

EXTERNAL PRESSURES ON MONETARY POLICYMAKING

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Monetary policymaking is a much more complicated, perhaps even more perilous, venture than it used to be. Until recently, there were two different public pressure groups that the Federal Reserve had to contend with: those who wanted easier policy to achieve faster economic growth and those who wanted tighter policy to achieve lower inflation. And, until recently, monetary policymakers worried chiefly about the trade-offs between short-run policy effects on domestic economic growth and long-run effects on inflation. They knew that easier policy would only temporarily spur economic growth at a cost of faster inflation in the long run; or conversely, that tighter policy would produce lower inflation in the long run at a cost of temporarily slower economic growth.

Faced with these pressures and policy trade-offs, the Federal Reserve focussed primarily on their internal or domestic consequences; their external or international ones were often overlooked or dismissed as being unimportant. This is no longer the case. After having run up a series of multi-billion dollar trade deficits over the past several years, the U.S. has managed to achieve the dubious distinction of being the world's largest debtor--bigger than Mexico, bigger than Argentina, bigger even than Brazil. At last count, we owed the rest of the world, on net, about \$350 billion.

During the first few years of our surge to the front of the world-class debtor ranks, there were few problems; indeed, from 1982 to 1985, the dollar's value rose steadily in world currency markets,

indicating international confidence in our economy and in our ability to repay our debts. Since 1985, however, things have changed considerably. As our net foreign debt has continued to mount, the dollar's value has plummeted in foreign exchange markets. The huge foreign debt overhang and the dropping dollar have produced new pressures and new constraints on the kinds of policy actions that the Federal Reserve can undertake.

Today, I would like to discuss "why" and "how" these external pressures have impacted monetary policymakers. To do so, however, first requires a brief look at the causes of the U.S. trade deficit.

Technically, the term "trade deficit" is a misnomer. What we should be concerned with is the "current account deficit," that is, a deficit in our international transactions in goods and services, not just goods alone. However, we can use the more commonly-heard term "trade deficit" as long as we remember that what really matters is we have been buying more goods and services, on net, from foreigners than they have bought from us.

The basic notion of a trade deficit is not much different for a country than for an individual. You and I can always spend more on goods and services than we earn currently, as long as we can sell off our assets or borrow from others to finance our deficit spending. When we do this as a nation, we run national trade deficits. In other words, we spend more on goods and services than we produce, with the difference provided and financed by foreigners.

Why are foreigners willing to finance a trade deficit? In some cases and, specifically in our case since 1980, the existence of differential returns between domestic and foreign investment opportunities can be a chief cause for the emergence of trade deficits. In order to make

loans in the U.S. or to purchase U.S. assets because of attractive returns, foreigners must first acquire dollars. In the process, they bid up the dollar's value. The increased value of the dollar encourages more imports and discourages exports--the trade deficit that ensues provides the necessary dollars for foreign investment in the U.S. In simple accounting terms, other things unchanged, every dollar that foreigners lend to or invest in the U.S. increases our trade deficit by exactly one dollar.

But aren't these trade deficits harmful? Aren't we exporting our jobs, reducing our income, or lowering our standard of living by incurring greater foreign indebtedness? Not necessarily. As long as we are using these borrowed funds productively and as long as foreigners maintain confidence in our economy and our policies, trade deficits should be no cause for public alarm. Every dollar of the trade deficit represents a dollar that foreigners are spending in the U.S.; if they are not buying our goods and services, they are buying U.S. stocks, bonds and other capital items. Because the people who sell these assets to foreigners now have their dollars, total spending in the U.S. is unchanged. There is no reason to expect that trade deficits per se produce a general contraction in the U.S. economy.

Our experience during the 1980's clearly supports this view. The major trade deficits associated with our dash for world indebtedness began in 1982. From 1982 to now, real GNP grew 3.8 percent per year, the U.S. employment rate rose from 58 to 62 percent and the unemployment rate fell from 10 percent to around 6 percent; even real manufacturing output, supposedly victimized by trade deficits, increased at a 5.6 percent annual rate over this period. Of course, production and employment did

fall substantially at U.S. firms that competed directly with imported goods, or produced goods for export markets. However, as we should expect, other sectors of the U.S. economy took up the slack. In general, the economy expanded. The U.S. expansion is even more remarkable in comparison to the economic stagnation that affected many other nations--including those that were running trade surpluses.

However, just as you or I cannot increase our indebtedness forever, likewise, no country can continue to run trade deficits forever. Eventually, the day of reckoning will approach when debts must be repaid--or, at least, a reasonable repayment schedule worked out. This day of reckoning can be postponed as long as relative investment returns continue to encourage net investment in the nation and confidence in the nation's ability to repay remains unimpaired. This essentially describes the period from 1982 to 1985, when our trade deficits were accompanied by a rising value of the dollar.

But what happens when foreigners become more reluctant to lend to us, or when they become unwilling to purchase our assets or promissory notes at current prices and interest rates? This change triggers an adjustment process that shows up initially as a fall in the value of the dollar; such a turn-around started in early 1985, when the dollar began its long slide in foreign exchange markets. Eventually, the adjustment process spills over into the domestic economy, producing higher U.S. interest rates and, until the adjustment process is complete, a period of slower U.S. economic growth.

The best way to understand the nature of this adjustment process is to take a closer look at some key domestic macroeconomic relationships. The trade deficit is simply the flip side of the foreign capital inflow;

it represents the net amount of foreign savings that is being invested in the U.S. These foreign savings fill the gap between U.S. savings, on the one hand, and U.S. investment and the federal deficit, on the other hand. When the inflow of foreign savings begins to diminish, the trade deficit will narrow correspondingly. Other things the same, unless U.S. savings increase or the federal deficit decreases enough to offset the loss of foreign savings, U.S. interest rates will rise. This rise in interest rates will reduce consumer spending and investment, producing slower real growth in the U.S. economy. This represents the process by which the economy must adjust to a reduction in net foreign investment in the U.S.

Now, as this adjustment takes place, it will produce exactly the kinds of economic conditions that, in the past, have generated wide-spread public pressures on monetary policymakers. Only this time, if these pressures are accommodated, the results are likely to be disastrous. As economic growth begins to slow, some private and public groups will demand easier monetary policy in hopes of spurring faster growth. Unfortunately, an easier policy would retard the necessary reduction in the trade deficit--as our income grows, we generally import more as well. Furthermore, an easier policy generally produces higher future inflation; thus, an easier policy would further reduce international confidence in our economic policies and result in even more downward pressure on the dollar's value in exchange markets. If the stock market's collapse was due in part to concern over excessive depreciation in the dollar's value, an easier policy stance could produce even more bearish financial markets.

Of course, there will be other groups, perhaps less vocal, who will pressure the Fed for tighter monetary policy actions. Some of these will hope to prevent further decline in the dollar's value; others, noticing the temporary rise in prices associated with higher prices for imported goods and services, will hope to choke off what they perceive as higher inflation. Unfortunately, excessively tight monetary policy at this time will only exacerbate the economic slowing necessary to bring about the underlying adjustment to our changed external environment; it could easily turn a period of slow economic growth into a recession.

At this point, you might ask "Aren't there any policy actions that can make the adjustment less costly?" Remember that old joke that starts: "I have some good news and some bad news?" In this case, as you may have guessed, the message is similar. The good news is that there are some policies that could help; the bad news is that they are unlikely to be achieved.

As you know, the U.S. has been trying to convince our major trading partners--Germany and Japan in particular--to stimulate their economies. "Stimulation," of course, is a code word for, among other things, easier monetary policy, which would raise their rates of inflation, make foreign goods more attractive to their citizens and, thus, increase our exports to them. So far, they have resisted pursuing this policy in an aggressive way for reasons that seem sensible to them. Basically, they find it unrewarding to place their own economies in disarray just to help us straighten out our problems.

We could attempt to raise our own savings rate, perhaps through lower taxes on savings and increased taxes on consumption. Because, however, many people would view such tax changes as a transfer of wealth

from the poor (consumers) to the rich (savers), the prospect for such changes seems small.

Finally, substantial reductions in the federal deficit would be nice. Of course, we have been saying this for a long time now with very little results toward achieving it. Will international considerations improve the probability of substantial progress in reducing the budget deficit? Frankly, from what I've seen so far, I am skeptical of this.

Thus, the message that I want to leave with you this afternoon may not be a happy one, but it is a necessary one. Changes in this nation's external circumstances will produce--indeed, must produce--an adjustment period during which interest rates and prices are likely to rise and real growth is likely to slow. In the past, when external pressures did not exist, the Federal Reserve had considerable leeway to substantially tighten or ease monetary policy when similar economic conditions arose. Today, because of the external situation, we have much less discretion in what can be done--financing our savings deficit must take precedence over these other factors.

If we ignore this painful reality in the conduct of policy, rather than make things better, we are apt to make them much, much worse. A volatile monetary policy aimed at short-run objectives will only exacerbate already sensitive conditions in financial and currency markets. With the exception of temporary deviations to assure liquidity in time of crisis, as occurred last October, the thrust of policy needs to be consistent and oriented towards long-term objectives. Translated, this means a steady policy that is neither too easy nor too tight. Interfering with the externally-induced adjustment process will only postpone the pain and probably make it worse.