ASSESSING U.S. ECONOMIC PROSPECTS IN A GLOBAL CONTEXT

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Virtually any assessment of the outlook for the United States economy today must take a host of international economic and policy considerations into account. This statement holds because, to a far greater extent than many of us had realized or acknowledged until recently, the United States has become part of a highly integrated, sophisticated, increasingly competitive global economy. This development has had far-reaching implications for consumers, for manufacturers, for financial firms, for agriculture, and for those of us in public policy. I will not at this stage attempt to spell out the multitude of implications of international interdependence. However, several strike me as both particularly relevant and significant in assessing current economic circumstances and prospects. Thus, before turning explicitly to a discussion of the outlook and some of the policy issues associated with it, I will describe a few of the implications of international interdependency.

The indisputable fact that the United States is part of a highly integrated global economy means, among other things, that policies pursued beyond our borders, over which we may have little if any leverage, significantly affect economic performance here. We are concerned, for example, about the pace of the expansion in Western Europe, about the ability of the developing countries of Latin America to restore sustainable economic growth, and about demand in the newly industrialized economies of Asia for goods produced in the United States. We currently take satisfaction in the rapid expansion under way in Japan, Canada, and the United Kingdom, and urge West Germany to join in. We are concerned about the "slope" of the playing field in international trade and threaten protectionist legislation if the field does not become level.

A second critical implication of our full-fledged participation in the global economy is that, without question, global competition has worked to restrain the rate of inflation in the United States in recent years. It has done so directly, as domestic producers have been confronted with an influx of low-priced, competitive products. But, I suspect, the indirect effects are even more pervasive and profound. That is, domestic producers have learned if they raise prices excessively or acquiesce in outsized wage increases, foreign competitors will seize the opportunity to make further inroads in domestic markets. This attitude appears to prevail even with the appreciable decline in the dollar of the past three years. Thus, global competition has exerted a forceful discipline on price and wage determination in the United States, to the benefit of the productivity and efficiency of domestic producers.

With regard to the near-term prospects for domestic economic growth, international considerations may well be paramount because the economy of the United States is in the midst of a necessary transition from a consumer-driven expansion to one led by growth in exports. The significance of this change is probably under-appreciated. In point of fact, this transition has been under way since the third quarter of 1986, when the trade deficit of the United States peaked in volume terms. Since then, our exports have increased at an annual rate of about 15 percent, exceeding substantially the growth of imports over the period. At the same time, consumer spending has expanded at a sluggish pace of less than 1 percent per year. Hence, the economy has already been dependent on export growth for a time, while consumer outlays have only inched ahead. Consumers have been a major element in the expansion of the past four or five quarters only to the extent that they have not sharply curtailed their spending.

I fully expect that this transition to export-led expansion will continue and characterize the United States economy for the next several years. That is, a healthy proportion of our growth will depend upon further expansion in exports. For this to happen, it is essential that economies abroad expand, so that their demands for goods and services increase. A degree of international policy coordination can be helpful in this regard to the extent that it promotes relatively rapid expansion in foreign economies and a stable foreign exchange market environment. I personally do not see that the dollar needs to decline substantially further for the improvement in our trade balance to continue.

It is also essential to the transition to export-led growth that we avoid protectionist legislation that might provoke a trade war and lead to a contraction in world trade. In my judgment, the case for protectionism is always weak, and such policies would be particularly ill-timed just as our exports are increasing.

Some have raised the concern that export-led growth necessarily implies reduced standards of living in this country over time. Such a conclusion overstates the situation. It is true that such a pattern implies that living standards here will increase more slowly than otherwise, because domestic production must exceed consumption as net exports expand. But whether this divergence involves outright declines in living standards depends on the overall pace of growth relative to the population increase. And in any event, such an adjustment is simply the reverse of the first four years of this expansion, when consumption and living standards expanded more rapidly than domestic production.

I should point out that, in the short run at least, an economic transition of the type we are experiencing does not always go smoothly, and we may encounter some obstacles along the way. There is no "law" in economics that says that the expansion in exports must just necessarily offset slowing in domestic demand, be it in consumption or in other areas. If, for example, consumption slows more than exports advance, inventories may build for a time; indeed, such a pattern apparently occurred in the final quarter of last year. An inventory overhang may lead to constraints on production, implying that the overall pace of activity may slow as excessive inventories are worked down. But I see nothing in these developments that is fatal to the domestic economic expansion, an expansion which is now more than five years old. Moreover, in view of the enormous increase in imported goods over the past five years, it is likely that a portion of the production slowdown will occur abroad. We do not, however, have data to enable us to quantify this effect.

In my judgment, the stock market crash of last October makes the continuation of the transition to an export-driven economy all the more certain. In essence, this is because, whatever was forecasted for consumer spending before the decline in equity values, the forecast certainly must be lowered after that event. To be sure, the economy thus far has displayed remarkable resilience in the face of the October stock market decline, with only the housing sector turning out weaker than earlier anticipated.

Further, there is little reason to expect the sharp drop in equity values will necessarily trigger a recession. Many other factors influence economic activity. Appropriate public policy responses can help to offset the deleterious consequences of the break in stock prices. The policies required are not in any way extraordinary. Rather, they emphasize adequate money supply growth, maintenance of world trade, and the significance of a viable and smoothly functioning banking system. They constitute the application of experience and knowledge gained over the past sixty years.

In suggesting that the economic expansion is likely to continue and will be marked by further milestones along the transition from dependence on the consumer to relative emphasis on exports, I am also suggesting that sharp departures in monetary policy should not be anticipated over the next year. In many respects, the economy remains on a positive course. Equally important, continuity is essential to sound monetary policy, and the most significant contribution that we in the Federal Reserve can make to economic stability and to long-run prosperity is achievement of price stability. Growth objectives for the economy are best achieved in an environment of generally stable prices. It would be a mistake at this stage in the business cycle to take actions to try to resist or to retard the transition in the economy that is already so firmly in progress.

In view of the deterioration that in recent years has marked the relation between the money supply and economic performance--as measured by Gross National Product or other variables--this policy prescription does not translate precisely into narrow growth targets for the monetary aggregates. The monetary aggregates should not be overemphasized in any event. They are valuable in the monetary policy process in several ways, but they ought not to be treated as targets to which policy makers respond irrespective of other developments in the economy and in financial markets. Such an approach, if it were followed, would run the risk of interfering unnecessarily with attaining more important policy objectives.

All of this is not to suggest that the economy today merits a "clean bill of health." There is no shortage of issues that continue to threaten sustained stability and prosperity here and abroad, including still volatile financial markets and vulnerable financial institutions, debt problems of developing countries, and, most importantly, the stubborn imbalance in our fiscal affairs. Indeed, as these federal budget deficits persist, we are in effect sacrificing the economic well-being of future generations, in that our capital stock will over time be smaller than it otherwise would be or, alternatively, more of the returns to capital will go to foreign investors. In short, the unpleasant arithmetic of budget deficits is that such deficits are highly likely to result in a combination of large trade deficits and inhibited domestic investment. As trade deficits diminish, more of the burden of persistent budget deficits falls on domestic investment.

In sum, the United States today is an integral part of a complex and competitive global economy. Further economic expansion in the United States over the next year depends in large measure on increased exports, a development that appears to be in train but that is subject, among other things, to the pace of growth and the policies adopted abroad. This is just one example of how the performance of our economy is explicitly intertwined with that of the rest of the world. And, despite a favorable, if not ebullient, near-term outlook, we should recognize that we are shackling future generations by failing to discipline and balance our federal fiscal affairs. We must address this issue promptly.