FEDERAL RESERVE BANK
OF SAN FRANCISCO

OFFICE OF
THE PRESIDENT

The U.S. Economy and the Pacific Basin: A Central Banker's Perspective

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Beijing
May 24, 1988

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Thank you, Mr. Che. As you may know, the Federal Reserve Bank of San Francisco is one of twelve regional banks within the Federal Reserve System, which is the central bank of the United States. The San Francisco bank's region comprises the nine westernmost states in the United States, and these states together cover an area about one-third the size of China. Because this region borders on the Pacific Ocean, it traditionally has had strong economic, financial, ethnic, and cultural ties with the Pacific Basin.

That is why over the last fourteen years the San Francisco Reserve Bank has maintained a program to promote understanding between the U.S. and Pacific Basin countries, with a special emphasis on our relations with the central banks and academic communities in the region. Under the auspices of this program, for example, economists and bank regulators from the Peoples Bank of China and the Federal Reserve Bank of San Francisco have exchanged experiences and research findings through personal visits and correspondence.

I am pleased to have this opportunity to present my views on the growth of the U.S. and Pacific Basin economies and to hear your views on this subject. I would like to focus my remarks today on a topic of common interest: the conditions for continued economic prosperity and growth in the Pacific Basin. The experiences of the United States and a number of Asian countries are instructive in this regard. Let me start with the U.S. experience.

The U.S. Economy

The United States now is in the sixth year of the longest peacetime economic expansion in its history. Instead of slowing down as many observers had expected, output growth spurted to 4 percent last year, up from 2.2 percent in 1986. Fueled by the dollar's decline, the exceptional growth in exports of U.S. products became an engine for expansion in 1987. Sectors that had been depressed -- such as capital goods, industrial materials, energy, and agriculture -- picked up sharply.

Strong export growth and an increase in business investment during the year helped to add more than three million new jobs to the U.S. economy. As a result, the civilian unemployment rate declined sharply from about 7 percent in mid-1986 to 6 percent in the middle of last year and to 5.4 percent now.

I believe it is no accident that the U.S. has been able to sustain the current expansion for so long. A deliberate and hard-fought effort to bring inflation under control has been central to our current economic success. For fifteen years, from 1965 to 1980, accelerating inflation stunted economic growth by increasing uncertainty, and by distorting business investment and consumer spending decisions. Accelerating inflation induced businesses to build up inventories, workers to press for ever higher wages, and households to undertake greater leverage to finance purchases of inflation hedges, such as real assets. Also, during this period, the stop-and-go nature of monetary policy heightened the economy's instabilities;

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policymakers tended to apply the brakes on inflation too late and too strongly and then to step on the gas too heavily at the first signs of recession. At times, the U.S. economy ended up with both inflation *and* recession.

Stronger determination to bring inflation under control forced a dramatic change in policy in the late 1970s. Instead of the usual stop-and-go pattern, the Federal Reserve implemented policies aimed at steadily bringing inflationary forces under control. As a result, the problem of accelerating inflation is of considerably less concern to businesses and households today. In fact, consumer price inflation declined from 13 percent in 1979 to a low of 1.2 percent in 1986 before hitting 4 percent last year.

The U.S. economy paid a heavy price to achieve this success, however. We had to tighten monetary policy and let interest rates rise sharply; banks' prime lending rate, for instance, rose from about 7 percent in the 1977-78 period to a high of 21.5 percent in 1981. We suffered two back-to-back recessions, in 1980 and again in 1981-82. For the three years from 1979 to 1982, output did not grow at all, and our unemployment rate rose from 6 percent in 1979 to a peak of 10.8 percent in December 1982.

Still, I believe that the high price Americans paid was worth it. Winning the battle and bringing inflation under control have paved the way for the steady economic expansion we have enjoyed in the last five years. But because the price was so dear, naturally we in the Federal Reserve must be more vigilant in our efforts to prevent a resurgence of inflation.

That is why we grew concerned that the economy in 1987 was expanding too rapidly, pushing a number of key industries beyond the limits of their capacity and reigniting inflationary pressures. Consequently, the Fed followed a less accommodative policy throughout much of last year, and interest rates rose in the spring and summer.

The stock market crash in October, however, forced us to set this policy aside temporarily in light of concerns about the possibility of severe financial and economic distress. To restore confidence, the Federal Reserve provided ample liquidity to the banking system. By early this year, it became clear that the economy had weathered the stock market crash well, and the Federal Reserve returned to its primary focus on keeping inflationary pressures under control.

Vigilance in controlling inflation is paramount, given the nation's persistent and huge federal government budget and foreign trade deficits, both currently running in the $140 billion to $160 billion dollar range. The large federal budget deficit would be less problematic if Americans saved more. But households' and businesses' spending has been growing rapidly, too. With the economy's aggregate demand growing more rapidly than productive capacity, we have had to rely to a far greater extent than is healthy on imports of goods and funds from abroad. This reliance on foreign funds has raised concerns about the relationship between the

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exchange value of the dollar and the level of domestic interest rates. It also threatens the prospects for stable long-term growth.

Therefore, we must reduce our foreign trade deficit. Depreciation in the value of the dollar has stimulated growth in U.S. exports, but we cannot and must not depend on exchange-rate adjustment alone to correct our trade imbalance. Moreover, it would be disastrous to appeal to protectionist trade legislation to solve the problem. Excessive reliance on imports cannot be arrested as long as domestic demand continues to expand so vigorously. Rather, we must reduce our budget deficit in order to reduce the trade deficit. The two deficits are inexorably tied together.

To sum up, reduced inflation has enhanced the performance of the U.S. economy in the 1980s. Problems with the budget and trade deficits remain, though.

Growth in the Pacific Basin

Let me now turn to the Pacific Basin, where I believe the economic successes of a number countries are particularly instructive.

Over the last thirty years the Pacific Basin region has been the fastest growing region in the world economy. From 1960 to 1980, both the world economy and world trade were expanding rapidly. Output growth in the industrial countries ranged between 3 and 5 percent; Latin American countries averaged 6 percent growth; and the average growth rate of Asia Pacific countries was 8 percent. Some individual Asia Pacific economies achieved even more spectacular growth. For example, South Korea, Taiwan, Hong Kong, and Singapore have become the "Newly Industrialized Economies," and the envy of developing nations today.

In the 1980s, output growth in industrial countries as a whole has slowed down considerably, and the economies of developing nations in other regions deteriorated under the double burden of external debt and domestic mismanagement. Asia Pacific countries alone have continued to enjoy vigorous growth and substantial economic prosperity.

The performance of these economies is indeed remarkable since many observers in the early 1980s predicted the demise of the Pacific Basin economic miracle. They reasoned that since the rapid economic progress of Asia Pacific countries depended on export-led growth, the end of the favorable environment for world trade meant the end of rapid growth in these economies.

Indeed, in real terms, world trade growth has slowed to only 2.5 percent in the 1980s, compared to an average annual rate of about 7 percent in the preceding twenty years. Moreover, the prevailing free-trade spirit is threatened by rising protectionism and trade barriers in this decade.

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Fortunately, events in recent years have proven the pessimists wrong. Most of the developing economies in the Pacific Basin region have continued to record exceptionally high growth rates. South Korea, Taiwan, Hong Kong, and China have all maintained double-digit or near double-digit growth rates in the last two years. Singapore and Malaysia have bounced back from recessions in 1985-86 and achieved 9 and 5 percent growth, respectively, in 1987. Thailand's growth has hovered in the four to seven percent range throughout the 1980s.

Ingredients for Economic Success

Why were the doomsayers wrong? What is the secret of the Pacific Basin's recent economic success? In the answers lie important lessons for all countries, including the United States.

The doomsayers were wrong because they missed the true significance of "export-led growth." They mistakenly assumed that the export growth of individual Pacific Basin economies was passively dependent on the average rate of growth in world demand.

This view, quite simply, is wrong because the export-led growth practiced by the Newly Industrialized Economies is first and foremost an active *strategy* for economic growth. Such a strategy requires domestic businesses to look abroad for markets and in so doing, forces manufacturers of exports to employ the most efficient technologies and shift to new product lines in response to changes in world demand. Such a strategy similarly changes the orientation of the businesses that supply the intermediate goods needed by the exporting industries. In time, the strategy transforms the entire economy, making it more industrially diversified, technologically advanced, and resilient to rapid changes in the world market place.

Moreover, this transformation is best accomplished in the absence of special government programs. The government of Hong Kong, for example, has not sponsored any specific export promotion programs, and yet the territory has enjoyed unquestionable economic success through the free rein of market forces. Of course, a number of Pacific Basin countries have had government-sponsored export-promotion programs. But recent research suggests that such programs have distorted resource allocation and have not been effective in achieving their goals.

Still, government has a crucial role to play in promoting economic growth. In all the Pacific Basin economic successes, the government has provided a favorable environment for economic growth: political stability, no wars, substantial investment in important infrastructure -- particularly education -- and in most instances, low government budget deficits, and low inflation. Given such a favorable environment, businesses naturally will seek to compete in world markets by adapting to changes in world tastes and by applying the most efficient technologies, with or without specific government guidance and export-promotion programs.

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Lessons from the Pacific Basin

The economic developments I have chosen to focus on today all suggest that continued prosperity requires more than good luck. It requires a concerted effort to create an environment conducive to free trade and competition. In the last five years, despite our budget and trade deficits, the United States has achieved impressive economic growth. I attribute a large measure of this achievement to our success in keeping inflation under control, and thereby providing a more stable economic environment for businesses and households.

Over a much longer time span, the success of Pacific Basin economies can be attributed, in my opinion, to an outward-looking, export-oriented growth strategy that has transformed the economic structures of these Pacific Basin countries. Despite the slowdown in world trade and the rise in protectionism in the 1980s, these countries and territories have enjoyed impressive growth by getting a larger share of a smaller pie. Of course, even these economies will suffer if the pie continues to shrink in years ahead. That is why policies aimed at enhancing free trade are so crucial to the economic growth of the Pacific Basin and the rest of the world.

Of course, many of these Pacific Basin economic successes involve relatively small economies with poor natural-resource endowments. They are, therefore, naturally inclined to look outward to the world market for business opportunities. Even Japan, though not a small country, traditionally has been keenly aware of its heavy dependence on foreign supplies of nearly all the essential materials for sustaining its economic growth.

In contrast, both China and the United States are continental countries with huge domestic markets, and exports still are a relatively small fraction of national output. Businesses in both countries are not naturally export-oriented. In recent years, dollar depreciation has provided a strong incentive for U.S. business firms to look outward to markets abroad. Generally speaking, though, U.S. businesses still have a long way to go to learn to compete in world markets. This is especially true in the rapidly growing Pacific Basin region, where a number of countries and territories provide the most promising opportunites for business expansion.

Ladies and gentlemen, I am glad to have had this opportunity to share my thoughts with you. Now, I would be pleased to hear your views and answer your questions.

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