"U.S. COMPETITIVENESS AND MONETARY POLICY"

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Federal Reserve monetary policy actions can have profound effects, either for good or for ill, on our lives. The lure of hoped-for good effects often prompts various interest groups to plead for, even demand, monetary policy actions that they believe will promote their own interests. Unfortunately, unbeknownst to them of course, such actions can have pernicious longer-run effects on these very groups and on the rest of us as well.

A recent example of such well-intentioned, but fundamentally misguided, public pressure on the Federal Reserve stems from widespread concern that this nation's international competitive position has been dangerously weakened during this decade. The standard story is that the rising value of the dollar from 1980 to 1985 undermined U.S. competitiveness; it made our goods too expensive for foreign markets and made foreign goods much cheaper in the U.S. The presumed solution, according to conventional public wisdom, is to use monetary policy to drive down the dollar's exchange value and, thereby, reverse our weakening competitive position.

Now, what could possibly be wrong with resurrecting our international competitive position through "appropriate" monetary policy actions? I hope to convince you this afternoon that both the alleged problem and the purported solution are simply dead-wrong. First, despite what you may have heard or read, our ability to compete, either in domestic or international markets, has not declined substantially during this decade. Second, deliberately pursuing monetary policy actions intended to drive down the value of the dollar would have disastrous consequences for this nation.

International competitiveness is a widely-used term that becomes difficult to define when the discussion gets down to specific issues. Some people attempt to assess competitiveness by comparing the current value of the dollar with the level that would achieve "purchasing power parity," a situation where goods cost about the same in all countries. Other people focus on the share of imports or exports in the domestic market, as in the case of steel or autos, while others look at the share of U.S. trade in world trade, as in the case of corn or other farm commodities. Still others focus on the quantity or growth of U.S. exports and imports, or on the pace of innovation of new goods and services, or on a host of other alternatives.

Now, while discussions and disagreements about the most appropriate measure or measures of international competitiveness may be entertaining at times, they can easily distract us from the problem that we are concerned with. Regardless of what definition of international competitiveness one considers most appropriate, there must be a "bottom line" comparison for all such definitions. The "bottom line" is simply this: if we have generally lost our competitiveness, however defined, then our overall economic performance must have worsened relative to our own past performance and relative to other nations that presumably have gained competitiveness at our expense. A nation's performance is typically assessed by looking at trends in productivity and output growth. Accordingly, how our record in these areas stacks up against those of other nations tells us what has been happening with our international competitiveness.

First, let's consider what happened to U.S. international competitiveness in the 1980s. As you may recall, from mid-1980 to early 1985, the international exchange value of the dollar generally rose sharply; at the same time, the trade deficit mushroomed. These two developments often are taken as evidence that U.S. competitiveness was eroded by the appreciation of the dollar. The rise in imports and fall in exports are assumed to indicate that U.S. production was reduced, while foreign production was boosted. Given resources available, U.S. productivity is believed to have declined relative to foreign competitors.

A good story, but nothing could be further from the truth! A recent study completed at our Bank shows that, in fact, the U.S. enjoyed a renaissance of productivity in the 1980s, especially in the manufacturing industries where the trade deficit rose the most. Five industries--electric and nonelectric machinery, transportation equipment, primary metals and apparel--account for about three-fourths of the rise in the trade deficit in the 1980s. Yet these industries as a group had a growth rate of output of about 5 percent annually from 1980 to 1985, more than twice the growth rate of other manufacturing industries or the rest of the economy. These industries were the leading sectors of manufacturing and the overall economy. What a change from the 1970s! These same industries, like the rest of manufacturing, grew at a 1 percent rate in the 1970s, less than half the overall GNP growth rate from 1973 to 1980, and about one-fifth of their growth rate in the 1980s.

This renaissance in domestic output of internationally-traded manufactured goods was due to a rebirth of productivity growth.

Productivity had been stagnant in the 1970s, but in the 1980s it registered renewed growth, especially in manufacturing, where it rose nearly 5 times faster than it did in the 1970s.

Productivity and output growth boomed in the 1980s because, until recently, business investment in plant and equipment was incredibly strong. Adjusted for the business cycle, business investment was stronger from 1981 to 1985 than it had been since the transition to a peacetime economy in the late 1940s.

This phenomenon of strong investment, productivity and output growth, however, did not occur abroad. Manufacturing output growth in the 23 other industrial nations making up the Organization for Economic Cooperation and Development, the OECD, showed little acceleration in 1980 to 1985 from its relatively stagnant 1.3 percent rate in 1973-80.

When one looks at investment, the reason for the slow relative growth of productivity and output is fairly obvious. OECD data on gross fixed capital formation show that investment declined throughout the world in the early 1980s and that few countries had been able to regain their 1980 pace of real investment by 1985. Among those few, the United States was the leader, investing 21.6 percent more than in 1980. Next was Japan which, in 1985, invested 15.1 percent more than in 1980. Italy did not achieve its 1980 pace until 1986; Germany and France did not until mid-1987. Not surprisingly, the ranking of U.S. manufacturing output growth climbed from near the bottom among industrial nations in the 1970s to nearly the fastest pace in the 1980s.

How could this be? How come the facts are so much at odds with popular perceptions about trade and competitiveness? The missing link is the understanding that our imports of goods can rise, or our exports can fall, while domestic production of these internationally-traded goods rises; it is not necessary that our production of such goods declines when the trade deficit rises. Improvements in U.S. productivity have meant rising U.S. income relative to the income of our trading partners. Our productivity advances in producing internationally traded goods lowered their relative prices and redistributed income toward the United States. Lower prices and higher incomes allowed U.S. consumption of traded goods to boom. While imports rose, U.S. production of import-competing goods also rose sharply. Imports rose to meet booming U.S. purchases, not to replace declining output. Similarly, while exports fell, production of these goods generally did not decline. Goods that formerly would have been produced for export were redirected to meet the increased demands of U.S. purchasers. Sure there are exceptions, like farm equipment or some other items, but generally the decline in exports did not mean declining U.S. production.

How, then, does monetary policy fit into this discussion? The developments we just talked about suggest that the link between movements in the value of the dollar and U.S. competitiveness has been opposite to the popular view. The rise in the value of the dollar did not retard U.S. competitiveness; instead, it reflected the resurgence of U.S. productivity. The dollar rose because the supply of dollars for international transactions was diverted to investment in the United States. This investment raised U.S. productivity; the value of foreign currencies had to fall so that foreign goods could remain competitively priced with U.S. goods in international markets. This experience should raise doubts about whether U.S. competitiveness requires boosting. It also raises doubts about whether policy efforts to do so by lowering the value of the dollar would work.

The existence of a link between monetary policy actions and the international exchange value of the dollar is well established in economic theory and in statistical evidence. Simply put, a rise in the growth rate of U.S. monetary aggregates tends to reduce the exchange value of the dollar. On the domestic front, this means a rise in inflation; internationally, the counterpart is a more rapid rate of decline in the exchange value of the dollar against foreign currencies. Thus, the conventional view requires that the Fed inflate to raise "competitiveness," which indeed does not seem like a desirable outcome. We can go a step further, however: inflating the currency to lower the value of the dollar does not boost U.S. competitiveness either.

Policies aimed at lowering the value of the dollar in fact, and inevitably, lower U.S. competitiveness. The higher inflation which results raises taxes and the cost of capital for business. Increased capital costs, in turn, reduce investment incentives and domestic productivity. Lower productivity raises the cost of U.S. output relative to our competitors and reduces both our ability to compete and the U.S. share of world markets.

Monetary policy influences many facets of our complex economy. In the long run, however, about all a central bank can influence is the value of the country's money in terms of the goods it will buy. Central banks can't produce resources; they don't discover the new products, new technology, or new managerial practices that influence a nation's competitiveness. A responsible monetary policy aims at domestic price stability. This is ultimately the only valuable social outcome that a central bank can achieve. I believe that the pursuit of this goal furthers the nation's competitiveness, despite the fact that its single-minded pursuit can raise the exchange value of the dollar. Such appreciation reflects a strong economy, not one that is losing its ability to compete.

There is other recent evidence of these linkages between monetary policy, the dollar and international competitiveness besides the 1980-85 experience. From mid-1976 to mid-1980, money growth had been quite rapid and the value of the dollar fell sharply; inflation surged up from about 5 percent in 1976 to double-digit levels by 1980. Despite a declining dollar, however, U.S. investment and the nation's productivity and output growth stagnated, relative to both our own previous history and to the performance of our major competitors.

Another episode began in early 1985 when money growth jumped to double-digits and, not coincidentally, the value of the dollar began to plummet. A falling currency, however, reflected the worsening of U.S. inflation expectations and the associated worsening outlook for investment, productivity and output growth. It did not signal an improvement in U.S. competitiveness, but just the reverse. Business fixed investment declined sharply from the end of 1985 until mid-1987, despite the emergence of a cyclical boom in output and employment. It is also not surprising that productivity growth plummeted. From early 1986 to the present, output per hour in the business sector has risen at only a 0.4 percent annual rate, about what it did in the 1970s when U.S. competitiveness more genuinely seemed to be a risk. This is a relatively sharp slowing from the 1.6 percent growth rate of productivity from 1980 to 1985.

Since early 1987, the growth rate of M1 has slowed. Not surprisingly, the value of the dollar stopped falling, and, since early 1988, has generally moved higher. Some analysts have cursed the slight improvement in the value of the dollar as threatening U.S. competitiveness. If the past is any guide, however, this view is likely to prove wrong.

In conclusion, I believe that U.S. competitiveness has improved markedly in this decade, especially from 1980 to 1985. Thus, I do not believe that monetary policy needs to focus more narrowly on competitiveness; it doesn't appear to require any special boosting. More importantly, I believe the policy strategy often proposed for boosting competitiveness is wrong. That strategy--lowering the dollar's international exchange value--requires an accelerated and inflationary pace of monetary aggregate growth which would be counterproductive. Inflationary policy invariably has proven to retard productive investment and, thereby, has retarded the growth of productivity, output and our standard of living.

On the contrary, policy should, I believe, focus on the long-term goal of price stability. Such policy, by holding inflation to a minimum, also promotes economic growth and competitiveness. A rising value of the dollar can more easily occur under such a policy, but this is not a shortcoming. Instead, it would be a reflection of the rising value that foreign and domestic money holders place on well-managed monetary assets and a reflection of the increased competitiveness of the U.S. economy.

Competitiveness is a worthy goal. But, like many other worthy goals, it is best pursued by first getting the basics right. When it comes to monetary policy, getting the basics right means providing a stable and noninflationary pace of growth of monetary aggregates. If the Fed does this, it will be doing all it can do to maximize U.S. competitiveness.