

"U.S. COMPETITIVENESS AND MONETARY POLICY"

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

One example of this is the well-intentioned, but misguided pressure on the Federal Reserve to do something about this nation's international competitive position, which many believe has been dangerously weakened in the 1980s. The standard line 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? According to conventional wisdom, we can use monetary policy to drive down the dollar's exchange value and thereby reverse our weakening competitive position.

I hope to convince you this afternoon that not only is this conventional wisdom about the solution wrong, but also that there isn't a problem in the first place! Despite much press to the contrary, our ability to compete, both domestically and internationally, has not declined substantially during this decade. Furthermore, deliberately pursuing monetary policy actions intended to drive down the value of the dollar would be disastrous.

Let's consider, first, the claim that we have become less competitive. International competitiveness is a term that gets tossed around casually, but is actually difficult to pin down when the discussion gets specific. Some people think competitiveness can be judged by comparing the dollar's current value with the level that would achieve so-called "purchasing power parity;" this is a situation in which goods cost about the same in all countries. Other people look at how much we import or export compared to the size of the domestic market, as in the case of steel or autos, or how much we trade compared to world trade, as in the case of corn or other farm commodities. Still others focus only on the amount or growth of U.S. exports and imports, or on the pace of innovation of new goods and services.

Which measure of U.S. competitiveness should we look at? It turns out that, while disagreements about the "best" measure of international competitiveness might be interesting at times, we shouldn't let them distract us. There has to be a simple, clear-cut "bottom-line" comparison that transcends all quibbles about definitions. And there is one that, I think, we can all agree on.

If we have really lost our competitiveness, our economic performance should have gotten worse: worse than our own past and worse relative to that of other nations--especially those who supposedly have gained competitiveness at our expense. Where can we look 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 a great deal about our international competitiveness.

Let's look, then, 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, at about the same time, our trade deficit mushroomed. These two developments often are cited as proof positive that our competitiveness eroded. Imports rose and exports fell, presumably proving that U.S. production fell while foreign production was spurred upward. Given this picture, our productivity must have declined relative to our foreign competitors.

As convincing as this argument must seem, nothing could 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, more than twice the growth rate of other manufacturing industries or, for that matter, of the economy as a whole. Moreover, this was a remarkable change from the 1970s, when these same five industries, like the rest of manufacturing, grew at a dismal 1 percent annual rate.

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

The real key to the booming U.S. productivity and output growth in the 1980s was investment in plant and equipment which, until recently, was incredibly strong. Adjusted for the business cycle, business investment was stronger from 1981 to 1985 than it had been since the late 1940s.

Meanwhile, in the rest of the world, investment declined to such an extent in the early 1980s 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, 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.

Why, then, are the facts so much at odds with popular perceptions about trade and competitiveness? The missing link is the understanding that our imports 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 these goods must decline when our trade deficit rises. Improvements in U.S. productivity have meant that U.S. income was rising faster than that of our trading partners. Our productivity advances in manufacturing internationally-traded goods lowered the relative prices of these goods and redistributed income toward the United States. Lower prices and higher incomes allowed U.S. consumption of traded goods to boom. As imports rose, U.S. production of import-competing goods also rose sharply. Imports rose, then, to meet the booming demands of U.S. purchasers, not to replace declining output.

Likewise, while exports fell, the 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. There are some exceptions, of course, like farm equipment; in general, however, the decline in exports did not translate into declining U.S. production.

This experience should raise doubts about whether we need to boost U.S. competitiveness. It also raises doubts about whether lowering the value of the dollar is an appropriate way to do it, inasmuch as the dollar's rise in the early 1980s apparently did not adversely affect U.S. competitiveness. The existence of a link between the international exchange value of the dollar and monetary policy actions 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 means a rise in U.S. inflation; internationally, it means a faster drop in the dollar's value against foreign currencies.

But, asking the Fed to push up inflation just to raise U.S. competitiveness doesn't seem like a good idea--even if it would work. In fact, the notion that we can trade off a little more inflation for a little 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.

The 1980-85 experience confirms these linkages between monetary policy, which was generally restrictive during that period, the dollar and international competitiveness. And there is further evidence of such linkages as well. 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 from 5 percent in 1976 to double-digit levels by 1980. During this period, U.S. investment, productivity growth and output growth all stagnated compared to historical trends and compared 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 a 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 U.S. competitiveness and monetary policy? Our 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 strategy

often proposed to boost competitiveness is wrong. A strategy of lowering the dollar's international exchange value requires accelerated and inflationary monetary growth; such a policy is counterproductive in the long run. Inflationary policy invariably has reduced investment and retarded the growth of productivity, output and our standard of living.

Instead, I believe that monetary policy should focus on the long-term goal of price stability. Only this policy--of holding inflation to a minimum--promotes both economic growth and competitiveness. While a rise in the dollar's value can occur under such a policy, this is not a shortcoming. Rather, it reflects both 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 ensure our competitiveness.