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Short-Term Achievements and Long-Term Problems

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It is a great pleasure to appear again before this committee. The committee, has long advocated and worked for a more responsible budget position. The Chairman has co-sponsored an excellent proposal for tax reform that would strengthen the economy and raise standards of living permanently by encouraging saving and investment. The focus of that reform is long-term. I believe that is the proper focus and, as I will comment presently, if we are going to solve our major economic problems, we must focus on the long-term.

Currently the economy enjoys robust growth with low inflation. Growth of employment is strong. Productivity has increased. The budget deficit has fallen.

The administration crows like a cock about these achievements and takes credit for them. It is understandable that they would do so. Anyone of us might be tempted to do the same if we had the opportunity.

They are, nevertheless, wrong to do so. Their major economic achievement has been in trade policy -- their support for Congressional action to approve NAFTA and GATT. Both will have a long-term benefit and, I believe, NAFTA contributed to the growth of exports and output in 1994. But the main contribution of NAFTA and GATT is to future living standards.

The administration's discussion of fiscal policy is entirely focused on the short-run. They make the economically absurd argument that raising tax rates stimulated the economy by reducing the deficit. An economics student who gave that answer would fail elementary economics. It is both sad and disgraceful that the Council of Economic Advisors has become so politicized that it endorses this incredible
The robust recovery came despite, not because of, the 1993 tax increase. The administration's argument that lower interest rates stimulated the expansion is correct, but the reason long-term interest rates fell until October 1993 was the same as the reason they fell in 1991 and 1992. Federal Reserve policy -- measured by growth of bank reserves, the monetary base, or purchases of securities -- turned decisively in first quarter 1991. Rapid monetary growth continued until last winter. Rapid money growth initially lowers interest rates, stimulates spending, and encourages expansion. So it was in 1992 and, 1993. But economic growth and interest rates typically move in the same direction. When growth picked up, so did long-term interest rates. And, when money growth slowed, interest rates continued to increase both because the recovery continued and money growth slowed.

I do not want to concentrate only on these short-term matters. We all give too much attention to forecasts of what will happen next quarter or next year. It should be no secret that economists forecasts are often inaccurate. The sluggish recovery of 1991 and early 1992 led many to believe sluggish growth or a double-dip recession was in the cards for late 1992 or 1993. Instead, the economy entered a period of robust growth. Many economists predicted that the unemployment rate could not fall below 6 or 6-1/2% without inflation. Unemployment is a percentage point lower with only a 1-1/2% increase (to 1.7%) in producer prices and no change in the rate of increase of consumer prices in 1994.

It is a mistake to base policy actions on short-term forecasts. Even if we, economists, could forecast much more accurately, attention should be on a longer horizon than a year or a quarter. Long-term programs are the only way to raise living standards permanently, provide good jobs at rising wages, accumulate the resources to build better schools, offer medical care for an aging population, and contribute to the solution of other social problems. A one-half percent increase in the economy's long-term growth rate from current levels would add $27 billion of real income the first year. But if the increase is maintained, ten years from now there is an additional $350 billion to allocate to consumption investment, and social programs.
Long-term solutions depend on the economy’s ability to provide future resources. A longer-term perspective on the performance of the U.S. economy is given by the decline in the dollar. In the 23 years since President Nixon ended the fixed exchange rate system in 1971, the dollar has depreciated 65% against the German mark and about 72% against the Japanese yen. Most of the decline cannot be explained by differences in inflation, particularly in recent years. International Monetary Fund data show that the real (inflation adjusted) effective exchange rate has fallen. The dollar continued to depreciate against major currencies in 1994 despite low inflation and robust growth that typically appreciates a currency.

The most important reasons for the decline are the lower long-term expected return to investment in the U.S. compared to other countries and the gradual decline in the relative importance of the dollar as a reserve currency. I do not want to suggest that intervention is required to stop the decline. It is much better for the dollar to be allowed to depreciate, as the market demands, than for the dollar to be fixed to other currencies. Those who propose fixed exchange rates or coordinated policies to manage exchange rates never take account of the persistent decline of the dollar against the mark, the yen, or the Swiss franc. Nor do they recognize that much of the decline reflects differences in prospective real returns to investment.

The decline in the dollar is in part a measure of the market’s judgment about the prospects for U.S. growth relative to growth elsewhere. Supportive evidence comes from investment decisions of domestic and foreign investors. Through most of the 1980s, foreigners wanted to invest here and U.S. investors found attractive opportunities at home. As recently as 1988 or 1989, the net flow of private capital to the U.S. was about $100 billion a year. For 1991 to 1993, the average is about $25 billion. Since the U.S. continues to run a current account deficit, it continues to borrow substantial sums abroad. Voluntary private lending financed the borrowing in the 1980s. In the 1990s, foreign government purchases of dollars, and recently currency depreciation, have become more important. For the 3-1/2 years ending in June, foreign central banks and governments -- mainly in Europe and Asia -- financed half our net borrowing. In 1993, the share was 70%. Preliminary data for 1994 suggest we
have borrowed an additional $140 billion. Much of it came from foreign central banks.

Foreign and U.S. investors alike find more attractive opportunities abroad than at home. That leaves foreign central banks and governments three choices. They can buy dollars and increase money growth. They can let the dollar depreciate or, they can run budget surpluses and sterilize money inflows. The last choice would allow the U.S. to determine the domestic budget policy of foreign governments. Few countries will make that choice.

The remaining choices are inflation and currency appreciation abroad. Many countries have done some of each, and no doubt they will continue to do both. Countries like Argentina, Mexico or Hong Kong keep their currencies pegged to the dollar, so they buy whatever dollars come to them. Others pursue a mixed policy, choosing between faster money growth and currency appreciation. If these countries choose to avoid a new round of inflation, they will limit their purchases of dollars. Given our borrowing requirement, the dollar will depreciate over time against major currencies. The depreciation may not, probably will not, be a daily or monthly event. There will be both ups and down, but the long-term trend will continue.

This may seem to be an odd conclusion and one that runs against the popular belief that the U.S. has become more competitive. Whatever the overused term competitiveness means, higher productivity growth, corporate restructuring, NAFTA, higher growth abroad, and the real devaluation of the dollar have boosted exports and retarded imports. At some point, U.S. goods, assets and travel will be so cheap for foreigners that they will both buy more and expand investment here. And foreign goods, assets and travel will be so expensive that U.S. citizens will substantially curtail purchases and investments abroad. In the light of recent private investment decisions that, I suggest, reflect expected rates of return in the U.S. and other countries, the amount of further depreciation appears to be relatively large.

In my view, recent depreciation of the dollar is mainly a nonmonetary event. Federal Reserve policy can not correct for the real problems engendering depreciation. Raising market interest rates to support the dollar would bring a temporary appreciation that would last only until this mistaken policy brought on the
next recession. Nor can we count on problems abroad, as in Mexico recently, to have a permanent effect on capital flows.

A second, long-term problem is related to the first. The U.S. is a chronic borrower in international markets, but it is not the only borrower. In fact, the world economy has many borrowers and few large lenders. The principal lender is Japan.

U.S. policy seeks to reduce the Japanese surplus. The administration encourages -- and at times demands -- that the Japanese spend more at home so as to reduce their surplus. This is as counterproductive and short-sighted as any policy can be. A lower Japanese surplus means less Japanese lending to us. Since Japan is the world's principal net lender, higher real interest rates would result. This would reduce investment here, and elsewhere, adding to our long-term problem of improving productivity by investing more in equipment, plant, and education.

The popular, current view of Wall Street economists and perhaps others is that market interest rates have been rising mainly because of fears of inflation. There is some prospect of higher inflation in the U.S. but, in my judgment, neither current nor future inflation can account for the simultaneous rise in interest rates on long-term bonds on all world markets. A better explanation, I believe, is that real interest rates have increased this year in response to the prospective additions to demands on world capital markets from developing and recovering economies. Higher real interest rates reduce some of these demands and slow economic growth here and abroad. I do not believe that current projections for world recovery and expansion in 1995 will be realized at current real interest rates.

Growth helps to solve many of the long-term problems of the U.S. and other countries. Better jobs at higher wages will not be realized without investment in capital and education. The widening spread between high- and low-income earners, and the slow growth of median income, that arouse so much political comment, reflect mainly differences in productivity growth for different parts of the population. A lasting change in the income distribution or a lasting increase in median income will require changes in relative productivity, hopefully achieved while overall productivity increases.

Discussion in Washington mainly concerns policies that shift income around
without increasing -- and possibly reducing -- standards of living. The Clinton administration started with the usual redistributive rhetoric. The emphasis was on punishing those who earned the most in the 1980s, or taxing corporate profits and capital accumulation, while spending more for health care, welfare, and other transfer programs. Current talk in Congress and the administration is about increased family allowances or a middle class tax cut. Either of the two would stimulate consumption much more than investment. Whatever their political merits, these proposals do not address long-term problems.

To increase investment and productivity growth, the U.S. as a nation should be reallocating resources to remove the bias in favor of consumption not redistributing income. Increased real returns to investment in education and physical capital will not solve all social problems or even all our long-term economic problems. But the nation will be better able to pay for the promised social security and health benefits, to improve education, to build jails, and raise living standards if we start now to save and invest at a higher rate.

The tax program we should adopt, Mr. Chairman, is the program you have sponsored. It would tax consumption, not saving, and would raise the after-tax, expected return to capital. We should replace the income tax with a tax on consumed income, and allow new investment to be charged as an expense when it is put in place. We should begin to privatize social security, increase the retirement age at which full social security benefits are paid, reduce or repeal the corporate income tax, and increase competition in educational services.

Devolution of responsibility for some social programs to state and local governments is on its way. Devolution eliminates a layer of bureaucracy and recognizes that federal programs and federal rules have been ineffective and at times counter productive. Better programs may develop through competition between local or state governments and through experimentation. But the most costly current and prospective social programs -- social security, health care, and care of an aging population -- will not be solved in this way. These programs will require more resources, both private and public. The only way to avoid the social conflict that will
follow attempts to increase greatly the redistribution from young to old now required to pay for past promises, is to increase the resources that will be available in the future. That will require increased attention to future growth -- more saving, more domestic investment, and better quality education for more of the population. The administration has taken a short-timer's view. I hope the Congress will help them to shift their focus and extend their vision.