

"U.S. COMPETITIVENESS AND MONETARY POLICY"

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Federal Reserve monetary policy actions have profound effects--sometimes for good, sometimes for ill--on our lives. In search of the hoped-for good effects, people often plead for, even demand, policy actions that they believe will benefit them, at least in the short run. Unfortunately, some of these demands, if actually met, can have pernicious longer-run effects, not only on them, but on the rest of us as well.

One example of such well-intentioned, but misguided pressure on the Federal Reserve stems from widespread concern that this nation's international competitive position has been dangerously weakened in the 1980s and that the Federal Reserve ought to do something about it. The standard story is that the rising value of the dollar from 1980 to 1985 undermined U.S. competitiveness; our goods became too expensive for foreigners, while foreign goods became too cheap for U.S. consumers to resist. What can the Fed do about this? The presumed solution, according to conventional public wisdom, is for monetary policy to drive down the dollar's exchange value and, thus, reverse our weakening competitive position.

Now, what's wrong with this picture? I hope to convince you this afternoon that the presumed problem and the purported solution are both, quite simply, dead-wrong. First, despite popular clamor to the contrary, our ability to compete, both domestically and internationally, has not declined substantially during this decade. Second, deliberately pursuing monetary policy actions intended to drive down the value of the dollar would be disastrous for this nation.

Consider, first, the claim that we have become less competitive, even uncompetitive, at home and abroad. International competitiveness is a term that gets tossed around casually, but is actually difficult to define when the discussion gets down to specifics. Some people think competitiveness can be judged by comparing the current value of the dollar with the level that would achieve something called "purchasing power parity;" this is a situation where goods cost about the same in all countries. Other people look at the share of imports or exports compared to the domestic market, as in the case of steel or autos, or at the share of U.S. trade to world trade, as in the case of corn or other farm commodities. Still others focus just on the amount or growth of U.S. exports and imports, or on the pace of innovation of new goods and services, or on other things.

Which measure of U.S. competitiveness can we can look at to see how we are doing relative to the rest of the world? It turns out that, while discussions and disagreements about the "best" measure of international competitiveness might be interesting at times, we shouldn't let them distract us from what we are really concerned with. There has to be a simple, clear-cut "bottom line" comparison that transcends all possible quibbles about definitions. And there is one that, I think, we can all agree on.

If we have really lost our competitiveness, however defined, then our economic performance should have gotten worse; worse relative to our own past and worse relative to that of other nations--especially those who supposedly have gained competitiveness at our expense. What can we look at for this bottom line comparison? A nation's performance is generally measured by what is happening to its productivity and output

growth. Thus, our record in these areas, stacked up against those of other nations, should tell us what has happened to our international competitiveness.

Let's, then, look at what really happened in the 1980s. As you know, from mid-1980 to early 1985, the foreign exchange value of the dollar skyrocketed and, about the same time, our trade deficit mushroomed. These two developments often are cited as proof positive that our competitiveness was eroded. The rise in imports and fall in exports are assumed to prove that U.S. production fell and that foreign production was spurred upwards. Given this picture, our productivity must have declined relative to our foreign competitors.

As convincing as this argument must seem, nothing could actually be further from the truth! A recent study completed at our Bank shows that, in fact, the United States has 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, the average annual growth of output in those industries together was about 5 percent from 1980 to 1985; this growth was more than twice the growth rate of other manufacturing industries or, for that matter, the rest of the economy as a whole. Moreover, this represented a remarkable change from the 1970s, when these same five industries, like the rest of manufacturing, grew at a dismal 1 percent annual rate, less than half the overall GNP growth rate.

Underlying the rapidly expanding output in these five industries was a rebirth of U.S. productivity growth in general. While productivity had been stagnant in the 1970s, it surged in the 1980s, especially in manufacturing, where it rose nearly five times faster than it had in the 1970s.

U.S. 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 late 1940s.

Moreover, this phenomenon of strong investment, productivity and output growth was virtually unique to the United States. Manufacturing output growth in the 23 other industrial nations making up the Organization for Economic Cooperation and Development, the OECD, was nearly the same from 1980 to 1985 as its relatively stagnant 1.3 percent growth rate in the 1970s.

When you look at where the investment was taking place, the reason for the slow relative growth of productivity and output abroad is fairly obvious. Investment declined throughout the world in the early 1980s to such an extent that few countries were able to regain their 1980 pace of real investment by 1985. Among those few that did, the United States was the clear leader, investing 21.6 percent more in 1985 than it had in 1980. Next came 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. It is no surprise that U.S. manufacturing output growth climbed from near the bottom among industrial nations in the 1970s to close to the top in the 1980s.

If this is true, why are the facts 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 simply not true that our production of internationally-traded goods must decline when our 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, then, 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 some exceptions, like farm equipment or some other items; generally, however, 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—both in theory and in practice. Simply put, faster U.S. money growth tends to reduce the dollar's value. At home, faster U.S. money growth inevitably means a rise in U.S. inflation; internationally, it means a faster drop in the dollar's value against foreign currencies.

Now, asking the Fed to push up inflation just to raise U.S. "competitiveness" somewhat doesn't seem like a good idea—even if it would work. However, the notion that we can trade off some more inflation for some more competitiveness is a mirage. Inflating the currency to lower the value of the dollar does not boost U.S. competitiveness. Instead, it inevitably lowers it. Higher inflation raises taxes and pushes up 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 our 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 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. And the higher value of the dollar brought about by stable monetary policy reflects a strong economy, not one that is losing its ability to compete.

There is considerable evidence of these linkages between monetary policy, the dollar and international competitiveness besides the 1980-85 experience that I just discussed. For example, money growth was quite rapid from mid-1976 to mid-1980; in response, the value of the dollar fell sharply, while inflation surged up from 5 percent in 1976 to double-digit levels by 1980. Yet, during this period, U.S. investment, productivity growth and output growth all stagnated relative to historical trends and relative to our major foreign competitors.

Again, in early 1985, money growth surged and the value of the dollar began to plummet. The falling currency, however, did not signal an improvement in U.S. competitiveness. Instead, business fixed investment declined sharply from the end of 1985 until mid-1987, despite the emergence of a cyclical boom in output and employment. And, productivity growth plummeted to less than one-half of one percent, about one-quarter of its growth 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 argued that the slight improvement in the value of the dollar is, once again, threatening U.S. competitiveness. If the past is any guide, however, this view is "flat-out" wrong.

So, what's the bottom line on monetary policy and U.S. competitiveness? U.S. competitiveness has improved markedly in this decade, especially from 1980 to 1985. Neither monetary policy nor monetary policymakers need to focus specifically on U.S. competitiveness; it doesn't seem to require any special boost. More importantly, the policy strategy often proposed for boosting competitiveness is dead wrong. A strategy of lowering the dollar's international exchange value requires accelerated and inflationary monetary aggregate growth; such a policy would be counterproductive. Inflationary policy invariably has reduced productive investment and retarded the growth of productivity, output and our standard of living.

On the contrary, I believe that monetary policy should focus on the long-term goal of price stability. Only this policy, by holding inflation to a minimum, also promotes economic growth and competitiveness. While a rise in the dollar's value can occur under such a policy, this is not a shortcoming of the policy. Instead, it reflects the rising value that foreign and domestic money holders place on well-managed monetary assets and the increased competitiveness of the U.S. economy.

Competitiveness is a worthy goal. But, like all worthy goals, you can't achieve it unless you get the "basics" right first. When it comes to monetary policy, getting the basics right means providing stable and noninflationary growth in the monetary aggregates. If the Fed does this, it will be doing the best it can do to maximize our competitiveness.