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Some Long-Term Problems of the American Economy

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The theme of my comments today is that many of the problems facing the U.S. economy look intractable politically and expensive in resources if we want to solve them quickly. There are two basic reasons for that conclusion. First, no one has proposed reliable, quick-acting answers for such multi-faceted problems as crime, delinquency, welfare, illiteracy, drugs, low quality education, the low saving rate, the future shortfall of social security revenues, and several others. Several of these problems will take a decade or even a generation to show substantial improvement, if such improvement ever occurs. Second, many past efforts have not succeeded but they have left behind entrenched bureaucracies and clientele who exercise veto power over any proposal that is not to their benefit. These groups often function like the most entrenched private monopolists in textbook examples of monopoly power. In a modern economy open to trade, the most durable monopolies are often those supported or developed by governments.

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 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 real returns to investment.

My main purpose in raising this issue is to suggest that 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%.

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 this 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.
The long-term trend, however, 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, 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 investment decisions that, I suggest, reflect expected rates of return in the U.S. and other countries, the amount of further depreciation would 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.

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. We encourage -- and at times demand -- that the Japanese spend more at home so as to reduce their surplus. This is as counterproductive as any policy can be. A lower Japanese surplus would mean less Japanese lending. 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 addition 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 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 growth. 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 is about increased family allowances or a middle class tax cut. Either of the two would stimulate consumption much more than investment. Whatever their merits, these proposals are inappropriate now.

To increase investment and productivity growth, the U.S. as a nation should be reallocating resources not redistributing income. Increased real returns to investment in education and physical capital will not solve all problems or even all the problems that I mentioned at the start. 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 programs we should be discussing would tax consumption, not saving, and would raise the expected return to capital. To improve our long-term prospects we should replace the income tax with a broad-based tax on spending, allow new
investment to be charged as an expense when it is put in place, privatize social
security, 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 required to pay
for past promises is to increase the resources that will be available in the future. That
will require more attention to future growth, more saving, more domestic investment,
and better quality education for more of the population.