

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## International Developments and Monetary Policy

by W. Lee Hoskins

International considerations have taken on a more prominent role recently in economic policy decisions around the world. Partly this reflects the growing interdependence and openness among nations, characterized by large trade and capital flows. It also reflects the problems of the day, particularly the serious international imbalances that currently exist.

We now seem to be on a path towards redressing the global trade imbalances. A long journey remains, and the conditions that will be in place when we reach our destination will depend on the policy choices we make today. I sense an increasing uneasiness in financial markets about policymakers' willingness to maintain the progress they have made towards achieving price stability. This uneasiness does not stem as much from recent price or money-growth trends, as from a sense that future economic policies will not be adequate to manage the difficult transition ahead. Central banks continue to establish multiple objectives for monetary policy and to alter the importance they attach to each.

What is the appropriate role for monetary policy in an international context? I believe that an emphasis on price stability both in the United States and abroad not only could reduce price uncertainty, but could also keep us on the desired path of adjustment in our international accounts.

### ■ Correcting International Imbalances

By late 1985, the exchange market began to view trends in global trade imbalances and existing exchange-rate configurations as unsustainable. Protectionist sentiments were growing, and the dollar had begun to depreciate. The standard textbook remedy to global trade imbalances relies on expenditure-adjustment policies in both deficit and surplus countries and on exchange-rate management.

Domestic expenditure patterns began to adjust in late 1985, but the market did not view these adjustments as proceeding quickly enough, and completely enough, to obviate a sharp realignment in dollar exchange rates. By mid-1986, Germany and Japan became increasingly concerned about the impact that the dollar's rapid depreciation could have on their economies. Exports were an important source of economic growth in both countries. By mid-1986, Germany

Policy choices we make today can strongly influence the process by which trade imbalances will adjust. The most desirable path for reforming our international accounts and for creating a healthy economic environment requires the use of monetary policy to promote price stability in the United States and abroad.

and Japan were intervening in exchange-rate markets—at times in very large amounts—to slow the dollar's depreciation.

One result was an acceleration in the growth of their money supplies in 1986 and 1987. For example, central-bank money in Germany grew at nearly an 8 percent annual rate in 1986 and 1987 compared to upper targets of 5.5 percent and 6.0 percent in these years respectively. Money growth (M2 & CDs) in Japan accelerated from an 8 percent annual growth rate in late 1985 to approximately 11 percent late in 1987.

Other countries, notably Canada and the United Kingdom, also intervened to slow the dollar's decline and consequently experienced accelerating money-growth rates. Meanwhile, in the United States, money (M1) grew rapidly in 1985 and 1986, well above target, before slowing in 1987.

#### ■ On the Path of Adjustment

To date, the effect of these policies has been to put us on the path to adjustment. The dollar now stands approximately at its 1980 level, before our serious trade balance problems began. Real net exports in the United States have begun to adjust, as have real net exports in Germany and Japan. Domestic demand in many foreign countries, especially in Japan, has improved. Given the stimulative policies undertaken to date, not only are foreign economies likely to continue expanding, but growth probably will accelerate. The IMF's recent *World Economic Outlook* shows domestic demand in most foreign countries growing as the export sector slows, and maintaining overall real growth at an acceptable pace.

This does not suggest that a boom is in progress abroad. But growth abroad does seem to be picking up, and is exceeding expectations in most countries, with the possible exception of West Germany. Although high levels of unemployment and excess capacity exist, these countries have coped well with the recent shift in real exchange rates, and economic growth, led by domestic demand, has picked up.

In the United States, domestic demand slowed in 1987 and the export sector became the driving force for real growth. Recent data, however, show a strong rebound in consumption growth. The U.S. economy appears strong, and unemployment is low by recent yardsticks.

My concern is that we have made only part of the adjustments necessary to eliminate trade balance problems without sparking a resurgence in inflation both here and abroad. Through the dollar's depreciation, the terms of trade have been altered and a shift in worldwide demand towards U.S. goods and services is underway. Through expansionary policies abroad, our major trading partners have begun to increase domestic expenditures, but a counterbalancing reduction in domestic expenditures in the United States has yet to be made. How will the future resource demands—domestic and foreign—be satisfied? We stand at a point in the adjustment process where policy choices must be made, both here and abroad.

#### ■ Price Uncertainties

Concern about the choices that world policymakers might make is manifested in recent uncertainty about inflation. The rapid growth in the money supply, against a backdrop of continuing real economic growth, the disappearance of a margin of excess capacity here in the United States, and a firming in commodity prices, has increased concern about the future prospects for inflation, not only in the United States but also in Germany, Japan, and the United Kingdom.

Evidence of this concern was found in a steepening of most industrial countries yield curves last year, as well as in moves by the Federal Reserve to drain liquidity last summer and early fall. The stock-market crash interrupted these moves and resulted in a temporary increase in global liquidity. Inflation concerns subsided immediately following the stock-market crash, but have recently resurfaced as the dampening effects of the crash on real economic activity have not proved to be discernible.

Recent price trends in the major developed countries provide little evidence yet of a serious acceleration of global inflation. However, it is clear that we are not making further progress towards reducing inflation.

Most industrial countries currently are experiencing inflation rates of approximately 4 percent—or slightly higher. Germany and Japan are exceptions. In these countries, consumer prices, after declining in late 1986 and early 1987, are rising at approximately a one percent annual rate. France and Italy have demonstrated a substantial moderation in their inflation rates in recent years. Consumer prices in the United States accelerated in 1987, but they are rising at a modest pace relative to the experience of the late 1970s.

The risk is that foreign inflation rates may converge towards the inflation rate experienced in the United States. This may not be surprising given the relative size of the United States' economy and the importance of dollar exchange rates to foreign economies. The outcome of worldwide efforts to reduce inflation largely will depend increasingly on the willingness of the United States to reduce and eventually to eliminate inflation.

#### ■ Present Choices and Future Directions

The sharp dollar depreciation potentially has begun to redress global trade imbalances. We are on a path where real growth abroad is continuing and where demand will shift more and more towards U.S. goods and services. While inflation trends remain moderate, uncertainty about future inflation is growing.

Economic theory, however, warns that nominal exchange-rate depreciations can intensify price pressures and ultimately will fail to improve trade imbalances if not accompanied by appropriate adjustments in domestic expenditure trends in both the deficit and surplus countries. Deficit

countries must increase private savings relative to investment and reduce their government budget deficit. Surplus countries must increase private and public consumption. Consequently, our journey is bringing us closer and closer to an inevitable crossroads, and we must choose down which path we will travel. One path leads to renewed inflation, the other does not.

The path leading to renewed inflation is one where we fail to institute the necessary mix of monetary and fiscal policies to reduce domestic expenditures. The exchange-rate change increasingly raises demand for many U.S. goods and services, both by reducing U.S. demand for foreign goods and by increasing foreign demand for U.S. goods. However, without a counterbalancing slowing in real domestic expenditures, domestic capacity eventually will be unable to accommodate this shift in demand patterns. If this were to occur, inflation would accelerate—initially in the United States and later abroad—offsetting the initial competitive effects of the dollar depreciation. At this point, the trade deficit would no longer improve and could begin to deteriorate again. The growing U.S. international debt could imply a further slowing in the growth of our standard of living, as an increasing proportion of our future GNP would service our foreign debts.

The effect could even snowball if the acceleration in U.S. inflation and uncertainty about policy discouraged investors from holding dollar-denominated assets. In 1987, private foreign investors began to show an increased reluctance to hold dollar-denominated assets. Interest-rate spreads widened and the dollar depreciated further. The inflow of foreign capital in recent years has helped to finance private and public credit demand in the United States.

Unless a reduction in foreign capital inflows is matched by an increase in U.S. savings (including a reduction in the federal budget deficit), U.S. investment growth could slow.

If we want to avoid traveling down this inflationary path, we must adopt policies that reduce domestic expenditure growth, encourage savings, and allow us to shift resources to the export sector as foreign demands for our products rise. In this case, prices will not rise and offset the terms-of-trade effect associated with the recent exchange-rate depreciation. This scenario does not imply a reduction in our long-run growth, but it does imply a trade-off of current consumption for future consumption.

#### ■ The Role of Monetary Policy

I have already indicated that the recent uncertainty about inflation does not stem solely from a reading of the recent price numbers. While there are worrisome signs and harbingers of future problems, price and wage behavior has been better than past experience might suggest. Moreover, given the shifts in recent years in the short-run linkages between money and prices, it is not clear that the uncertainty stems in large part from the past rapid growth of money. While these events certainly are important, the chief source of concern about the long-run prospects for inflation is uncertainty about the future path policymakers will take.

It is important, therefore, that the Federal Reserve System and other central banks commit and persistently pursue a goal of price stabilization. Central banks throughout the industrialized world continue to pursue multiple objectives including price stability, exchange-rate objectives,

and output growth, and tend from time to time to change focus and emphasis among these goals. The consequence of this failure to assert the preeminence of a “zero inflation” objective is that the market cannot be certain about the future course of monetary policy.

The basic objective of monetary policy should be to stabilize the price level. Monetary policy can do little directly to affect the supply of goods and services to the public; these depend on the supply of productive resources. Central banks can affect the price level and can encourage investment, employment, and real economic growth by providing a stable price environment.

When central banks lose credibility by failing to commit to a zero-inflation objective and following through with credible actions to achieve it, they create uncertainty. Individuals become more cautious about looking ahead. They become reluctant to proceed with plans if those plans entail fixed commitments or balance-sheet exposure in some future period when inflation might be different than anticipated today. They seek a risk premium and pursue alternatives that pay off quickly. The information that prices, wages, and interest rates provide can become clouded and resources can be misallocated.

When central banks stabilize price levels, they create a healthy environment for private decisionmaking and resource allocation. They prevent inflation from becoming worse and they prevent inflation expectations from becoming embedded in wages, in long-term interest rates, and in other fixed contracts. They insure that money serves its purpose as a unit of account, an efficient medium of exchange, and a stable store of value.

Therefore, recent uncertainty about inflation is not rooted in recent price trends, nor does it depend on the amount of excess capacity, nor does it depend on recent trends in money growth. It depends primarily on the credibility of central banks' price goals.

■ **Conclusion**

Inflation presented a persistent threat to global growth in the 1970s. The ultimate lesson of the decade was that central banks could not do all things at all times. Attempts to shift the focus of monetary policy between inflation and unemployment failed to achieve lasting success in either direction. We learned that monetary policy can contribute to real growth only indirectly by providing a stable price environment.

We have gone through a protracted, and painful, period in the 1980s of reducing inflation to a low level. In many countries — Germany, the United Kingdom, the United States, Japan — much of the success of that effort was a result of a demonstrated willingness to eliminate inflation despite continued weakness in real output and high levels of unemployment.

In the past few years, we have been fortunate. We have initiated policies that have begun to redress our global trade imbalances without aggravating inflation. Our good fortune clearly is being stretched. The Federal Reserve and foreign central banks must reaffirm in statements and in actions a commitment to price stability.

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