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SOLVING THE TRADE DEFICIT PREDICAMENT:
AN AGENDA FOR ACTION

Remarks by
Roger Guffey
President, Federal Reserve Bank of Kansas City

Rocky Mountain Chapter
Financial Executives Institute
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Thank you for inviting me to come to one of my favorite cities to visit with you about one of my favorite topics--the U.S. economy and monetary policy.

As a monetary policymaker, I am pleased to report to you that the U.S. economy has been performing fairly well lately and it is now into its fifth year of expansion. National output is rising, employment and income are expanding, interest rates are relatively low, and inflation has been restrained. Moreover, I expect these favorable economic trends to continue at least through 1987.

I should hasten to add that even though the overall economic situation is satisfactory, we still face a number of problems. My own list of concerns includes the depressed condition of the agriculture and energy sectors, the possibility of renewed inflationary pressures, and our large budget and foreign trade deficits. Of these problems, the one at the top of my list is our huge foreign trade deficit and the structural imbalances associated with that deficit. This is the topic I want to discuss with you today.

Before considering this issue, however, I want to acknowledge my concern about the depressed conditions in this region served by the Kansas City Fed. As you know, the agricultural and energy sectors that provide much of our region's economic base have not fully participated in the nation's economic prosperity. However, as I have traveled around the region lately, I have detected some modest improvement in overall

business conditions and attitudes. Rest assured that this situation commands my attention and the attention of other members of the Federal Open Market Committee as we meet regularly to determine monetary policy.

The Federal Reserve's first priority in establishing monetary policy, of course, is to adopt policies designed to keep inflation under control within the context of a growing national economy. With respect to inflation, certain developments recently have led to concern by some people that inflation may be on the rise once again. For example, the falling U.S. dollar has boosted prices of imported goods, some commodity prices have increased in recent months, and the narrowly defined money supply, M1, grew rapidly last year in a manner typically associated with inflation.

Fortunately, in my view, these developments are not alarming at the present time. While rising import prices will boost inflation, the impact should be modest, assuming--as I do--that the dollar's decline has mainly run its course. As for the increase in commodity prices, experience shows that commodity price movements are not very precise indicators of future inflationary pressures. For this reason, I am skeptical that commodity prices can be usefully elevated to a more important role in guiding monetary policy actions. And lastly, we know that declining money velocity has made M1 an unreliable policy guide in recent years. Further, we also know that when velocity is falling, rapid M1 growth is not inflationary and, in fact, is needed to support continued economic expansion.

Other developments reassure me that inflation should remain under control. For example, unit labor costs are growing slowly, there is excess capacity in most industries, the unemployment rate is relatively high, the economic growth rate is moderate, and oil prices are not expected to rise sharply. Therefore, while I expect inflation to be higher in 1987 than in 1986, I nonetheless expect inflation to remain moderate.

If not inflation, then, what is our major economic problem? As I have indicated, I believe it is our large U.S. trade deficit. As many of you know, the trade deficit is rooted in our huge federal budget deficits. Given the low savings rate in this country, we have had to finance these budget deficits plus our domestic investment needs by relying on a massive inflow of capital from abroad. As a result of this inflow, the dollar was bid up in value in the early 1980's, which curtailed our ability to export, while encouraging foreign imports and, in the process, devastated many U.S. industries.

The trade deficit continues to be a very serious problem for a number of reasons, despite the recent drop in the dollar. First, much of the expected measured growth in our economy this year is expected to come from a turnaround in the trade deficit. Without such a turnaround, economic growth could be quite slow. Further, if the trade deficit is not reduced soon, the dollar may come under further downward pressure and thereby lead to higher inflation. An additional concern is that if the dollar drops sharply lower, it could discourage the inflow of foreign capital, cause higher interest rates, and endanger the current economic expansion.

The conclusion from this set of circumstances is inescapable. We as a nation are spending more than we produce and we are financing the balance by borrowing heavily from the rest of the world. As Paul Volcker has said, "These are not conditions that are sustainable for long, ... It's not sustainable from an economic perspective, ... not supportable politically, ... and not supportable from an international perspective either. Sooner or later, the process will stop. The only question is how." And I would add -- at what price.

One way to try to cope with the trade deficit problem is to employ protectionist measures. However, protectionism would only invite retaliation from abroad and, in turn, unravel the international trading order that is essential for balanced world growth. Moreover, while trade barriers would keep a few more workers employed in the protected industries, they would only do so at the cost of fewer jobs in other sectors of the economy and higher prices for consumers and businesses. In short, protectionism is not a viable solution to our trade deficit problem.

Another approach to correct the trade deficit problem is to allow the current system of floating exchange rates to operate freely and without government interference. Under such a system, countries with trade deficits such as the United States would see their currencies drop in value, thereby reducing their imports, increasing their exports, and correcting their trade deficits. Conversely, countries with trade surpluses would experience currency appreciations that eventually would eliminate their

surpluses. Thus, the floating rate system depends on what is called the "price effect" to correct trade imbalances. That is, it depends on changes in the prices of traded goods leading to changes in trade volumes.

Sole reliance on the price effect, however, has a number of drawbacks. It tends to be ineffective in the short run because of the long lag between changes in prices and changes in trade volumes. It also can contribute to exchange rate instability as exchange rates tend to overshoot in the short run the levels needed to produce long-run trade balances. And finally, under present circumstances, allowing the dollar to drop significantly further could discourage the inflow of the foreign capital that we need to finance our budget deficit and lead in turn to higher interest rates and a possible recession here and abroad.

Alternatively, we could return to some form of the fixed exchange rate system that prevailed during much of our history. Under that system, exchange rates were not allowed to fluctuate in response to demand and supply conditions. Rather than being corrected by the price effect, trade imbalances under a fixed rate system were corrected mainly by "income effects." That is, changes in national income, or GNP, were relied on to produce changes in trade volume.

In practice, many countries elected not to subject their national economies and employment levels to the constraints of the fixed rate exchange rate system. Thus, the system broke down in the early 1970's and a return to such a system is not considered likely or desirable.

The challenge today, therefore, is to make the current flexible rate system work more effectively. One way this can be done is through better international coordination of economic policies. Coordination can make the adjustment process more effective by allowing for both the income and price effects. Coordination also can minimize exchange rate instability and encourage sound monetary and fiscal policies. In this way, the advantages of both systems can be enjoyed and their weaknesses avoided.

A number of efforts have been made in recent years to better coordinate economic and exchange rate policy. A good example is the coordinated action taken on two occasions last year by the Federal Reserve and other central banks to reduce their discount rates. By coordinating their actions, the major industrial countries achieved lower worldwide interest rates without disruptive changes in exchange rates.

Another effort at international coordination is the Paris accord reached on February 22 between the United States and five other major industrial countries. In this accord, the countries agreed that the current large trade imbalances posed serious economic and political risks; and they agreed to intensify their economic policy coordination to correct the trade imbalances. Countries with large surpluses, such as Germany and Japan, committed to policies that would strengthen their economies; while deficit countries, such as the United States, agreed to policies that would encourage steady, noninflationary economic growth and a reduction in their budget deficits.

Given these policy commitments, all the countries agreed that prevailing exchange rates were broadly consistent with underlying economic fundamentals, and they agreed to cooperate closely to foster stability of exchange rates around their prevailing levels. As we have seen, this cooperation implied a willingness to intervene directly in foreign exchange markets to influence movements in exchange rates and thereby smooth the adjustment process.

After the Paris accord, as you may know, there was a brief period of relative stability in foreign exchange markets. Recently, though, the dollar has come under considerable downward pressure, especially against the Japanese yen. For example, at one point early this month, the dollar had fallen to a post-World War II low of 145 yen. While the dollar has subsequently rebounded--in part due to large support operations by central banks--its value against the yen remains below the level at the time of the Paris accord.

The continued instability of the dollar in foreign exchange markets is perhaps not surprising, despite the intervention efforts of authorities. The markets know, as do policymakers, that direct intervention in exchange markets is ineffective in the long run unless it is accompanied by more fundamental changes. Unfortunately, there is scant evidence so far that these fundamental changes agreed to in Paris are taking place. After all, the latest figures show that the U.S. trade deficit has not yet declined significantly. Moreover, there is no evidence that the Japanese and German economies are

strengthening. On the contrary, weak economic growth is projected in both countries. And, major uncertainty surrounds the course of the U.S. budget deficit.

Quite clearly, more aggressive policy actions are needed both here and abroad. They are needed now, not later. Specifically, Japan and Germany must act now to stimulate their economies, and not wait until later as the Paris accord implies.

The United States also must act now to reduce further its budget deficit. In my view, this is one of the most important steps that we in this country must take. We know that the sharp rise in the budget deficit was a major factor in generating the trade deficit in the first place. And, we also know that if we succeed in reducing our trade deficit, the large foreign capital inflow upon which we depend to finance our budget deficits will decline as well. All of which emphasizes the vital need to reduce our budget deficits, or otherwise we are likely to see congested capital markets, higher interest rates, and the possibility of lower-than-desired economic growth.

In summary, the solution to the U.S. trade deficit is for the United States to reduce our budget deficit and for countries with large trade surpluses--Germany and Japan in particular--to stimulate their economies. These policy steps need to be taken soon and in a convincing manner. Otherwise, the recent turmoil in foreign exchange markets that we have seen may simply be a prelude to further substantial downward pressure on the dollar that would not only be inflationary in nature but would seriously threaten economic growth both here as well as abroad. Given this

grim alternative, I am hopeful and confident that we as a nation--as well as our trading partners--will make the right policy choices in the period ahead.