FRBSF WEEKLY LETTER

February 2, 1990

A Net Export-Led Downturn?

The U.S. economy is now in the eighth year of the longest peacetime expansion in its recorded history. However, slower growth in consumer spending and business investment, together with new weakness in certain sectors such as autos, have raised concerns over the sustainability of this expansion. One of the factors often cited as contributing to the economy's potential lull is the strength of the dollar over the past two years and the export slowdown in the second half of 1989. Indeed, forecasters are saying that even with modest depreciation in the dollar, net exports (exports minus imports) probably will have a negative influence on U.S. growth in 1990, after having had a strongly positive impact from 1987 through mid-1989.

Although exports constitute only 10 percent of U.S. output, growth in net foreign demand for U.S. goods and services (real net exports) has accounted for 21 percent of U.S. output expansion since 1986. To a considerable extent, therefore, prospects for the U.S. economy depend on those of our major trading partners.

Experience indicates that economic developments abroad can either reinforce or offset developments in the U.S. For example, simultaneous expansions in the major industrial economies during the early 1970s and simultaneous contractions during the early 1980s had mutually reinforcing effects that caused severe world economic instability. But there also have been periods in which these economies moved in ways that had mutually stabilizing effects. (See the *Letter* of November 3, 1989.) The present situation and what lies ahead may prove to be an example of the latter.

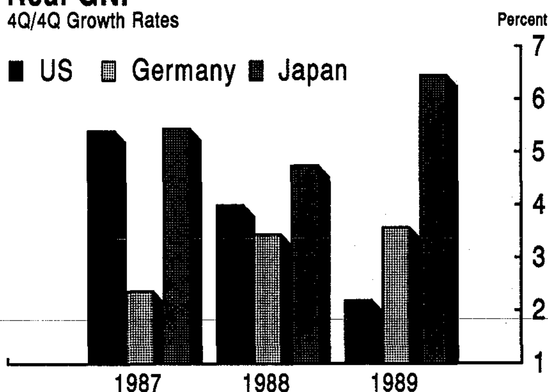
Sustainable growth

Surges in aggregate demand, stimulated either by private spending or by government policy, can temporarily lift output growth above the economy's "sustainable growth rate," defined as the rate of growth that would maintain a constant rate of inflation. However, such surges in demand can create distortions in relative prices and resource allocation that can seriously impair the economy's productive efficiency.

The sustainable growth rate depends on the rate of growth in the economy's productive capacity, or aggregate supply. Our best estimate is that productive capacity currently is growing at an average rate of approximately 2½ to three percent per year. (The rate of productivity growth appears to have accelerated during the 1980s, but slower labor force growth has offset some of the effects of productivity advances.)

Using this range as a gauge of economic performance, it is clear that growth in 1987 and 1988, at rates of 5.4 and (drought-adjusted) 4.0 percent, respectively, was well above the sustainable rate (See Chart 1). During this period, the civilian unemployment rate fell from 6.7 percent to 5.3 percent, a figure somewhat below the 5.5 to 6.0 percent rate that probably is consistent with stable wage inflation.

Chart 1
Real GNP
4Q/4Q Growth Rates



U.S. data for 1988 and 1989 are drought adjusted.
1989 estimates based on 3 quarters.

In concert with this rapid growth, inflation remained above four percent (see Chart 2). U.S. interest rates reversed the downward trend observed from 1980 through 1986, rising steadily through early 1989, except for a brief decline after the October 1987 stock-market crash (Chart 3). To keep inflation under control,

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U.S. monetary policy tightened over this period. Tighter policy, in turn, undoubtedly was a significant factor behind the rise in the international value of the dollar during 1988 and early 1989, and ultimately, slower U.S. growth in 1989.

Chart 2
Consumer Price Index
Moving Averages of Past 12 Months

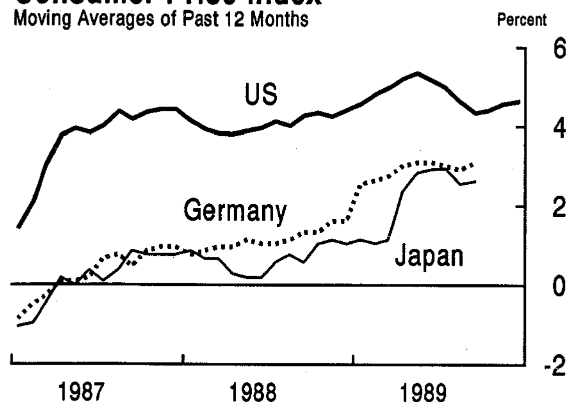
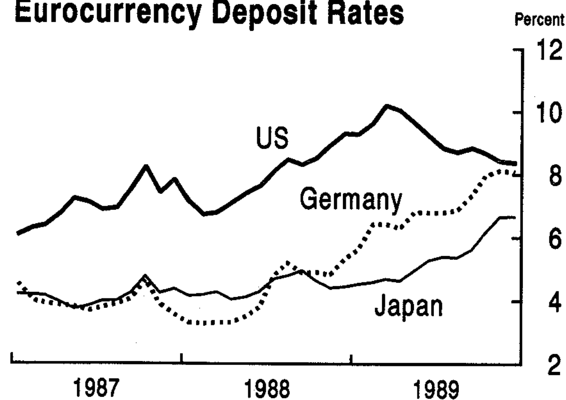


Chart 3
Eurocurrency Deposit Rates



Indeed, growth in 1989 averaged only 2.3 percent over the first three quarters (abstracting from the bounceback from the drought). Even at this slower growth rate, however, the civilian unemployment rate ended the year at 5.3 percent, the same rate as recorded at the end of 1988.

Forecasters expect even slower growth in 1990, with most calling for a growth rate of between 1.5 and 2.5 percent on a fourth quarter over fourth quarter basis. These forecasts are predicated on somewhat slower U.S. domestic demand growth. But importantly, they also presume that net exports will make either a very small positive, or more commonly, a negative contribution to growth in 1990, in sharp contrast to their strongly positive contribution through mid-1989. How closely the behavior of U.S. net exports in 1990 follows this prediction will depend in part on the outlook for the world economy.

The global context

The rate of economic growth varies across the major industrialized countries, with the U.S., Canada, and the U.K. at the lower end of the scale. Most others remain considerably stronger heading into 1990 than was expected a year ago. Strong economic growth is particularly evident in continental Europe, Japan, and the rapidly growing economies in the Pacific Basin region. Among the industrial countries, economic developments in two leading members—Japan and West Germany—will have an important impact on U.S. net exports and growth.

Japan enjoyed sustained economic growth and relative price stability during most of the 1980s. From 1980 to 1985, a rising trade surplus, aided by steady yen depreciation, provided a major stimulus to Japan's economic growth, which averaged four percent a year during this period. The precipitous yen appreciation from 1985 through 1987 caused Japan's trade surplus (in real terms) to fall and output growth to slow to 2.1 percent over the four quarters of 1986, substantially below Japan's growth potential.

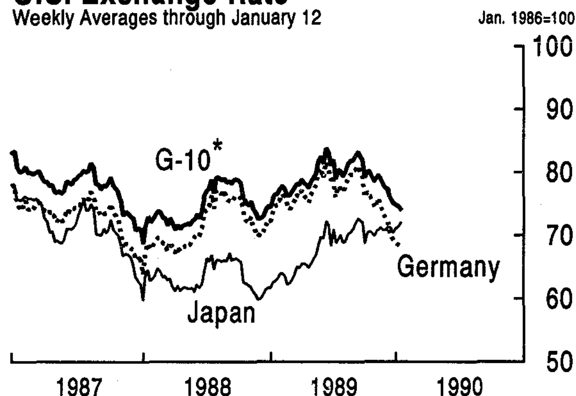
Then, in 1987, accommodative monetary policy and industrial adjustments to the rising value of the yen boosted domestic business investment, residential construction, and household consumption. Output growth rose to 5.7 percent in 1987 and 4.8 percent in 1988, with rapid expansion in domestic demand more than compensating for the shrinking trade surplus. In 1989, output growth spurted to an average rate of 6.4 percent over the first three quarters of 1989, higher than what is generally regarded as a sustainable rate for the Japanese economy.

During the late 1980s inflation also began to rise. From less than one percent a year in 1987 and 1988, the consumer price inflation rate climbed to three percent in 1989 (Chart 2). Among the major industrial countries, Japan alone had not tightened monetary policy in 1988 because there appeared to be little sign of overheating in its economy. In May, October, and again in December 1989, however, it too raised its central-bank discount rate (Chart 3).

Compared with Japan, West Germany's output growth rate was relatively low, averaging 2.2 percent a year from 1983 to 1987. As a result of policies that favored domestic price stability over short-term output gains, Germany's consumer price inflation rate fell from an average of 2.6 percent a year in 1983–85 to zero in 1986–87.

However, in the face of a steady currency appreciation and a stubborn eight percent unemployment rate, monetary policy eased somewhat in 1986 and again in 1987. Domestic business investment responded strongly. National output rose by 3.4 percent in 1988 and 3.5 percent over the first three quarters of 1989. With rapid demand growth, West German consumer price inflation accelerated from about one percent in mid-1988 to three percent in 1989. The German central bank has responded strongly to this surge, raising interest rates four percentage points since June 1988 (Chart 3), far in excess of the two percentage point rise in consumer price inflation.

Chart 4
U.S. Exchange Rate
Weekly Averages through January 12



*Multilateral trade-weighted against Japan, Canada, and 8 European currencies.

At the same time, developments in East Germany and throughout Eastern Europe are placing new pressures on West Germany and the economies of Western Europe. In the short run there are likely to be increased demand pressures in West Germany, giving further upward momentum to the German interest rate and exchange rate. Indeed, since July, the U.S. dollar has fallen more than 15 percent against the West German mark, with most of the movement since September. Because of the system of pegged exchange rates within the European Monetary System, the dollar has fallen almost as much against the other members' currencies as well.

Implications

The surprising strength of the Japanese, West German, and other European Community (EC) economies probably will lead to continued increases in their interest rates and exchange rates. This combination of strong foreign economic growth and further declines in the value of the dollar should bolster the demand for U.S. exports. At the same time, U.S. import demand will slow down due to more sluggish U.S. economic growth and rising foreign currencies. Consequently, U.S. net export growth may not be as weak as feared.

In summary, recent international events provide an interesting example of the international repercussions of external economic developments. In an attempt to stabilize U.S. inflation, the Federal Reserve tightened policy through early 1989. Relatively tight U.S. monetary policy probably was a major factor behind the dollar's rise from late 1987 through mid-1989. In recent months, subsiding growth and inflation in the U.S. have led to declining U.S. interest rates, while continued strength abroad, particularly in Japan and West Germany, has resulted in further increases in foreign interest rates. The effects of these divergent movements should be felt in the U.S. through strong foreign aggregate demand and through a weaker dollar, which will tend to mitigate both the expected deterioration in U.S. net exports and the lull in U.S. output growth.

Thus, it is likely that even through our economy has slowed, the continuing strength of the economies of our major trading partners should have a stabilizing effect on U.S. economic growth in the near future.

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