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Lessons from World Markets

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Good evening, ladies and gentlemen. I appreciate the opportunity to talk to you about "lessons from world markets." A title like that gives me a lot of leeway. For example, I could talk to you about the lessons American businesses have learned in crossing international boundaries. I'm sure all of you have heard success stories: for example, the businessman in Texas who made a fortune setting up a chain of Mexican restaurants in Spain. No doubt you've heard the horror stories, as well. I know of a consulting company that lost several million on a deal in the Middle East because its (now former) negotiator was not familiar with Arabic customs.

But the lessons from these experiences are not what interest me as a central banker. Rather, I'm interested in how to sustain prosperity and economic growth. And I'm finding a number of policy insights as I look at U.S. and foreign economies. Let me share some of my current thinking with you. I'll begin with the U.S. experience and then talk about other countries, particularly those in the Pacific Basin.

The U.S. Experience

The United States is in the sixth year of the longest peacetime economic expansion in its history. Contrary to most analysts' expectations, output growth spurted late last year to 4.8 percent and continues at a robust pace this year. In fact, we have weathered the stock market crash of October 1987 so well that it may be hard now to fathom the panic that gripped financial markets a few months ago.

Nonetheless, structural problems with the economy remain. We have high federal government budget deficits and low private saving. Inflation no longer is waning. And we still face enormous foreign trade deficits, even though we are regaining our international competitiveness.

Taming Inflation

I believe it's no accident that the U.S. has been able to sustain the current expansion for so long even in the face of such pressing structural problems. A deliberate and hard-fought effort to bring inflation under control has been central to our success. For fifteen years, from 1965 to 1980, accelerating inflation stunted economic growth by increasing uncertainty, and by distorting business and consumer spending decisions. Accelerating inflation induced businesses to pile up inventories, workers to press for ever higher wages, and households to accumulate inflation hedges.

As you know, a dramatic change in monetary policy in the late 1970s finally broke this inflationary spiral. But the U.S. economy paid a heavy price between 1979 and 1983: soaring interest rates, two back-to-back recessions, and high unemployment. Still, I believe the continued economic prosperity we now enjoy has been worth the high cost of controlling inflation.

International Competitiveness

Taming inflation is not the only problem that Americans have had to tackle in recent years. Relatively tight monetary policy, coupled with soaring federal budget deficits and robust growth in private demand, led to a dramatic rise in the value of the dollar between 1979 and the beginning of 1985. The dollar's rise wreaked havoc on our competitive position in international markets. Imports surged and exports plummeted, leaving us with massive foreign trade deficits. In 1985, the U.S. became a net debtor for the first time since early in this century. Worse, the loss of international competitiveness devastated our durables manufacturing and agricultural industries.

Then, as financial markets became concerned about the excessive buildup in dollar debt in 1985, the dollar began to slide. Although the speed of the dollar's fall has concerned policymakers, the correction was needed. By 1987, the prices of U.S. products had regained their pre-1980 competitiveness. The turnaround in the industries hurt by the dollar's rise has been remarkable.

But I don't want to give the impression that this turnaround has been due solely to the dollar's fall. During the lean years of the lofty dollar, U.S. businesses embarked on major modernization campaigns to improve productivity and competitiveness. For example, investment in R & D and in more efficient production technology picked up sharply in the 1980s. Likewise, changes in work organization, closings of older, inefficient plants, and even the merger mania during this period reflect heightened concern for productivity. These efforts are paying off: productivity growth in the U.S., as measured by growth in output per manhour, now is outstripping productivity growth abroad. There also is mounting evidence that the <u>quality</u> of U.S.-made goods is improving.

These improvements, coupled with the dollar's fall, low inflation in the U.S., and strengthening foreign economies, have made net exports the main engine for expansion in the last few years. In the first quarter of 1988, for example, real exports increased at a torrid 23 percent annual rate, and imports slowed down considerably. The trade deficit finally is falling.

To sum up the U.S. experience, then, we have undergone wrenching changes to bring inflation under control and to regain lost competitiveness in world markets. Structural problems with budget and trade deficits remain, but the adjustments we have made thus far have contributed to the longest peacetime expansion in our history.

The Pacific Basin Experience

Of course, the U.S. is not the only country in the world experiencing economic growth and prosperity. Many of our trading partners are recording strong growth. In 1987, for example, Japan, Canada, Australia, and the U.K. recorded growth in the four to five percent range (Q4-Q4). A number of countries did even better: Hong Kong, China, Singapore, South Korea, and Taiwan had double-digit or near-double-digit growth.

It's no coincidence that most of the countries I have singled out are located in the Asia Pacific Basin. Over the past thirty years, this region has been the fastest growing area in the world economy. Even when output growth stagnated in many industrial countries in the early and mid-1980s, developing and "newly industrialized" countries in the Pacific Basin continued to enjoy robust economic growth. In contrast, the economies of developing countries in Latin America and Africa have deteriorated under the double burden of external debt and domestic mismanagement.

Such a stellar track record deserves closer examination to see what lessons we might learn. I believe there are two factors that have contributed overwhelmingly to the Asia Pacific successes. The first factor is a stable economic environment. These countries enjoy political stability, substantial investment in important infrastructure -- particularly education -- and in most instances, low government budget deficits, and low inflation. In the newly industrialized economies of Hong Kong, Singapore, South Korea, and Taiwan, inflation has averaged 2.4 percent over the last five years. Japan, likewise, has kept prices under control since the mid-1970s. And Australia's economy resumed forward momentum recently only after strenuous efforts to curb inflation.

A second reason for the remarkable strength of Asia Pacific economies is their flexibility. A lot of analysts predicted these economies would falter along with the rest of the world economy in the early 1980s. A slowdown in world trade, they reasoned, would hurt the Pacific Basin because so much of its growth has been export-oriented. These analysts were fooled because of the flexibility of the Asia Pacific economies. Businesses shifted product lines, adopted new production technologies, and retrained their work forces to respond to the changing trade environment of the 1980s.

In Japan, for example, companies chose to emphasize exports of office equipment as the demand for consumer durables and other types of investment capital declined in the early 1980s. More recently, Japanese businesses have responded to the yen's appreciation by establishing plants abroad, as well as by producing more goods for domestic markets and fewer for export. They also are importing fewer raw materials and more semi-finished products to take advantage of lower production costs elsewhere.

Taiwan is another example of economic flexibility. In the last two years, the Taiwan dollar has appreciated relative to the currencies of other competitors, such as Hong Kong. Taiwanese firms have responded aggressively to this loss in price competitiveness. Shoe manufacturers, for example, are switching to a more upscale product line and are investing substantial amounts to retrain their workers. A member of my staff recently visited one such firm and was amazed to see that half of the work stations were empty because the company was retraining its workers. He also found that the workers <u>willingly</u> were accepting pay cuts to keep production and employment high. Of course, wages also have been cut in the U.S., but often at the expense of labor-management relations.

<u>Stability and Flexibility</u>

Voluntary or not-so-voluntary pay cuts aside, though, I believe there is much to be learned from the experiences of the U.S. and Pacific Basin economies. From my perspective as a central banker, I am struck by the clear need to keep inflation under control as a precondition for sustained economic growth. Accelerating inflation and stop-and-go monetary policies increase uncertainty and make it hard for businesses and households to interpret price signals. Price stability, in contrast, provides an environment more conducive to growth.

A second lesson is that a flexible economy is needed to sustain growth in the face of changing technologies and world demand. Flexibility requires an economic structure that allows resources to be shifted to their most productive uses. If businesses are hindered from replacing obsolete technologies and ways of organizing work, they will be swept aside by more efficient producers in other parts of the world.

I've already said that the economies in the Pacific Basin exhibit extraordinary flexibility in responding to exchange rate fluctuations and changes in world demand. And what impresses me most about the episode of the rising U.S. dollar is that U.S. businesses responded to the deterioration in their competitive positions by investing in more efficient technologies. Now that the dollar has fallen, U.S. businesses are well-positioned to compete head-to-head with some of the most efficient manufacturers in the world. No wonder the export sector of our economy is the engine for growth now.

One manifestation of the commitment to flexibility is the recent trend towards liberalization of the laws governing domestic financial markets. This is a trend for the entire Pacific Basin region, from the United States and Japan, to the newly industrialized and developing countries, even including China.

In the same vein, the recent trade agreement to remove most barriers to trade between the U.S. and Canada represents a step toward economic flexibility. Likewise, the European Economic Community's plan to achieve complete economic and financial integration by 1992 suggests that the Europeans are moving in the direction of greater flexibility, as well.

Lessons for the U.S.

So, if price stability and economic flexibility are central to sustained prosperity, the application of these lessons to U.S. policies seems pretty straightforward. First, we must continue zealously to pursue a noninflationary monetary policy. The pursuit of price stability is not easy, given the still-excessive federal government budget deficits. We need to reduce these deficits because they foster enormous underlying inflationary pressures. In fact, danger signs already are flashing on the inflation front. The inflation rate has been rising since 1986, and the unemployment rate, at 5.3 percent, is at or even below the level most economists believe is sustainable without significant wage inflation.

Another implication of my observations here today is that we must resist legislation that would reduce the U.S. economy's ability to respond to change quickly and efficiently. We have made notable progress in the area of financial reform. But I am deeply concerned that pending minimum wage legislation and latent protectionist sentiment could hamstring U.S. businesses' ability to compete in world markets.

Reorienting our policy focus to promote price stability and foster greater flexibility is not always an easy task. But assuming we can do this, experience is telling us that we can look forward to continued growth, particularly in our export sector, gradual improvement in our trade balance, and continued high employment. That's a lesson well worth learning, in my book.