THE U.S. AND THE WORLD ECONOMY

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I. Introduction

I am pleased to have this opportunity to speak to you on the current outlook and problems in the U.S. and the world economy.

As you may know, the Federal Reserve Bank of San Francisco is a part of the Federal Reserve System and is responsible for about one-third of the area of the United States, covering nine states in the nation's western region. Because of our region's strong economic ties with countries in the Pacific Basin, our Bank since 1974 has had a Pacific Basin program for enhancing understanding of common economic issues facing Pacific Basin nations. The program has brought us in close contact with the monetary authorities and financial leaders of major Pacific Basin countries. Since I became the President of the Federal Reserve Bank of San Francisco in February last year, I have set a goal to strengthen these contacts and to acquaint myself with major policy issues of our common concern -- and especially to hear your views on these issues.

Australia and the U.S. are two major economies in the Pacific Basin region. Through trade and finance, economic prospects for our nations have become closely entwined. Australia is the ninth largest market for our exports, and we are Australia's second largest market. For the western region of the United States, the trade ties are even closer: Australia ranks third among our region's export markets, following Japan and Korea.

Given this close trade relationship, it is indeed imperative that we enhance our understanding of each other's economic conditions and problems, and work together to promote stability and prosperity in our countries and in the entire Pacific Basin region as well.

With this objective in mind, I am grateful to The Committee for Economic Development of Australia for giving me this opportunity to share my thoughts with you and, more importantly, for me to hear your views on the U.S. and the world economy.

II. The U.S. Economy

Let me start with the U.S. economy.

The U.S. is now in its fifth year of economic expansion. Since the end of 1982, we have added 10 million jobs to civilian employment, the unemployment rate has dropped from 10.8 percent to 6.6 percent, and personal income has increased by more than 16 percent in real terms. Even more notably, these solid, sustained gains have been accompanied by steady declines in inflation and interest rates. Measured by the GNP deflator, the inflation rate has dropped from 9.7 percent in 1981 to 2.4 percent last year, and the 30-year Treasury bond rate declined from 14.7 percent in 1981 to about 8 percent now.

These gains, however, mask serious imbalances in our economy. I refer, of course, to our huge federal budget deficit and huge trade deficit. In fiscal 1986 that ended last September, the budget deficit reached $221 billion, up from $128 billion in fiscal 1982; in the meantime, the current account deficit in our international balance of payments increased from $9 billion in 1982 to almost $150 billion last year.

The two deficits are closely related. The trade deficit reflects national spending beyond what the nation produces, and the most notable change in our national spending in recent years has been the steep increase in federal deficit spending, rising from 2.6 percent of our national output in 1981 to 5.3 percent in 1986. The excessive national spending has been made possible by huge capital inflows.

Clearly, this is an unsustainable situation. As one of the wealthiest nations in the world, we should be exporting, not importing, capital. Moreover, no nation, however wealthy, can live indefinitely beyond its means by drawing down its investments abroad and borrowing from other countries. Sooner or later we will have to start servicing our external debts by generating a trade surplus in our balance of payments. And the sooner we can reduce our excessive national spending, the less painful it will be for us in the future to service these debts.

Moreover, the huge increase in the trade deficit has meant serious dislocations in many of our industries. From 1981 to 1986, our exports fell 5 percent in real terms, and real imports rose 52 percent. Our agriculture, mining, and manufacturing industries have all been hit hard. As a result, there has been a rising tide of protectionism in our country, pressuring our government to erect trade barriers, especially against those countries with which we have had the largest trade deficits. As you know, for the last 45 years the United States has been at the forefront of advocating free trade among nations. However, as imports flood our market and our exports face limited access to markets abroad, we are finding it increasingly difficult to contain protectionist pressures.

Trade protectionism is not merely a U.S. problem; it is a global problem. Our huge and persistent trade deficits have made us become more aware of the barriers against our exports, making us feel that these trade barriers are increasingly unacceptable.

In this regard, I am aware of the frictions between our two countries arising from the "export enhancement" program under our Food Security Act of 1985. As you know, the program was aimed at fighting European Community agricultural export subsidies, but unfortunately has hurt the exports of our friends, such as Australia, who do not subsidize their agricultural exports. I do not believe that agricultural subsidies are an effective way to solve trade deficit problems, and I applaud Prime Minister Bob Hawke's call for a multilateral freeze on all national agricultural subsidies and an orderly disposal of national food stockpiles.

Returning to our overall economic outlook, I believe that the steep dollar depreciation in the past two years should in time bring about a significant reduction in our trade deficit. Thus far, however, the improvement has been slow and meager. In real terms, our net exports deficit increased, not decreased, in 1986.

The slow improvement in our trade balance can be attributed in part to the slow pass-through of higher import prices, as foreign exporters tried to retain their market shares by cutting their profit margins. There are, of course, limits to how far profit margins can be cut. Indications are that these limits have largely been reached, as non-petroleum import prices have risen 6 percent since the second quarter of 1985, compared to a 1.5 percent increase in our non-petroleum wholesale prices. In time, higher import prices will induce our consumers and businesses to switch from imports to domestic products in a large enough volume to start a decline in our trade deficit.

Another reason why our trade deficit has not shown significant declines is that the dollar has depreciated sharply against major currencies in the international money market, but not against the currencies of some of our principal trading partners: for instance, Canada, Mexico, Korea, Taiwan, Hong Kong, and Singapore. The sharp dollar depreciation against major currencies in the international money market has done little to correct our trade imbalances with these major trading partners.

As I said earlier, the trade deficit reflects our excessive national spending, and the most significant part of our excessive spending is the federal budget deficit. In this regard, I am glad to see that we are making progress to reduce the federal budget deficit. Even though the Gramm-Rudman deficit reduction targets may not be met, we project that the federal budget deficit will decline from $221 billion in fiscal 1986 to $180 billion in fiscal 1987 and $160 billion in fiscal 1988. As a ratio to national output, the deficit would decline steadily from more than 5 percent in 1986 to 4 percent this year and 3 percent next year. Opinions vary on the likely magnitude of future budget deficit reductions. But, on one point all agree: at least in the near term the federal budget deficit is trending down, not up.

At the same time, private domestic spending will grow less vigorously this year than last. Our staff's analysis indicates that personal consumption last year was spurred on by several temporary factors (oil price decline, auto financing incentives, low inflation, anticipatory buying before tax law changes), resulting in an unusually low personal saving rate. As the effects of these temporary factors pass away, the saving rate is expected to rise. Moreover, business investment is likely to remain sluggish, as tax reform last year removed the investment tax credit for new equipment and lengthened the allowable service lives for structures. Construction this year will also be adversely affected by the high vacancy rates of commercial buildings in many of our major cities.

These two factors -- the expected reduction in our federal budget deficit and the expected slower growth in our consumption and investment -- mean that our trade balance can improve significantly this year and next without seriously straining our productive resources and rekindling inflation. I expect our net exports to improve substantially in both 1987 and 1988 from a deficit of just under $150 billion in 1986.

When I said that weak domestic demand will help hold down inflation pressures, I did not mean to suggest that there is no need for concern over inflation this year and next. In fact, as I indicated earlier, imported prices are expected to rise, as a result of the dollar depreciation over the last two years. Moreover, sharp declines in the price of oil helped to hold down the inflation rate last year. Oil prices have since rebounded and stabilized. Taking both factors into consideration, I expect the inflation rate, as measured by the GNP deflator, to rise from 2.4 percent last year to more than 3.5 percent this year and next.

It is important to recognize the temporary nature of this expected rise in the inflation rate, and not to conclude that this development is a sign of a persistent, higher rate of inflation. In his testimony to Congress last February, Chairman Volcker stated that the Federal Reserve's

Open Market Committee is committed to an anti-inflation monetary policy. To make sure that this message is clearly understood by the market, we have reduced the monetary-aggregate growth ranges for both M2 and M3 by half a percentage point from those for 1986. In fact, even their upper bounds are lower than their actual growth rates in 1986.

In summary, I see 1987 as a turning point for the U.S. economy. Our steady economic gains in the last four years have been based on serious structural imbalances and distortions in our economy. We cannot ignore these imbalances and distortions indefinitely. As a nation, we must reduce our huge budget and trade deficits. I think chances are good that we can carry out the adjustments gradually, while maintaining a moderate rate of output growth this year and next, similar to that of 1986, with only a temporarily higher inflation rate.

III. Implications for the World Economy

This prognosis, however, is based on the assumption that world economic conditions will indeed permit a substantial reduction in the U.S. trade deficit. In the last several years, the U.S. economy has been a major source of strength to world economic growth. The expected reduction in the U.S. trade deficit will mean a decline in that impetus.

This downward pressure will fall on a world economy of generally below-par growth in output. Trade surplus countries, such as Japan and West Germany, have already felt the impact of rapidly appreciating currencies. Japan's 2.5 percent growth rate in 1986 was the lowest since 1974, almost all attributable to a nearly 6 percent decline in its real exports. Similarly, West Germany's 2.7 percent growth last year was also primarily due to a slump in its export growth. In Japan and most of Western Europe, unemployment is at the highest levels since the 1930s. Against this backdrop, the expected decline in the U.S. trade deficit means an enhanced downside risk that these countries might not achieve even the projected average 2.5 percent growth rate in 1987. While a low average growth rate does not necessarily mean world recession, this downside risk is a cause for concern.

Low growth rates of the major industrial nations imply continued poor prospects for the capability of debtor nations to service their external debts and at the same time achieve some badly needed improvement in their standard of living. Recent events in Latin America reflect a growing sense of frustration and despair among some debtor nations in the face of poor world growth prospects, on top of their inability or unwillingness to adopt much needed domestic adjustment programs. The protracted economic slump in the debtor nations is another threat to the stability of the world economy. The best way to remove that threat is to help them pull out of the slump through faster world economic growth.

Lastly, as I said earlier, a strong sense of frustration is not confined to Latin American debtor nations. There is a temptation even for advanced industrial nations to resort to trade protectionism as a last-ditch measure for reducing their persistent trade deficits and for providing eagerly sought-after relief to domestic industries. Unless the protectionist tide is held back, there is a high risk of widespread retaliation and a collapse of the international trade system that has served the world so well in the last forty years. Holding back the protectionist tide is not merely a matter of political will, nor a matter of persuasion. A vigorously growing world economy with expanding markets would be far more effective to stem the protectionist tide than all the political arm-twisting and arguments against protectionism combined.

I said earlier that trade protectionism is not only a U.S. problem; it is a global problem. Similarly, the U.S. trade deficit is also not only a U.S. problem; it is part of a global payments imbalance problem. Global payments imbalance lies behind not only the rising tide of protectionism, but also the steep dollar depreciation in the last two years, which has generated deflationary pressures in the trade surplus countries and inflationary pressures in the United States.

To correct global payments imbalance without destabilizing the world economy requires the surplus countries to stimulate their domestic spending and open their markets to imports, and the deficit countries to restrain domestic spending and refrain from protectionist measures. Only by the surplus and deficit countries working together will the world economy be able to get out of the jam it is in.

IV. Conclusion

Recently, I had the opportunity to meet with government officials in Japan and discuss economic and financial matters of mutual interest. It certainly is not my intention to tell other nations what they should do to maintain world economic stability. I am reminded of the biblical injunction against observing the splinter in a brother's eye and not noticing the plank in one's own. There is indeed much we in the United States must do to put our own house in order.

However, I am also reminded of the close economic and financial ties that bind Pacific Basin nations together. We at the Federal Reserve Bank of San Francisco are keenly aware of the interdependence of the U.S. and the world economy, and especially of our close ties with other nations in the Pacific Basin region. Perhaps the U.S. used to be able to formulate and conduct economic policies from solely a domestic perspective, but we cannot do that now. All nations in the Pacific Basin region need to increase their understanding of each other's positions.

That is one of the reasons why I have come to visit your country and to meet with you today. I am grateful to The Committee for Economic Development of Australia for this opportunity to share my thoughts with you. I am eager to hear your views and shall be glad to try and answer your questions.