CONVERGENCE OF ECONOMIC PERFORMANCE AND POLICIES: MYTH OR REALITY?

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This week marks the sixth month anniversary of the Plaza G-5 meeting. It is therefore an opportune time to take stock of the progress toward the goals enunciated after that meeting. Those goals pointed out and emphasized the convergence of economic performance and policies that had occurred and thus aimed at convincing the markets that a realignment of exchange rates was consistent with the underlying economic fundamentals.

By concentrating on the events of the day, we sometimes lose sight of longer trends in economic policy. Today the derriere cri is to concentrate on the stellar performance of the bond market and the stock market in recent weeks. But what lies behind the exuberance of domestic financial market participants that gives rise to these performances? Why didn't the bond and stock markets begin to soar this time last year?

Step back in time with me and let us look at what the economic situation seemed to be this time last year. The United States was coming off a record $107 billion 1984 current account deficit. A year ago, virtually everyone forecasted further trade deterioration "as far as the eye could see", because the dollar was at a record high. Early in 1985 there was no firm evidence of a slowdown in the then robust growth of U.S. domestic demand nor was there clear evidence of a pickup in the growth of domestic demand.
Europe or Japan. Inflation in 1984 had remained much lower in the United States, the Federal Republic, and Japan than in most other industrial countries. Congress and the President appeared to reach a stalemate on ways to reduce the U.S. budget deficit for 1985 and beyond. Protectionist sentiment in the Congress was at a near record level and threatened to produce a trade war unless checked. Early in 1985, inflation was still headed upward in developing countries. The first phase of the LDC debt program had played out without any clear direction for phase II and beyond. In the concatenation of these circumstances, it is no wonder that domestic financial markets then saw no reason for an optimistic outlook regarding balanced and sustained world growth.

Contrast the situation then with today's prospects for global economic growth, for disinflation, and for international cooperation in policymaking. Even discounting the recent euphoria in financial markets, there is growing sentiment here and abroad that the world economy has improved and will continue to do so, and that we have gained added control over our economic destinies. What role has the September "Plaza" G-5 agreement played in this improvement? The policymakers built on the existing momentum, the 15% decline in the dollar which had occurred, and the passage of the FY86 U.S. budget resolution. However, before the Plaza meeting, market participants remained skeptical. They were skeptical not only about the performance of the U.S. economy, but also about the prospects for a balanced world economy. Skepticism, even cynicism, greeted the G-5 communique, with the typical commentary pointing out that "foreign exchange intervention won't work."

I argue that the Plaza G-5 meeting was important in achieving better balance in the world economy. It was important not because currency
intervention by itself has a lasting effect on exchange rates, but because the intervention that followed the G-5 meeting reflected and, indeed, reinforced trends toward a convergence of economic performance and a commitment to a better balance of policies throughout the developed world. What evidence do I have of such convergence? Look at the recent record.

First, consider the convergence of economic growth rates among major countries. After averaging 5-1/2% in 1983 and 1984, growth in the U.S. economy slowed to 2-1/4% last year. Other countries with similarly strong recoveries, such as Canada and Japan, also experienced a slowdown last year -- though less than in the United States. In contrast, several European countries showed some pickup in economic growth last year. For Europe as a whole, however, growth averaged about the same 2-1/4% last year as in 1984. Even this modest growth is much better than Europe countries experienced in the early world recovery from the 1981-82 recession.

By the time of the Plaza G-5 meeting, the outlook was for further convergence this year in most of these growth rates. According to IMF forecasts last fall, the outlook was for economic growth in the G-7 countries to be tightly bunched around 3-1/4%, only slightly above the 2-1/2% average rate in other developed countries. Importantly, more of the growth was expected to come from higher domestic demand, reducing the need for the United States to serve as "the locomotive". Since September, growth prospects have improved. The recent oil price crash improves the outlook for growth in almost all industrial countries, except perhaps the U.K. and Canada. Indeed, cheaper fuel implies further convergence in economic growth, and that toward a higher rate: the benefits of the energy cost declines are widespread.
The other side of the coin is that the oil price decline has also caused a convergence toward a lower inflation rate. This was well underway pre-Plaza, with predictions of further progress in 1986. In the United States, a different factor contributed to disinflation toward the admirably low inflation of the Federal Republic and Japan: the very strong appreciation of the dollar early in the decade. In the last year or so, however, progress against inflation has become widespread. Progress has been particularly noteworthy in France and Italy. In those countries, relatively high inflation rates had caused strains on exchange rate parities within the EMS. The announcement last week of a decline in French consumer prices made it clear that she has now joined the club of countries with consumer inflation rates below 3-1/2%. Given the oil price decline, worldwide excess capacity for both raw materials and manufactured goods, and the strengthening of most currencies against the dollar, consumer inflation this year may average only about 3% for industrial countries, with few above 4%. There may also be significant improvement in inflation performance in developing countries, especially Argentina and Brazil.

In summary, there is concrete evidence of convergence among economic growth rates and inflation rates in the industrial countries. The evidence was becoming apparent before the Plaza G-5 meeting. It is now unquestionable.

This convergence of economic and price performance would gradually have reduced external imbalances between the United States and other industrial countries. Slower economic growth in this country and somewhat faster economic growth in European countries would have led to slower growth of imports to the United States and a turnaround in the stagnation of U.S. exports. This would
have tended over time to reduce U.S. trade deficits and thus produce a more sustainable pattern of international trade.

Politically speaking, the self-correcting forces already in place may have been too slow, however. The gradual decline in the dollar, and thus in the U.S. trade balance, could have left the United States with an external debt nearly half as big as our annual GNP. Some economists use the differential between interest rates on dollar assets and on foreign currency denominated assets to forecast change in the exchange rate. On this basis, market forecasts of the depreciation in the dollar were in the neighborhood of 3%-4% per year for the next decade. Such a gradual depreciation in the dollar would have left the United States with very large trade deficits for the indefinite future. We would have had to borrow persistently from foreigners to finance these trade deficits. The cumulative effect of such borrowing would have left the United States with an external debt relative to GNP comparable to that of Brazil or Mexico. Many concluded that something had to change more quickly to prevent the cumulative effects of external imbalances from becoming unmanageable.

One response would have been to establish trade barriers to improve the U.S. trade balance. Before the G-5 meeting, this seemed a most likely outcome. Over three hundred bills had been introduced in Congress to impose tariffs and other import barriers. It was clear that political pressures for such protectionist measures would have prevented the exchange rate correction implied by market forecasts of exchange rate changes. We were in danger of adopting policies that reflected this "fortress America" mentality. Like the Maginot Line, such a fortress would have in the end proved to be entrapping.
One of the myths of our time is that trade barriers can substitute for balanced economic policies, providing sustainable and mutually advantageous world trade patterns. Protectionist barriers adopted by the United States as a substitute for balanced macroeconomic policies would inevitably have led to retaliation from our trading partners. The ultimate result would have been a precipitous decline in world trade with little or no improvement in the U.S. trade balance. The dislocations to our economy and to the economies of our trading partners caused by trade barriers would have led to a downward spiral in global economic well being. In short, protectionism is the Lactrile of economic policy. It is not only ineffective, but it also provides a false sense of security that prevents pursuit of more fundamental remedies.

Another recommendation for solving our trade imbalance was to adopt an inflationary monetary policy. It was argued in some quarters that exchange rates are a monetary phenomenon, that misalignment of exchange rates could be cured by easy monetary policy. This argument fails to cut through the distinction between real and nominal exchange rates. Our trade balance is determined by real exchange rates, which are not affected in the long run by monetary policy. Monetary policy can, nonetheless, affect nominal exchange rates by influencing inflation expectations. However, after the initial effect of monetary policy on real exchange rates is played out, real exchange rates return to the level determined by underlying factors: productivity, saving, and real growth rates. Inflationary growth of money and credit is thus only a cosmetic solution to underlying trade imbalances. A lasting effect of inflationary growth in money and credit is to reduce the productivity of the U.S. economy by increasing inefficiencies in the allocation of resources. By
this policy detour, our economic growth rate and ultimately our imports are savaged. Damaging our economy, eliminating our gains against the ravages of inflation, is hardly the approach to our trade imbalance.

What kind of policies were necessary in the view of the markets to remedy the international imbalances? I argue that differences in monetary policies were not at the heart of those imbalances. Money growth rates have surely varied widely across countries. But differential money growth rates belie the fundamental consistency of monetary policies in the industrial countries. In virtually every country, the objective in the past several years has clearly been disinflation. Whether at the Federal Reserve or the Bundesbank, whether at the Bank of Japan or the Bank of England, the Bank of France or the Bank of Canada, monetary authorities have recognized the need to get inflation down and then to prevent reacceleration to the ruinous rates of the 1970s. This underlying consistency of monetary policy objectives was perhaps masked by the monetarists' contention that money growth rates are the sole criterion for judging monetary policy.

The deceptiveness of money growth rates alone is illustrated by the U.S. experience. Virtually everyone would agree that Federal Reserve policy in the 1980s has been disinflationary. Yet M-1 growth has accelerated in the 1980s to an average rate of over 8%, compared with about 6-1/2% in the late 1970s. On the basis of this acceleration in M-1 growth, some monetarists have consistently predicted higher inflation, but have been consistently wrong. It may well be true that "a rose is a rose is a rose," but the same cannot be said about monetary aggregates. Financial innovation, financial deregulation, and periods of rapidly declining interest rates have altered the relationship of
M-1 growth to real growth and inflation in the United States. Such transformations in the characteristics of monetary aggregates have not been limited to the United States -- Canada, England, France, and Switzerland, among others, have experienced similar problems interpreting money growth rates in recent years.

Although necessary, such adjustment of our ranges for monetary growth is not an entirely satisfactory solution to the problems caused by deregulation, financial innovation, and other factors. We have thus encouraged research on alternative monetary measures both within the Federal Reserve and by outside academics and other researchers. A progress report on such research was presented in the FOMC's report to Congress on our monetary objectives for this year. Until such new monetary measures are perfected, however, it is necessary for the Federal Reserve to consider a broad range of variables in monetary policy implementation. The variables that we currently consider include interest rates, the outlook for inflation and economic growth, exchange rates, commodity prices, as well as the growth of M-1 and the broader monetary aggregates.

The technical details of monetary policy implementation, both in the United States and abroad, however, do not detract from the fundamental thrust both here and abroad -- which is to contain inflation while providing adequate scope for economic growth nearer our potential.

Such consistency has unfortunately not characterized fiscal policies on the whole in this decade. Indeed, the divergence of fiscal policy among the major industrial countries has in my view been one of the principal factors contributing to international imbalances. The International Monetary Fund uses
a concept called "fiscal impulse" to measure the fiscal stimulus in various countries. The fiscal impulse in the United States averaged almost 1% of GNP in the last three years. In contrast, other major industrial countries had either much less expansionary fiscal policies -- in the case of the United Kingdom and Italy -- or even moderately restrictive fiscal policies -- in the cases of Japan, Germany, and France. Fiscal policies operating at cross purposes contributed to the runup of the dollar, the U.S. trade deficit, and the massive capital inflow to this country.

The fiscal imbalances that underlie the imbalances in the international economy are fortunately being resolved. One aspect of fiscal improvement throughout the industrial world is a reduction in the size of government and a removal of government restraints on private markets. In this country, the Gramm-Rudman-Hollings process may sharply reduce budget deficits relative to GNP from the recent peak of almost 6% in 1983. As a result, the thrust of U.S. fiscal policies is now more similar to that of our major trading partners. Although not in itself attributable to the G-5 accord, the improvement in our fiscal outlook was one of the factors that was brought home to the market by the G-5 meeting.

Much, of course, remains to be done with respect to fiscal policy. One could argue, for example, that U.S. fiscal policy needs to be more restrictive for a while relative to the fiscal policies in other countries to compensate for the previous imbalances. One could even argue that for overall balance, the United States should have lower deficits relative to GNP than do countries that have more domestic savings on which to draw. The counterpart to this relatively restrictive fiscal policy recommendation for the United States
is that some of our major trading partners would adopt a somewhat less restrictive fiscal policy stance in the interest of a better balance of global economic policies. In this regard, Prime Minister Nakasone's "action plan" and the scheduled tax cuts this year and in 1988 in the Federal Republic of Germany help reinforce the effects of the Gramm-Rudman-Hollings process in achieving better fiscal balance among the industrial countries. I interpret developments in the last year on the fiscal front as a reflection of heightened awareness, both in this country and abroad, of the contribution that macroeconomic policies can have in achieving our mutual goal of balanced economic growth and sustainable international trade patterns.

This heightened awareness of the need for balance in macroeconomic policies has, of course, also been reflected in the action of the monetary authorities in industrial countries. The concerted reduction in central bank discount rates earlier this month is encouraging. It is the best evidence to date of policy cooperation among central banks. The decision to reduce central bank discount rates was in the best interest of each of the countries involved. It reflected in part a reaction to the worldwide effect of lower oil prices. The Federal Reserve and our counterparts abroad recognized that it was necessary to lower nominal interest rates to prevent a "passive tightening" of monetary policies in the face of lower expected inflation. In the absence of such action, real interest rates -- that is market interest rates adjusted for inflation -- could have risen enough to choke off the world economic expansion. Central bankers throughout the world recognized that keeping nominal interest rates constant does not in all cases constitute a neutral monetary policy. The private financial markets also recognize that market interest rates depend
importantly on the inflation outlook. The reduction in inflation expectations engendered by falling oil prices had already led to a bond market rally long before the Federal Reserve decided to cut its discount rate. Indeed, the yield curve was fast becoming a "yield plane".

My conclusion from these recent developments is that there is a definite convergence of economic performance among industrial countries and an increased awareness of the need for cooperation in economic policies among those countries. While it would be an exaggeration to characterize the Plaza G-5 agreement as a watershed, that agreement was nonetheless an encouraging development in the trend toward growing awareness of global economic interdependence. Policy cooperation need not be feared, if properly understood. It means simply each country adopting policies in its own self-interest, but taking account of feedback effects of such policies in a global economy. Policy cooperation does require taking a global view of national economic policies. It requires consulting with others to explore what mix of policies is mutually beneficial.

Analogously, inability or unwillingness to cooperate in macroeconomic policies can prevent each country from achieving its economic potential. In contrast, cooperation in developing national economic policies can in many instances improve the economic performance of all of the countries involved. Such policy cooperation does not imply surrendering national sovereignty or adopting policies that are damaging to domestic economies. It does require, however, that economic policy makers explore areas in which cooperation can be mutually beneficial.
Cooperation and consultation have long been pursued by central banks. The G-5 process has broadened participation in such consultations to include finance ministers. It thus holds out hope that governments as well as central banks will continue to explore possibilities for cooperation. Much remains to be done, but the G-5 process is an important -- perhaps an historic -- step toward better balance of policies.