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U.S. Monetary Policy in an Integrating World: Discussion

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Richard Cooper and Jane Little have produced an illuminating survey of the influence of international developments on U.S. monetary policy, including regulatory policy. It is a fitting tribute to Frank Morris, who had a keen interest in international economic issues. As a former international economist with the Federal Reserve Bank of Boston, I was gratified to discover that my area of concern seems to have weighed more heavily in the deliberations of the Board of Governors and the FOMC than I had suspected.

Their analysis begins with an examination of the extent to which the U.S. economy has become more open to the rest of the world over the past four decades. As they demonstrate, our international trade and capital transactions have increased substantially in relation to our domestic output and financing. For an even more comprehensive view, it would be helpful to know how the pattern of labor immigration has changed over this period. As the authors note, the import of goods and capital from abroad has helped to restrain inflation in this country, and surely the recent influx of workers, both permanent and temporary residents, has had the same effect.

The authors adopt the conventional definition of openness, measuring international transactions in relation to domestic, and they conclude, correctly in my view, that the U.S. economy has become much more open. From another perspective, if we define openness as the absence of barriers to international commerce, we should recognize that a highly open economy could conceivably carry on very little such commerce, if it

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had much the same tastes, techniques, and resource endowments as the rest of the world (so that its relative prices differed little from those abroad in the absence of trade). From this perspective, a revealing measure of openness would be how rapidly and thoroughly any changes in specific prices (adjusted for changes in exchange rates) were transmitted across boundaries.

In their interesting study of the influence of international considerations on the Fed's monetary policy decisions, the authors found that international considerations influenced those decisions from the beginning of the forty-year period they investigated. This is not surprising, because during the early 1960s controls such as Buy American and the tying of foreign aid were being initiated or intensified for balance of payments reasons. Indeed, President Kennedy became so concerned about the "dollar outflow" that his Administration began to compile a "gold budget" that recorded payments to and receipts from foreign residents under various government programs, with a view to reducing the payments and increasing the receipts (Fieleke 1969). Apparently the Fed shared his concern.

Although monetary policy, with a bit of luck, has been remarkably successful in recent years, it still seems ill-equipped to cope with some potential international economic threats to our prosperity. We have had a sample of one such threat recently, a moderate oil supply shock. The OECD recently estimated that a $10 per barrel increase from the level assumed in its base forecast would reduce growth in the advanced economies by about one-quarter percentage point and raise overall prices by about one-half percentage point. Twenty-five years ago such oil price increases had a much greater impact, but the advanced economies now use only half as much oil per dollar of GDP as they did in the early 1970s. And even with the recent increases, the price of oil, adjusted for overall inflation, remains far below its level in 1980. (See *The Economist* 2000.)

But in the past economic projections have underestimated the impact of oil shocks, and a fairly modest intensification of the current shock could well pose a stronger challenge than the OECD's numbers suggest. In principle, a tight monetary policy could prevent any surge in the general price level. But because many prices and wages are far from perfectly flexible, especially in a downward direction, such a policy would generate a rather unpalatable increase in unemployment, even if temporary in nature. Thus the Fed, confronted with such shocks, must find an uneasy compromise between its goals of price stability and maximum employment, and it must trust to such devices as the strategic petroleum reserve to mitigate its dilemma.

Another potential international economic threat that may prove frustrating to our monetary policymakers is our large and persistent current account deficit. In the short term, this deficit has been highly salutary for our economy, as net imports have provided resources to help

prevent the bottlenecks and accelerating inflation that might otherwise have overtaken our record-breaking expansion. The concern is directed at the longer term.

This year the deficit is expected to amount to more than $400 billion, equal to more than 4 percent of our GDP—both record numbers. The accumulation of such deficits over the years has increased our net indebtedness to the rest of the world to an estimated $1.9 trillion, or roughly 20 percent of our GDP, by the end of this year (Obstfeld and Rogoff 2000, p. 23). This rapidly growing indebtedness has provoked much speculation over how long the trend can continue and the conditions under which it might be halted.

That the trend must be halted is one of the relatively few certitudes we have in economics. No nation can increase its net foreign indebtedness relative to its GDP without limit. One of the first empirical investigations of this issue may have been a study I did in 1982, which covered fourteen industrial countries for which data were available for the period 1952 to 1980. Over these twenty-nine years, none of these countries accumulated a net current account deficit that amounted to more than 1.6 times its 1980 gross national saving, signifying that the nations with that ratio—Denmark and Ireland, both relatively small—could pay back that accumulated debt with approximately 1.5 years' savings (Fieleke 1982, p. 10). At the end of 1999, U.S. net indebtedness (on a market value basis) amounted to 0.85 times the nation's gross saving.

More recent studies report that ratios of external debt to GDP have risen to 40 to 50 percent or more for a number of OECD countries during the 1990s, well above the 20 percent cited for the United States. But as Obstfeld and Rogoff note (2000, p. 24), the United States looms much larger in the world economy than these countries and has a substantially smaller share of its production devoted to the sector (tradable goods) that could readily contribute to reducing the deficit. Thus, it is not too early for U.S. policymakers to consider measures that might ease the inevitable adjustment, that is, avert a "hard landing" in which net lending to this country abruptly plummets, causing the dollar to plunge in the foreign exchanges and U.S. real interest rates to soar. Such a scenario could be triggered by a number of events, such as a collapse in the U.S. stock market or fears of a U.S. recession, combined with mounting concern among investors over the nation's heightened indebtedness and the rising share of U.S. securities in their portfolios.

Fundamentally, the adjustment will require that the nation raise its saving relative to its domestic investment, so that less of its investment is financed by borrowing from abroad. Some years ago many of us thought that reducing the deficit, or net borrowing, of the federal government would help, but as the government has become a net saver the household sector has decreased its saving. Unfortunately, economists have no

sure-fire prescriptions for raising private saving in our free market economy.

If macroeconomic fiscal policy has made its contribution (which could be short-lived) to closing the gap between U.S. saving and domestic investment, what might the Fed's contribution be? Among other things, Cooper and Little suggest open market operations in foreign securities, which I take to be equivalent to unsterilized foreign exchange market intervention, as well as sterilized intervention (pp. 113–15). But as they recognize (p. 91), sterilized intervention seems to be rather ineffectual (although it might have more success in bolstering the euro against the dollar if unaccompanied by U.S. Treasury assertions favoring a strong dollar). Similarly, they recognize that open market operations might also prove unsatisfactory in easing our balance of payments adjustment (pp. 112–13). To amplify this caveat, econometric modeling commonly suggests that a change in U.S. monetary policy has little impact on the current account balance. A tightening, for example, reduces U.S. aggregate demand, which tends to improve the trade balance, but it also typically induces dollar appreciation, which tends to worsen the balance, with little net result. Of course, the Fed could tighten enough to generate a recession, during which the current account usually improves. However, the improvement would endure merely during the recession, and recessions are among the least favored of the Fed's options.

In sum, it seems that monetary policy has little to contribute to current account adjustment in the prevailing environment beyond occasional attempts to signal through foreign exchange intervention, perhaps accompanied by warnings to international investors against irrational exuberance.

Cooper and Little note that the Fed has a "purely domestic mandate," that is, to promote "maximum employment, price stability and moderate, long-term interest rates" within the United States (p. 1). Beyond this mandate, Fed and other U.S. officials do take influential policy positions on international monetary issues, such as reform of the "international financial architecture," and they also contribute to the deliberations of international monetary organizations such as the International Monetary Fund and the Bank for International Settlements. From this broader perspective, one might ask, what should be the U.S. position on "dollarization," that is, the adoption by other countries of the dollar as their currency or as their reserve currency to be held by a currency board?

While the formation of the European Monetary Union could be expected to diminish the international influence of U.S. monetary policy, the recent trend toward dollarization would tend to enhance it. As more countries became dollarized, the Fed would surely give more weight in its policy decisions to economic conditions in those countries, because one consequence of dollarization would be to knit the U.S. economy and the dollarized ones more closely together. The Fed might also expect

pressure to serve as a lender of last resort to such countries. If the trend toward dollarization continues, issues such as these will assume a more prominent position on the Fed's agenda.

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