commodity markets. These factors threatened to exacerbate the inflationary psychology already present in the nation and, if allowed to continue, would only have made more painful the ultimate process of economic adjustment.

I might note that a number of other industrialized countries reached similar conclusions in recent months. Some have interpreted their actions, which have also resulted in higher interest rates, as an attempt to compete with us. All the world's nations have a common interest in steps that will bring inflation under control. We believe this has been the motivation for the monetary actions taken abroad and we believe that there is broad understanding on this point.

As you know, our actions of October 6 included a change in operating procedures to give more day-to-day emphasis, in trying to achieve our longer-run money supply targets, to the supply of bank reserves -- and less to the level of interest rates. But I would emphasize that our basic monetary targets were not changed and that in a sense the Federal Reserve actions announced on October 6 were but a further step in a continuing effort to exert effective control over money and credit expansion. The special marginal reserve requirement on increases in "managed liabilities" of larger banks was decided upon in view of the fact that those sources of funds have financed much of the recent buildup in bank credit.

The experience of recent weeks has been hopeful but the new technique for conducting open market operations will not be a panacea. Over the longer run, the principal effects will occur through the impact of the new procedures on inflation. Of course, monetary policy by itself cannot eradicate the deep-rooted inflation problem that we are experiencing. Complementary policies, particularly in the energy and tax areas, are required to restore price stability and to assure that the dollar maintains its strength. Certain aspects of our tax structure, for example, have increasingly been recognized as being less conducive to savings and investment, and thus to the growth of U.S. productivity, than we might like. I do not come here today with specific proposals in these areas but

I know that we can do better. It is possible that careful study of policy approaches of our major trading partners could reveal some interesting options for discussion in this country (as, I hope, others may from time to time learn from us). The Federal Reserve, for its part, will be monitoring financial developments closely and will adapt our approach as changing economic needs may suggest. For one thing, we recognize that the definition of money itself requires review and we are well along in the process of such a review, recognizing the need to take into account both the existence of new domestic financial instruments and the availability of liquid assets at offshore banking centers.

Fundamentally, I think our new approach should be judged by the extent to which we are able over time to reduce the rate of growth of relevant monetary and credit aggregates and, thereby, to reduce inflation rates. As these rates of increase come down, interest rates can also come down and in a context of sustainable economic growth. I firmly believe that we must resist the tendency to overinterpret the very latest data or react to each twist and turn in the economy and instead must maintain a longer-term view of the needs of the economy. Such a steady approach will, I believe, advance, not postpone, the day when significant and sustained declines in interest rates will be possible and will be consistent with a healthy U.S. economy.

As we all know, and as I have alluded to earlier in these remarks, a responsible pricing policy on the part of oil-exporting nations is essential if the world is to get inflation under control. We, other oil-importing nations both in the industrial world and in the developing world, and the OPEC nations themselves, have an obvious and important interest in attaining this objective. The foreign currency value of the dollar is another important element in the picture. An erratic performance of the dollar in exchange markets has at times threatened the effectiveness of our basic anti-inflation program. We remain alert to any need for official actions to deal with such developments though we recognize that improvements in fundamental factors are central to the longer-run health of the dollar.

One factor that should be providing support to the dollar as the new year progresses is our current-account position. The U.S. current account is expected to be approximately in balance for the year 1979 after having registered a $14 billion deficit in each of the past two years. Even assuming some further increases in the value of petroleum imports, a surplus in our current account seems likely for 1980. Continued expansion of U.S. exports may be expected while increases in payments for non-oil imports should be moderate. This scenario is influenced, to be sure, by the prospect for a slackening in U.S. economic growth that is widely anticipated. What often goes unappreciated is the substantial underlying improvement in our external accounts that may be attributed to the improved competitiveness of U.S. goods resulting from the significant exchange rate adjustments of 1977 and 1978. For example, from the fourth quarter of 1978 to the fourth quarter of this year, we expect an increase of about 10 percent in the volume of exports of manufactures and other non-agricultural goods. Over this same period, while our economy has expanded at a respectable rate, the volume of non-oil imports has declined.

U.S. producers have thus demonstrated once again their capacity for recognizing and seizing opportunities. This is not to deny that we must continue to work at maintaining and improving U.S. competitiveness in manufacturing, selling, financing and servicing our products. It is perhaps not surprising that, in such a large country, we have sometimes tended to explore less fully than might be desirable the potential of foreign markets. There may continue for some time to be a useful role both for government agencies and trade groups to assist in heightening awareness of foreign marketing opportunities.

The major role for the Federal Reserve will be to exercise all its influence in the effort to address our inflationary problem. Success in this endeavor, as I have tried to emphasize this morning, is a prerequisite to a satisfactory resolution of a great number of pressing economic problems that face us.