

**EXTERNAL ADJUSTMENT: IMPLICATIONS FOR THE ECONOMIC
OUTLOOK AND MONETARY POLICY IN 1989**

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We begin the new year in enviable shape in many respects. The economy continues in the midst of the longest peacetime expansion on record; the unemployment rate has fallen to a fourteen year low; and, there has been significant improvement in the U.S. international trade deficit. The outlook for continued moderate expansion in output and employment in 1989 is encouraging. And, just as last year, our trade-related industries should continue to lead the way.

In fact, so pervasive is the influence of the U.S. external adjustment process--which is working to narrow our merchandise trade deficit--that any discussion of the outlook for this year is misleading or seriously incomplete unless it covers this process in some detail. Therefore, before turning to the outlook, I would like first to describe how our external imbalance arose and what adjustment generally implies, including the extent to which last year's developments fit this pattern. Then I will comment on what is likely to occur this year as the external adjustment continues. Finally, I want to say a little bit about the challenges that this process presents for monetary policy.

Since the early 1980s, we have been running large international trade deficits. The causes of these trade deficits have been the subject of much debate, but surprisingly little agreement. There have been assertions that, due to some unspecified reasons, our relative efficiency in producing goods has declined drastically; that is, we have somehow lost our "competitiveness" in the world marketplace. Other analysts have argued that our seemingly insatiable appetite for consumer goods, especially for those produced abroad, had suddenly run amok, causing a

huge increase in imports. These arguments have led to numerous sermons about what we need to do to get this nation back on track; unfortunately, these alleged causes do not fit the actual events that have occurred.

Suppose that either our loss of competitiveness (which reduced our exports) or our explosive desire for consumer goods (which increased our imports) was truly responsible. In this case, the lower foreign demand for dollars to purchase U.S. goods and the larger supply of our dollars to purchase foreign goods would have caused the international value of the dollar to fall substantially. However, from 1980 to 1985, this did not occur; rather than falling, the value of the dollar exploded upward during this period. Accordingly, I believe that these explanations are spurious. Instead, there is another explanation--one that better describes the events that actually occurred up to 1985 and is consistent also with the adjustment process that has been taking place since then.

The rise in the value of the dollar from 1980 to 1985 indicates that over this period there was a substantial and sustained increase in the demand for U.S. dollars by foreigners. This increase in demand, however, did not occur because foreign citizens wanted to buy our goods and services; instead, it happened because they wanted to invest in the U.S.--to buy U.S. assets, such as stocks, bonds, CDs, and real property. Now, why did investment in the U.S. become substantially more attractive than alternative investments that foreigners might have made virtually anywhere else in the world? First of all, as I am sure you will remember, many third world countries began to have problems servicing their international debt in 1982. Equally important, the perceived higher real return on investment in the U.S. was enhanced by the U.S. tax reductions of the early eighties.

Also, a relatively low rate of saving in the U.S. played a key role in this process. For reasons that are still not clear, the rate at which we save has been low, relative both to foreign rates of saving and to our own uses of savings. Our national savings are used to finance our investment projects and our federal government deficit. Since U.S. investment plans were strong following the 1982 recession and the government deficit rose substantially in the 1980s, real returns on savings rose. These higher rates did not, unfortunately, generate higher domestic savings; they did, however, attract foreign savings to the U.S.

There is, of course, another side to this inflow of foreign savings to the U.S. Foreigners must obtain dollars in order to buy assets in the U.S.; the only way that they can do so is to increase their sales of goods and services to us relative to those they buy from us. In addition, the rising value of the dollar made their goods cheaper to U.S. buyers; we naturally bought more foreign goods. This is the reason that our merchandise trade deficit ballooned during the early 1980s.

A trade deficit, then, means that we are exchanging our assets, including, of course, promissory notes, for foreign imports. But it is clear that a country, like any other borrower, cannot continue increasing its outstanding debt forever. The growing external imbalance that we have built up since 1982 inevitably forces adjustments on us that lead eventually to the disappearance of this imbalance. Short of our declaring bankruptcy, these adjustments must take place. Hopefully, they can occur gradually with only minor inconveniences to us and to our economy; however, under certain circumstances they can produce serious, even drastic, economic repercussions. It is this latter possibility that is creating the fears and uncertainties that currently overhang and threaten

to overwhelm our financial markets. But, what are these unavoidable adjustments? How do they manifest themselves in our personal and business lives? And what should we expect as we move back to a proper balance in our external trade relative to the rest of the world?

As we have seen, when foreigners were eager, perhaps even over-eager, to invest in the U.S., the result was an ever-rising value of the dollar. As our foreign debt accumulated, however, foreigners naturally became less eager to continue to invest more and, thus, to accumulate even bigger U.S. IOUs. Therefore, they demanded a higher return, either through higher U.S. interest rates or through a lower value of the dollar or both. Consequently, as part of the external adjustment process to reduce our capital inflows, one would expect to observe a decline in the value of the dollar and upward pressure on U.S. interest rates.

The depreciation of the dollar should cause imports into the U.S. to become more expensive and, accordingly, we should reduce the amount of goods and services that we buy abroad. In addition, the decline in the dollar's value should "spill over" into higher prices for U.S. goods and, thus, produce some upward pressure on the U.S. inflation rate over the next year or so. By the same token, the reduced value of the dollar should make our exports to foreigners cheaper and more "competitive;" thus, as part of the readjustment process, our exports should rise. Eventually these forces will produce a balance in trade, perhaps even a surplus when we begin to pay off some of our accumulated outstanding debt.

If our domestic investment levels and government deficit remain unchanged, we should see an increase in real interest rates as the inflow of foreign savings begins to decline. Additional upward pressure on

interest rates will occur to the extent that the fall in the dollar's value produces somewhat higher inflation in the U.S. The rise in the real interest rate should result in increased domestic saving and reduced U.S. investment. We should expect, then, higher real and nominal interest rates, some decline in U.S. investment growth in general, and an increase in the U.S. savings rate.

Another impact that we should observe as the external adjustment takes place is a shift of resources from goods and services produced for domestic consumption to those produced for export. Whether this shift will have a sizable impact on U.S. income and employment depends on which industries will enjoy the expanding share of the export market and which ones are contracting.

Having discussed what we "should" expect to see, let us examine whether these expected results of the external adjustment process actually took place last year. This will help us to gauge what to expect this year. One word of caution, however, is required. The U.S. economy is not driven solely by these adjustments. Monetary and fiscal policy actions, as well as a host of possible external "shocks," also could have substantial impacts on what happens in 1989. All I want to suggest is that the performance of the economy has been, and, therefore, will continue to be broadly consistent with the expected consequences of the external adjustment. Therefore, let's first look back before we look ahead.

While the value of the dollar remained relatively stable during 1988, it has declined by almost 30 percent since 1985. As a result of the usual lags in trade patterns, exports began to increase substantially, rising 30 percent last year. In contrast, imports rose only 10 percent.

Consequently, the U.S. trade deficit in 1988 will be about \$120 billion, 20 percent lower than its level in 1987. While imports seem to be somewhat slower to adjust to changes in the exchange rate than are exports, the trade gap is clearly closing in the expected direction.

Second, the government deficit, as a percent of income, has declined from 6 percent in 1983 to about 3 percent in 1988. However, investment spending grew strongly last year. Total capital expenditures rose at about a 10 percent rate in 1988; and, capital spending in manufacturing jumped about 13 percent. Rising investment, coupled with a decline in the inflow of foreign savings, should have put some upward pressure on interest rates last year. And, indeed, short term interest rates rose about 200 basis points and long term rates, about 100 basis points in 1988. The extent to which these increases were due to the international adjustment process or to increased inflationary expectations is uncertain; in all probability, however, it was due to some of both, as I suggested earlier.

With rising interest rates, savings have risen to 4 percent of income, up from the historic low of 3.2 percent in 1987. Of course this implies that personal consumption grew slower than income last year. The resources released from these sectors, however, were quickly employed by the growing export manufacturing industries. Unemployment declined from 6.1 percent in 1987 to 5.5 percent in 1988; moreover, we hear less and less about job expansion consisting primarily of low-skilled, "no future" kinds of jobs.

In general, economic activity in 1988 shows that the external adjustment is taking place, although at a somewhat slower pace than we might have expected from a historical perspective. This is particularly

true of imports, which have not yet actually declined, although their growth has slowed significantly. It is possible that foreign exporters, for a time at least, are willing to accept lower profit margins in order to retain their market share. Such a situation, of course, cannot continue indefinitely.

Well, what about 1989? I believe that the external adjustment will continue to exert the same pressures as in 1988. These pressures will be affected, of course, by past and present monetary policies. For example, the extremely rapid monetary growth of 1985-86, along with the declining dollar since 1985, has contributed to an acceleration of inflation in 1988; these factors will likely have a similar influence throughout this year. The higher inflation should put some additional upward pressure on interest rates throughout the year as well. On the other hand, the extremely slow money growth that we have observed in 1987-88 has made sure that inflation will not surge too strongly; indeed, it is likely that inflation and interest rates will begin to decline somewhat in the early 1990s.

However, the fast-slow money growth combination that we have faced over the past four years means that we should expect economic growth to slow somewhat in 1989. This does not mean that a recession is necessarily staring us in the face; it does mean, however, that growth in real GNP and employment will be slower this year than last year. The continuing expansion in exports should benefit manufacturing and agricultural sectors. Until the external adjustment is complete, however, we could well continue to see downward pressures on the dollar's value in foreign exchange markets.

There is one clear danger to the soft-landing scenario that I have just described. The external adjustment process inevitably exerts important pressures on policymaking. For example, if interest rates continue to creep up, however slowly, there will be a clamor to keep them from rising. Indeed, we see such pressures now. If policymakers, particularly the monetary authorities, respond to this clamor, money growth would be increased; with a larger supply of dollars in world markets, the result could be a precipitous decline in the dollar's value abroad. This sharp drop might trigger further events that would disrupt financial markets and spill over into the economy as a whole. On the other hand, if there are widespread demands for "fighting" the rise in inflation or a continuing decline in the dollar, growth in the money supply could be sharply reduced; based on historical precedents, too strong a reduction in money growth could easily produce a recession.

The moral for policymakers--and the public at large--hopefully, is clear: changes in this nation's external circumstances are producing--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 adjustment process, we have much less discretion in what can be done.

If we ignore this 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,

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.