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# FRBSF WEEKLY LETTER

August 10, 1985

## A Monetary Cure for the High Dollar?

It is now quite clear that the current economic expansion's initial rapid pace stopped in mid-1984. From the third quarter of 1984 through the second quarter of 1985, real GNP grew at an annual average rate of less than 2 percent — far below the average 7 percent growth in the first six quarters of the recovery that began at the end of 1982. The overall slowdown in the economy has caused some observers to call for a more expansionary monetary policy.

To evaluate this recommendation, it is important to realize that the economic slowdown is not evenly distributed across sectors. Those sectors largely insulated from foreign competition (such as housing, the service industry, and industries with important defense business) are booming, whereas sectors such as mining, agriculture and most manufacturers show little or no growth. The cause of this disparity is the high value of the dollar in the foreign exchanges. This *Letter* evaluates the likely effects of a more expansionary U.S. monetary policy in the context of imbalances created by a strong dollar.

### The high dollar

Many analysts attribute the overall strength of the dollar since 1980 mainly to the increasing federal government budget deficit. The federal deficit grew from \$58 billion in 1981 to \$110 billion in 1982, and further to \$195 billion in 1983. Since then, it has leveled off at roughly \$200 billion.

In a closed economy (one without trade and financial linkages to other, foreign economies), the fiscal stimulus to aggregate demand coming from an increased budget deficit would lead to higher real, or inflation-adjusted, interest rates and, assuming some economic slack, an expansion of real output and employment. Higher real interest rates, however, would serve to offset some of the fiscal stimulus by "crowding out" business and household expenditures that are sensitive to higher interest rates. Housing, business plant and equipment, and consumer durables are the sectors traditionally hit hard by high real interest rates in a closed economy.

In an open economy (one with extensive trade and financial ties to the rest of the world) with flexible exchange rates, a fiscal stimulus and associated higher government credit demands do not necessarily lead to crowding out of domestic interest-sensitive sectors. Instead, upward pressures on interest rates are likely to attract foreign capital into the country and cause the country's exchange rate to appreciate. The recent U.S. experience fits this paradigm.

Of course, factors other than the federal fiscal stimulus probably played some role in the appreciation of the dollar. Among those commonly pointed out are the perception of the U.S. as a safe investment haven and optimistic growth prospects for the U.S. economy compared to those for most other nations.

### The impact of the high dollar

Regardless of which factors have played the dominant role, the appreciation of the dollar has allowed foreign producers to improve their competitive position in the U.S. by cutting their dollar prices while still reaping higher profits in terms of their own currencies. At the same time, the price of U.S. goods abroad has increased. The result is that U.S. producers that compete with imports or that export their goods have found their position deteriorating in relation to their foreign competitors. Consequently, U.S. industries that produce goods that can be exported or imported relatively easily, and hence are exposed to foreign competition — the so-called "tradeable goods" industries — have contracted, or at least have not expanded at the same pace as nontradeable goods industries (such as housing and service sectors). Crowding out in the U.S. therefore has manifested itself largely in tradeable goods rather than domestic interest-sensitive sectors.

It is important to emphasize that the slowdown in U.S. tradeable goods manufactures is not a consequence of deficient aggregate demand (total purchases of goods and services). What has changed is the proportion of U.S. aggregate demand being satisfied by domestic producers. While production of U.S. goods and services has

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averaged 4.8 percent real growth per year since the end of 1982, real *domestic spending* on both domestic and foreign goods has grown faster still — at a 6.3 percent annual rate. The difference has been met by net imports. More specifically, particularly slow real GNP growth rates in the third quarter of 1983 (1.6 percent) and the first quarter of 1984 (0.3 percent) were directly attributable to surging sales of imported goods. Aggregate output, therefore, is growing slowly not because aggregate demand is sluggish, but because imports are satisfying a large share of the growth in aggregate demand.

What happens to the resources that become unemployed in the tradeable goods sector? If it were easy to move them from one industry to another, these resources would be moved rapidly to the nontradeable goods sector. In fact, resources cannot be transferred costlessly or rapidly across industries. Workers must search and obtain information about new jobs, acquire new skills and relocate. Similarly, employers must seek out new opportunities in the nontradeable sector and then set up the necessary production facilities. Thus, there will be a period of transition during which more resources than normal will remain out of use. This makes total output and employment in the economy lower than otherwise.

It is noteworthy that the loss in output and higher unemployment accompanies the recent reduction in the inflation rate — a phenomenon that has so often been vaunted as an advantage of the strong dollar. The lower inflation rate reflects little or no price change in the tradeable goods sector and continuing price hikes in the nontradeable goods sector. In the past five quarters, prices in industries such as manufacturing and mining have increased about 1 percent at an annual rate while prices in the service industries and housing have increased at around 5 percent. Thus, small price increases in the tradeable goods sector actually represent a situation in which the price of tradeable commodities has been *falling* relative to the prices of nontradeable goods. This decline then sets up a reallocation of resources, with its attendant dislocations discussed above.

## **The implications of increasing money growth**

Against this backdrop, what would be the likely effects of a significant monetary expansion in the near future? The answer depends upon how markets interpret the monetary authority's actions.

If financial markets perceive the monetary expansion to be a short-term measure, that is, if they are convinced that the Fed is still concerned about inflation, the dollar is not likely to fall by much. If markets believe that the increased money growth signals increased concern about reviving a temporarily lagging economy, however, the dollar is likely to decline sharply.

Consider what may happen to real GNP growth in the face of monetary expansion if the dollar does not decline sharply. What effect will the increased aggregate demand have on domestic tradeable goods industries? A high dollar continues to make it cheaper to buy the same commodities from abroad. Therefore, to the extent that the increase in money growth increases the domestic demand for tradeable goods, this demand is likely to be satisfied largely by foreign producers, and imports will rise. It is not clear how large the increase in domestic tradeables production will be.

Developments over the last three quarters provide some evidence on this issue. The level of industrial production — consisting largely of tradeable goods — has increased only about 1 percent from November 1984 to June 1985. At the same time, money has been expanding at a rapid rate. M1 grew at an annual rate above 11 percent from the fourth quarter of 1984 to June of this year. Even allowing for lags in the effects of money growth on output and the recent decline in velocity (the speed at which money circulates in the economy), the small response of industrial production has surprised many observers.

If the tradeable goods sector is unlikely to respond significantly to a monetary stimulus perceived as temporary, it is reasonable to ask whether the nontradeable goods sector will grow fast enough to compensate, i.e., fast enough to keep aggregate unemployment from rising. How quickly the nontradeable goods sector can expand without setting off inflation is likely to depend upon how quickly unemployed resources in the tradeable goods industries can be transferred to the nontradeable goods. This will not happen quickly. In the short-term, increasing aggregate demand is likely to lead to rising nontradeable goods prices with only modest rises in output. For the economy as a whole, this suggests that the rate of unemployment would not drop significantly while the rate of inflation would increase. Evidence cited above indicates that the nontradeable goods sector in the

## MONETARY POLICY OBJECTIVES FOR 1985 AND 1986

On July 17, Federal Reserve Board Chairman Paul Volcker presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1985 and proposals for 1986. The report reviews economic and financial developments in 1985 and presents the economic outlook heading into 1986. Single or multiple copies of the report can be obtained by request from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120. Phone (415) 974-2246.

U.S. economy is already expanding somewhat faster than is consistent with stable prices.

Now, what happens in the case where the dollar does decline sharply due to monetary expansion? Obviously, domestic tradeable goods industries will become more competitive. However, conditions in the tradeable goods sector will not improve immediately because the volume of imports and exports reacts to changes in prices with a lag. Furthermore, it takes time to re-start factories and redeploy workers to increase domestic output of tradeable goods significantly.

Gradually, imports will begin to decrease and exports to increase as the effects of the lower real exchange rate make themselves felt. However, as the higher growth rate of money persists, another factor comes into play — domestic prices begin to rise. Thus, the real value of the dollar (which is the nominal value adjusted for the price level) will increase again. Given the prevailing nominal exchange rate, rising U.S. prices *relative* to foreign prices make it favorable for American consumers to purchase tradeable goods from abroad once more. That is the reason monetary theory suggests that although the nominal value of the dollar exchange rate would be permanently lower following a monetary stimulus, the real value of the dollar — and the corresponding improvement in U.S. international price competitiveness — would eventually return to its former level.

### Longer term policy considerations

For the short-run, the analysis above implies that raising the rate of growth of the money supply is not likely to be very beneficial. Because it is not obvious that prevailing conditions in industries such as manufacturing and mining are the result of deficient aggregate demand, it is not clear how much remedies used to address a deficiency of

aggregate demand can accomplish. As the monetary expansion continues at an increased rate, the dollar will most likely fall, perhaps quite dramatically. But, as discussed above, any drop in the real value of the dollar induced by monetary expansion will likely only be temporary. The efficacy of monetary expansion then depends upon how long the factors responsible for the high dollar are expected to prevail.

There is considerable uncertainty about whether the factors underlying the strength of the dollar are of a temporary or permanent nature. If policy-makers believe that these factors are likely to be shortlived, then more expansionary monetary policy would be appropriate. Such a policy would slow the shift in resources from the tradeable goods sector to the nontradeable goods sector, and would also help avoid the costs of the reverse adjustment that would become necessary when the real value of the dollar declined at some future point (e.g., when the federal budget deficits decline). This saving in resource costs may well outweigh the short-term costs, such as higher inflation, discussed above.

If the factors responsible for the high dollar have a large long-term component (e.g., continued large U.S. budget deficits or the perception of the U.S. as a safe haven for foreign investments), then the costs of a decrease in the real value of the dollar induced by monetary expansion are likely to outweigh the gain. The gain is the short-term increase in output, which lasts only until the real value of the dollar returns to its original level. The losses consist of new inflationary pressures and the probability that monetary policy would be hindering the adjustment of resources necessitated by the strong dollar.

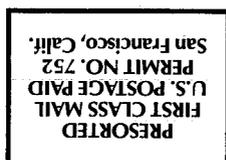
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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from	Change from
Large Commercial Banks	7/24/85	7/17/85	Dollar	Percent <sup>7</sup>
Loans, Leases and Investments <sup>1 2</sup>	191,990	- 519	10,437	5.7
Loans and Leases <sup>1 6</sup>	173,780	- 380	11,196	6.8
Commercial and Industrial	51,281	- 366	1,335	2.6
Real estate	63,615	- 27	2,975	4.9
Loans to Individuals	34,956	145	6,145	21.3
Leases	5,390	1	374	7.4
U.S. Treasury and Agency Securities <sup>2</sup>	11,403	- 119	- 552	- 4.6
Other Securities <sup>2</sup>	6,807	- 21	- 206	- 2.9
Total Deposits	195,212	- 2,218	9,020	4.8
Demand Deposits	44,871	- 1,975	2,713	6.4
Demand Deposits Adjusted <sup>3</sup>	30,128	- 1,234	2,024	7.2
Other Transaction Balances <sup>4</sup>	13,574	- 244	1,491	12.3
Total Non-Transaction Balances <sup>6</sup>	136,766	1	4,814	3.6
Money Market Deposit				
Accounts—Total	44,884	56	6,895	18.1
Time Deposits in Amounts of				
\$100,000 or more	37,696	50	- 2,886	- 7.1
Other Liabilities for Borrowed Money <sup>5</sup>	21,277	- 2,631	1,740	8.9
<b>Two Week Averages</b>	Period ended	Period ended		
<b>of Daily Figures</b>	7/15/85	7/1/85		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (-)	55	21		
Borrowings	106	91		
Net free reserves (+)/Net borrowed(-)	- 51	- 69		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change