For release on delivery
10:30 a.m. Central Europe Summer Time
4:30 a.m. Eastern Daylight Time
April 14, 1989

Economic Developments in the United States: An International Perspective

Remarks by

Manuel H. Johnson

Vice Chairman, Board of Governors of the Federal Reserve System

Annual Meeting

Swedish National Committee

of the International Chamber of Commerce

Stockholm, Sweden

It is an honor to participate in your annual meeting, which has such a distinguished audience, including His Majesty the King of Sweden. Looking over the list of previous speakers, I note that Sir Geoffrey Howe, the Secretary of State for Foreign and Commonwealth Affairs for the United Kingdom, spoke last year about the experience of joining the European Community. Although my talk will deal mainly with economic developments in the United States, my remarks strike a certain parallel to those of Secretary Howe. We in the United States have come increasingly to appreciate the extent to which our economic well-being is closely linked to developments outside our borders. If there was ever a time when the United States could view itself as a closed economy, that time has passed. The economies of all the major industrial nations are interwoven, and policies undertaken in one country can have an important bearing on conditions faced by others. Thus, my review today of challenges facing policymakers in the United States will have a distinctly international flavor, as it must if we are to understand the economic events of recent years and their implications for the future.

Economic developments in the U.S. and other industrial nations: 1983-88

The U.S economy is now well into the seventh consecutive year of expansion. This has been the longest period of sustained peacetime growth in recorded American economic history. Moreover, it has been accompanied by relatively subdued inflation, at least up to now. In the future, when economic historians analyze the performance of the U.S. economy in the middle and late years of the 1980s, I suspect they will render a favorable judgment.

I say this with full knowledge that these years have not, in any sense, been a golden age for economic growth. The expansion has not been steady--at times surging, while at other times flagging--and certain sectors of the economy have languished despite the generally rising tide of activity. In addition, productivity gains have not been as large as one would like to see. Imbalances have emerged in the mix of fiscal and monetary policy that pose significant risks to the long-term health of the U.S. economy and have had consequences for other nations. Nonetheless, overall, it is likely that the period from 1983 to the present will be viewed as a positive chapter in American economic history.

To provide some support for this view, it may help to review the major economic trends during the current expansion. Between the end of 1982 and the end of 1988, GNP in the United States increased at an average 4 percent pace per year, after adjusting for inflation. And the economy has shown few signs of fatigue as this expansion has matured, with output growth continuing to average about 4 percent annually over the past two years. As a result of this healthy rate of growth, almost 20 million new jobs have been created during this expansion. The unemployment rate, which stood at nearly 10 percent in 1982, has been cut about in half. At the same time, considerable progress has been made in the fight against inflation. Although price increases have picked up a bit recently, consumer price inflation has run at about a 4 percent rate throughout much of the current expansion--less than a third of what it was when we entered the 1980s. Thus, overall, I find much that is favorable in the performance of the U.S. economy over the past several years.

In many respects, the experience of other industrial countries during this period has been broadly similar. In particular, inflation rates throughout the industrialized world receded sharply in the early and mid-1980s, owing to increased discipline in monetary policy worldwide. Moreover, after stagnating in 1981 and 1982, economic activity in most of these countries picked up considerably over the next several years, though not to the same degree, on average, as in the United States.

There were, however, marked differences in the pace of growth across the industrial countries. As a generalization, Canada, Japan, and the United Kingdom posted growth similar to that in the United States, while continental Europe--including Sweden--has lagged somewhat. This dichotomy is visible as well in the behavior of unemployment. In Canada and the United Kingdom, unemployment rates now stand at levels well below their peaks earlier in the decade, and in Japan, the jobless rate has remained generally in the range of 2 to 3 percent. In contrast, the rates in Germany, France, and Italy have stayed relatively high by historical standards. Still, despite these differences in performance, it is fair to say that the industrialized nations as a group, and not just the United States, have posted impressive economic gains since the early part of the decade. Moreover, the pace of growth has turned up in the past two years, moving closer to that of the United States.

Unfortunately, we cannot ignore the fundamental imbalances that have emerged in the U.S. economy, some of which are mirrored in other countries. We have been contending with a large federal budget deficit and a comparably sized deficit in our foreign transactions. Both of these deficits indicate that, in a manner, we in the United States have chosen to consume more than we produce. The federal budget deficit implies that we have opted for ever-growing government services, but have been unwilling to pay for them through direct taxation. Moreover, we have borrowed heavily from abroad to finance our acquisition of both public and private goods and services, resulting in a large external deficit.

One measure of this external imbalance is the deficit on current account, defined as the excess of U.S. purchases of goods and services from other nations over the sum of our sales to these countries and the net earnings from our international investment portfolio. This deficit rose to more than $150 billion in 1987, roughly 3-1/2 percent of nominal U.S. GNP. The current account deficit for 1988, though somewhat smaller at $135 billion, remained a large share of GNP by historical standards. As the converse of our external deficit, some of our major trading partners have registered sizable current account surpluses. In 1988, both Japan and Germany had surpluses in the range of 3 to 4 percent of nominal GNP. The concern with these imbalances, of course, is that any reduction in the willingness of foreigners to ship their savings and production to the United States could result in wrenching adjustments first in foreign exchange and domestic financial markets and then in our economy. Even if the capital inflows could be sustained for some time, the burden of servicing our growing foreign debt eventually could diminish the living standard of future generations of Americans, especially if we are borrowing for nonproductive purposes.

Fortunately, it appears that these imbalances have peaked and that a corrective process is underway to reduce them to more manageable proportions. This process involves changes in relative prices and relative incomes among the major trading nations, both of which depend in part on movements in exchange rates. Between the early part of 1985 and the end of 1987, the value of the dollar fell sharply against the currencies of our trading partners. This depreciation had two primary effects. It led to strong growth in exports from the United States, as our producers again became competitive in world markets. And it made foreign goods less attractive to American consumers, damping domestic demand for imports.

Owing in large part to these effects, the volume of U.S. net exports began to improve toward the end of 1986 and continued to register substantial gains through the middle of last year. And, as I noted a moment ago, the U.S. deficit on current account narrowed considerably in 1988, the first annual improvement in this deficit since 1981. Some adjustment toward external balance also occurred in Japan last year, partly in response to earlier yen appreciation. Moreover, the German trade surplus with the United States narrowed in 1988, even though Germany's total current account surplus rose slightly, owing to offsetting changes with its other trading partners.

Recent developments

Amid these encouraging developments, we have begun to see certain worrisome signals in the economic data for both the United States and other industrial countries. First, inflation has started to pick up from the subdued rates that prevailed throughout most of the current expansion. Second, during the second half of 1988, the pace of external adjustment in the industrial world slowed rather abruptly.

Despite the global stock market crash in late 1987--which appeared at the time to be a serious threat to economic expansion worldwide--real GNP advanced 3-1/2 percent in the United States over 1988, after adjusting for the effects of last summer's severe drought. Industrial production increased even more rapidly, reflecting the stronger demand for U.S. exports, as well as the continued buoyancy of domestic demands. At the same time, the unemployment rate has continued to trend down, hitting 5.3 percent at yearend 1988 and 5 percent last month, the lowest level in a decade and one-half. Although there is much uncertainty about the long-run growth potential of the U.S. economy and the level of the unemployment rate at which wage and price inflation will begin to pick up, there is now some risk of a reversal in the disinflationary trend established earlier in the decade.

Indeed, upward pressure has become apparent in measures of U.S. wage and price inflation. Broad indexes of price change indicate inflation ran in the range of 4 to 4-1/2 percent last year, and for most of these indexes, this represents some acceleration from the 1987 pace. The pickup in inflation is even more apparent if we abstract from food and energy prices, which--owing to their volatility--tend to obscure underlying price trends.

Similarly, the tightness in labor markets has led to some acceleration of labor costs. Along with the rise in wage inflation, there has been a slowdown in the rate of productivity gains, perhaps reflecting the employment of less efficient labor and capital as the pool of unused resources has become thinner. Due to this combination of accelerating labor costs and slower productivity growth, unit labor costs for the entire nonfarm business economy rose more rapidly in 1988 than during any previous year of this expansion.

Let me take a moment to stress the importance of defusing the inflationary pressures that have emerged. Our experience in the 1970s and early 1980s demonstrated all too well the adverse effect of uncontrolled inflation on economic performance. During inflationary periods, too much effort is spent attempting to shift the negative effects of rising prices to others. From the perspective of the macroeconomy, this is completely wasted effort. Moreover, decision-making of all types is impaired by the increased level of uncertainty that tends to accompany bouts of inflation. Not only is long-range planning made more difficult, it also becomes harder to allocate resources efficiently, owing to the absence of a stable benchmark against which to judge movements in relative prices. For all of these reasons, inflation is an insidious process, and too much is at stake to roll back the progress we have made in recent years in the fight against inflation.

The inflationary pressures now apparent in the United States also are evident in many of the other industrial nations. Consumer and wholesale price increases moved steadily higher over 1987 and 1988 for the G-7 countries as a group. Among these nations, only Japan has avoided much evidence of an uptick in inflation to date. However, even in Japan, there are some signs of increased pressure--mainly in the form of tightening labor-market conditions--that have raised concerns about higher inflation in the coming year.

As I noted earlier, the second worrisome development in recent quarters has been the reduced pace of improvement in external positions.

In particular, the growth of U.S. exports has tapered off from the rapid gains recorded between the middle of 1987 and the middle of 1988. A small part of this slowdown reflects the reduced level of agricultural exports after last summer's drought. However, most of the deceleration has been due to less robust export growth for our nonagricultural products. Actually, this shift to more limited gains in U.S. exports should not be viewed as much of a surprise. Given the firmness of the dollar since the beginning of 1987, it would have been unrealistic to expect export growth to continue with such intensity. We appear now to be entering a period of slower, but probably more sustainable, growth in exports.

It also seems likely that the pace of external adjustment has been limited by the continued strength of domestic demand in the United States, especially consumer spending. Over 1988, consumer outlays rose about 3-3/4 percent in real terms, in line with the growth of after-tax income. This robust pace of consumer demand contributed to fairly rapid growth in imports, underscoring the need to restrain domestic demand if we are to check inflationary pressures in the United States while at the same time continuing to make satisfactory progress toward balance in trade.

Monetary policy developments

Acting against signs portending higher inflation, monetary authorities in the United States and elsewhere have tightened policy. Moreover, the cumulative degree of restraint that has been applied in many cases would appear to be appreciable. For example, short-term interest rates in the United States have increased more than

3-1/2 percentage points over the last two years, with the bulk of this occurring in the past year.

Given the lags between changes in monetary policy and their effects on activity and inflation, the effects already in train may be sufficient to slow demand to a pace more in line with potential growth. There are some hints that growth in the United States may have begun to moderate, though these signs remain tentative. In the other industrial nations, there is also some evidence of a transition to slower growth. Nonetheless, no one has a precise fix on the current amount of momentum in our economies or on the extent of slowing still to come from policy moves already undertaken, some of them fairly recently. Accordingly, it seems to me that monetary policy is now at a particularly difficult juncture.

The ever-present problem for policymakers is the need to peer into the future--to predict the effects of policy actions that will occur only with a lag. These lags, together with the uncertainties in all economic relationships, have led economists over the years to search for variables that would give reliable indications of whether the stance of policy is appropriate--that is, whether the economy is likely to be moving in a way consistent with broad economic goals. In this regard, the money supply has received special attention. The association between expansion of the money supply and subsequent inflation has been studied extensively for various economies and various times. These studies typically have found a significant correlation between the rate of growth of the money supply and the rate of inflation, at least over the long run.

In the United States, monetary growth has been relatively low for the last few years, suggesting policy restraint. Unfortunately, the reliability of the money-inflation relationship, particularly over the short and intermediate run, recently has been weakened in the United States and elsewhere by financial innovation and sweeping institutional change. In the United States, we have come to appreciate that the closely watched monetary aggregates M1 and M2 have a rather high degree of interest sensitivity. This characteristic greatly complicates the use of these aggregates as indicators of monetary policy over shorter periods of time, although the relationship between money and prices likely remains intact over the long run.

The level of interest rates traditionally has been used as another indicator of the stance of monetary policy. Over the years, we have learned some hard lessons about inferring the tightness of monetary policy from the level of interest rates, especially nominal rates. However, the theories of the prominent Swedish economist, Knut Wicksell, may provide a valuable framework for using interest rates to assess the restrictiveness of monetary policy. Nearly a century ago, he pointed out that the balance between aggregate demand and potential aggregate supply in an economy--and hence the outlook for inflation--can be observed in the difference between the market interest rate and the long-run equilibrium or "natural" rate. His message was that price pressures will tend to increase as long as the prevailing market rate lies below the natural rate and will decrease when the prevailing rate exceeds the natural rate.

Today, we would view this in terms of real interest rates--that is, interest rates adjusted for anticipated inflation. In this framework, real interest rates in the United States appear to have moved up over the past year and may be in the neighborhood of the natural rate--another indication that a considerable amount of restraint has been put in place. Nonetheless, despite the value of Wicksell's conceptual framework, its application is difficult because the real interest rate and the natural interest rate are both unobservable. As a consequence, I have searched for other variables that might serve as useful indicators of the degree of policy restraint.

My own observations have suggested to me that commodity prices, exchange rates, and the yield curve, when taken together with other measures, can be helpful in assessing the stance of monetary policy and the degree of restraint on inflation. When, for example, commodity prices are falling, the dollar exchange rate is increasing, and the yield curve is flattening or becoming inverted, I tend to view U.S. monetary policy as increasingly restrictive.

None of the indicators that I have mentioned--nominal and real interest rates, growth of the money supply, exchange rates, commodity prices, and the slope of the yield curve--captures all the complexities of an evolving economic and financial system. But taken together, they suggest that monetary policy in the United States has applied appreciable and sustained restraint and that over time we are likely to see an ebbing of inflationary pressures. At the same time, however, we in the United States stand prepared to apply more restraint should it become evident that inflationary pressures have not receded.

Structural imbalance in mix of fiscal and monetary policy in the U.S.

One of the dominant features of the current expansion in the United States has been the persistence of large deficits in the federal budget. The deficit for the current fiscal year has been projected by most analysts to exceed $150 billion, which represents about 3-1/4 percent of nominal GNP. The presence of such a large federal deficit at a time when the economy is near full employment indicates a serious structural problem with fiscal policy.

Compared to the situation several years ago, it is true that some progress has been made to control federal spending, particularly in the area of defense outlays. But, while defense spending declined last year in real terms, sizable increases continued for a wide range of entitlement programs. At the same time, greater burdens were placed on the deposit insurance agencies mostly owing to the savings and loan crisis, and interest payments on the national debt mounted further.

At the macroeconomic level, the basic problem with government deficits is that they contribute to a shortfall of domestic saving relative to domestic investment. To grasp the magnitude of the problem in the United States, note that the deficit in fiscal year 1988 exceeded total domestic personal saving during the same period. Because our total private saving--the sum of personal and business saving--is so meager, and the federal deficit absorbs such a large proportion of it, the United States has found itself borrowing heavily from abroad to finance private domestic investment.

In addition to being responsible, in part, for the large U.S. external imbalance, the federal deficit also has important effects on the conduct of domestic monetary policy. Because government spending has continued to be too high, tighter monetary policy remains the only tool available in the near term to restrain domestic demand and inflationary pressure. Unfortunately, this policy mix means that the sectors we least want to see squeezed--business investment and exports--are among those that bear the brunt of the anti-inflation effort. Capital spending is crimped directly by the higher real interest rates that are the byproduct of such a policy mix. These higher real rates also place upward pressure on the dollar, limiting gains in net exports. Indeed, it has been argued that the tighter stance of U.S. monetary policy has affected the domestic economy to a large extent through the external sector.

Clearly, it would be better to shift toward more restrictive government spending, which over time would allow an adjustment to monetary policy. In this way, we could limit the contractionary impact on domestic investment of an anti-inflation policy and finance more of that investment domestically, rather than with resources from abroad. Such a development should be welcomed by other countries, too, as more of the saving of their residents would remain at home to finance investment.

The United States must follow through on its commitment to reduce the federal budget deficit. Given the adverse effects of higher taxation on incentives for work and investment, deficit reduction should be accomplished as much as possible through spending cuts. The Gramm-Rudman targets provide for a phased reduction of the deficit to zero by 1993. It is essential that the targets be met not only in the 1990 budget process now underway, but over the remaining years as well. Equally important, the targets should be hit without budgetary gimmickry, so that demands on scarce domestic saving really are reduced. We must not use creative accounting to satisfy the target for the coming year, only to have the actual deficit come in far above the target level. Hard choices will have to be made to restrain federal spending, but these cannot be avoided any longer. I am optimistic about the prospects for meaningful deficit reduction. The public has come increasingly to realize the importance of this endeavor, and the President and Congress seem to be approaching this challenge with new vigor.

Exchange rates and international policy coordination

The United States, acting alone, can make changes in domestic policy to bring us closer to global balance while at the same time reducing inflationary pressure. However, continued international cooperation improves the odds that these goals will be achieved smoothly and efficiently for both the United States and our trading partners. In this vein, it is particularly important that policymakers in the industrial nations not work at cross purposes and that we seek to temper excessive swings in exchange rates. For the same reasons that price volatility associated with domestic inflation can impair economic performance, noisy and unnecessary movements in exchange rates also can be detrimental. Such movements complicate the efficient allocation of resources not only within a single country but across nations as well.

As I noted earlier, the dollar depreciated substantially from its peak in 1985 until the end of 1987. Over the past year or so, the value of the dollar has fluctuated relative to the currencies of the other industrial countries, but has not departed sharply from its late-1987 level. At that level, U.S. producers have cost structures that are quite competitive with their foreign counterparts. Owing to the significant lags with which trade flows adjust to movements in exchange rates, I suspect that a considerable part of the adjustment to the lower exchange value of the dollar is yet to come. Therefore, I would counsel patience to those who argue that the dollar must be driven below its late-1987 level to achieve external balance.

Exchange rate stability is not a realistic, or even a desirable, outcome without compatible policies among the major trading nations. This coordination requires frequent and candid discussions on ultimate objectives and the policies across countries to achieve those objectives. Such a process has been pursued in the Group of Seven and in other international forums. It is a challenging process, one that requires a sensitive balance between domestic and international policy goals. But, in a world with economic influence dispersed among many nations, there is no substitute for this give and take, for the inevitable compromises that must be made to promote the common good.