

A VIEW OF THE ECONOMIC OUTLOOK:  
POLICIES FOR PROGRESS

Remarks by  
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Thank you for the invitation to join you in Denver for your international conference. Because Federal Reserve policymakers and financial executives share so many concerns in these times, I am pleased to have this opportunity to discuss with you the economic outlook and some important policy issues related to that outlook.

The international flavor of your conference is particularly relevant, I think, because of the rapid and fundamental shift to full economic and financial interdependence among the nations of the world that has been occurring in recent years. As trade and capital flows across national boundaries have multiplied rapidly, many of you undoubtedly are now dealing with London, Hong Kong, or Tokyo more than ever. So it should not be surprising that growing global interdependence clearly affects domestic economic policy and ultimately, the longer-run prosperity of the U.S. economy.

As a preface to my comments, let me note that the nation is enjoying a lengthy economic expansion that will be four years old in November. Inflation has come down sharply and has remained relatively low for several years. Millions of new jobs are being created in our economy every month, and American consumers appear confident about the future.

Nonetheless, our economy does have a number of problems. Economic growth has been sluggish and unbalanced through much of the recovery period. A huge deficit has developed in our international trade account. And various sectors of the economy, such as agriculture, oil, heavy manufacturing, and commercial

real estate have shared very little in the economy's prosperity in recent years. Moreover, problems in these sectors have adversely affected some financial institutions serving them, a particular concern in this part of the nation.

In light of these problems, a number of questions are now being asked about the economy and its future. Must we be satisfied with slow and unbalanced economic growth? Is a recession waiting in the wings? Should we be concerned about a resurgence of inflation? And, finally, are the Federal Reserve and other economic policymakers doing enough to help solve the economy's problems?

Answers to these questions are difficult, of course, but I would like to share with you my thoughts about them. In doing so, I want to briefly examine the causes of our problems and then discuss what can be done about them.

One of the most important causes of the poor performance of the U.S. economy lies in the international trade sector. U.S. exports have grown very sluggishly during the current expansion, while imports have surged, leading to a trade deficit that may reach \$170 billion in 1986. This deficit is the major reason that economic growth has been sluggish despite continued strong growth in the domestic demand for goods and services. Strong domestic demand has not resulted in corresponding growth in U.S. production because it has been satisfied more and more by imports. At the same time, foreign demand for our exports has been weak. While the trade deficit is not our only problem, it is a major imbalance that is related to and symptomatic of many

other problems. Moreover, I believe the United States is not likely to enjoy strong balanced growth in the future unless our trade account is brought into balance relatively soon.

With so much of our nation's economic weakness tied to imbalances associated with the trade deficit, we need to consider why this situation has developed. I believe the large trade deficit can be traced to four fundamental factors.

One factor contributing to the trade deficit is the growing internationalization of the U.S. economy. International trade, for example, has become increasingly more important to our economy. Both exports and imports have increased sizably as a percent of GNP in recent years, rising from about 12 percent in 1965 to close to 24 percent this year. As a result, any trade imbalance has a much greater overall impact now than it would have 10 to 20 years ago. At the same time that trade has increased, the United States has lost the advantage in world trade that it enjoyed in the 1950s and 1960s, as the competitive capabilities of Japan, Europe, and Third-World countries have advanced. This has left the U.S. international trade position more vulnerable to adverse developments, such as the changes in exchange rates that have occurred in recent years. And, finally, massive capital flows moving across international borders have risen geometrically in recent years, such that our money and capital markets are closely linked on a global 24-hour basis. All of which increases greatly the sensitivity of our economy to international developments.

A second factor contributing to the trade deficit is that inflation got out of control in the late 1970s and early 1980s. We all know of the heavy costs resulting from rapid inflation: misallocated resources, weak productivity growth, erratic financial markets, and sharply overstated values for farmland and other real assets. U.S. inflation also caused our wage and cost structure to get seriously out of line with those abroad, so that our nation's goods became markedly less competitive in world markets.

A third factor causing the trade deficit is the continuation of large federal budget deficits. When the 1981 tax cuts failed to stimulate supplies of new capital, as the so-called "supply siders" had predicted, the government's large credit needs required us to borrow abroad to fund both economic growth and the budget deficit. The resulting huge inflow of foreign capital forced up the exchange value of the dollar to levels that--even now after a 30 percent decline in 18 months--make it difficult for high-priced U.S. goods to compete in world markets. With U.S. exports at such a price disadvantage, the resulting trade deficit should not be surprising.

The fourth factor contributing to our trade deficit is the slow pace of economic recovery in other industrialized nations. Combined with slow growth or recession in many LDC's and oil-exporting nations, the net result is an extremely weak export market for U.S. goods. It is very difficult for U.S. firms to regain market shares abroad when these markets are not expanding. So, even with strong domestic demand in our own economy--much of

it being satisfied by imports from abroad--weak export sales of U.S. products are dragging down the entire economy.

In brief, then, the nation's international trade imbalance is rooted in four fundamental factors: (1) the growing internationalization of the U.S. economy; (2) past inflationary excesses; (3) continuing large budget deficits; and (4) weak economic growth in foreign countries. With these factors in mind, I now want to consider what might be done to help restore economic balance and improve the performance of the U.S. economy.

Of the various policies now being debated to improve our trade imbalance, the most ominous and inappropriate would be to adopt trade protection policies. Clearly, we must recognize that the internationalization of the U.S. economy has occurred and quit trying to roll back the pages of economic history by adopting trade protection policies. While pleas of those seeking protection are understandable, I fear that protectionism would unravel the international trading order that is essential for a healthy world economy. Protectionism would surely bring on a trade war, which would bring further problems to our nation's export-oriented sectors, such as agriculture, and then spread to the economy as a whole. Protectionism, therefore, is a destructive and self-defeating policy option.

In addition to rejecting protectionism, we must reject inflation as an alternative to relieving our domestic and international debt problems. We must remember that past inflation was one of the principal causes of our current problems, and not be deluded into thinking that " a little bit

more" inflation might be a good thing. As a central banker, I am especially mindful that an overly stimulative monetary policy can be inflationary. Such a policy, in my judgement, must and will be avoided.

If protectionism and inflationary policies are to be rejected, what policies are appropriate to reduce the trade deficit and restore balanced economic growth? Two very important steps that recognize the major causes of the trade deficit can and should be taken.

One of the most significant actions this nation can take to restore economic balance is to reduce the government's huge budget deficits. Despite spending cuts enacted last year, the deficit this year will total about \$225 billion. Future deficits are expected to be lower, but they are likely to remain large and troublesome for years. Thus, it is absolutely essential that the Gramm-Rudman-Hollings process--or some such procedure that promotes discipline--be in force to preserve fiscal credibility.

Whatever the mechanism, some progress toward budget balance is necessary to relieve pressures on domestic financial markets. Those markets need reassurance that inflation can, in fact, be kept under control. A shrinking budget deficit would also reduce the nation's dependence on foreign capital, ease interest rate pressures in the credit markets, and thereby set the stage for a return to balance in our international accounts.

Another area for policy action is to increase economic growth abroad. Many officials here, including Chairman Volcker and Secretary Baker, have encouraged foreign governments in

Europe and Japan to stimulate their economies to help take up worldwide economic slack. Without such action, many believe, the world economy could slip into a recession, with ominous implications for the repayment of LDC debt and for the prospects of many American farmers and manufacturers. Given high unemployment rates in Europe, it would appear that our major trading partners could contribute to improved economic balance by moving toward more expansionary monetary and fiscal policies.

The need for more economic expansion abroad underscores the necessity for economic policymakers worldwide to coordinate their actions more fully. Clearly, such coordination is required to match the accelerating global interdependence of national economies. Moreover, I believe that all nations must recognize the undeniable interdependence of their economies and financial systems and step up to a new level of cooperation in economic affairs. For the United States, this new level of cooperation means that we must acknowledge the effects of our domestic policies on other nations. Other major economic powers must accept the same responsibility. To do otherwise is to risk the continuation of stagnant economic growth and, perhaps, recurring bouts of international downturns.

In summary, then, as I assess the various policy options now before us, I believe that protectionism should be emphatically rejected, and that sound U.S. fiscal policy--that is, a reduction of the massive federal budget deficits--should be vigorously pursued. Moreover, I believe that improved international economic coordination is an essential element in any solution to our current economic imbalances.

But what is the role of Federal Reserve monetary policy in supporting these economic policies?

I believe monetary policy must continue to provide a level of liquidity needed by the economy to generate moderate economic growth. In line with this approach, Federal Reserve policy has been generally accommodative this year, permitting relatively rapid money growth and lower interest rates. However, a further easing of monetary policy now, say through a further unilateral discount rate cut, does not appear to be appropriate at the present time. After all, domestic demand is already quite strong, as are many of the interest-sensitive sectors of our economy. Moreover, stronger domestic spending cannot solve our current international imbalance and, in fact, probably would aggravate our trade deficit, given the ability of foreigners to meet our demand.

I am also concerned that an overly stimulative monetary policy would be perceived as inflationary. Financial markets have already become apprehensive about the long-run inflation outlook, as evidenced by the sharp drop in bond prices over the past two weeks. Moreover, if an inflationary psychology were to materialize, market participants could lose confidence and start a "run" on the dollar. Such a flight from the dollar would force the exchange rate down rapidly and create an outflow of capital from the United States. Under those circumstances, upward pressure on interest rates might follow and our economy could well be damaged.

It should also be recognized that the prospect of further Federal Reserve easing depends to some extent upon the actions of foreign central banks. As you know, the first two cuts in our discount rate this year were coordinated with similar cuts abroad. These coordinated reductions are an encouraging sign of what can be achieved through policy coordination. They led to lower market interest rates both here and abroad and were accomplished without causing a run on the dollar. They also serve to underscore the growing interdependence of policy actions worldwide, as well as the potential problems if policy actions are taken unilaterally.

Let me hasten to add that if further coordinated international action is slow in coming and if U.S. economic growth appears to be jeopardized in the process, I believe it would be correct for the Federal Reserve to consider further unilateral monetary policy action to sustain the economy's forward momentum.

In conclusion, as I assess the outlook, I believe that a recession in the U.S. economy is not imminent. One reason to expect continued growth is that the nation's trade position should begin to reflect the declining value of the dollar and begin to shift back toward balance toward yearend or in early 1987. Domestically, I am encouraged by the continued low rate of inflation and by the efforts being made to reduce the Federal Government's budget deficit. More broadly, the longer term outlook for the economy also appears good--provided we can put in place the correct mix of domestic policies and international

cooperation that will be required in an increasingly interdependent world.

In any case, we cannot expect the problems of more than a decade to be resolved quickly. But I am optimistic that if we implement appropriate policies and generate more international economic cooperation we will surely bring about more general worldwide and domestic economic progress, so that the years ahead can be a period of stability and prosperity.