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Greenspan's Assignment

Since the late 1960's, when economists posed the policy issue of how to assign policy instruments to reconcile potential conflicts between internal and external balance, both economic theory and economic reality have changed immeasurably. There is no longer the beguiling simple **assignment** of monetary and fiscal policy instruments that depended upon the foreign exchange regime and the state of capital mobility in which the economy operated. Forty-odd years ago, in a fixed exchange rate environment, external balance was seen to be an issue of counteracting any imbalance between imports and exports by means of an interest rate policy attainable by monetary policy (inducing offsetting short term movements of capital) while fiscal policy was to be directed toward achieving full employment (price stability?). The same theoretical apparatus directed policy makers to reverse the assignment in a floating exchange rate world. These models truncated any real treatment of policy when there was growth and there were complex motivations for the movement of capital between countries. The aggregative nature of the models used often concealed their only faint connection to the behavior of underlying economic agents. They were faulty models for policy makers, simple, no doubt, but misleading.

Fortunately for policy makers, those somewhat simple-minded Keynesian model that produced such unambiguous results have given way to a much more complex characterization of economic relationships built not so much on national income aggregates but on bottoms-up estimation of particular segments of both current and capital accounts. Capital mobility continues to provide complexity for national policy, the more so since we now observe that central banks can operate to frustrate or defer the attainment of a suitable structure of exchange rates, even in a nominally, flexible exchange rate world. Today's models are very different and much improved since both capital and growth treated explicitly and no longer ignored. Current research attempts to provide a micro-theoretic foundation for the structure of each part of the external accounts, including the expectations of economic agents, while specifying some explicit linkages between the behavior of the current account and economic growth at home and overseas. However, those improvements come at a price. The rules for policy makers have become much more complex. The policy "assignment" is now less a rule than an assessment of which parts of the "model" need policy attention. Beguiling simplicity has given way to complex assessments and policy rules are now 'man-made.'

As a result, the assessment of whether an exchange rate needs to appreciate or depreciate to rectify a payments imbalance is hotly debated. Exchange rates no longer play simple, unambiguous roles in external balance determination. The importance of that realization is that not only do policy makers in the U.S. tend to stay away from probative statements on the value of the dollar, but in fact most of them now realize that the value of the dollar is such an endogenous variable that it is generally misleading for the exchange rate to be even thought of as a policy tool. This is ever more the case when it comes to the dollar with its somewhat unique role as a reserve currency for the world.

Greenspan's speech Friday takes pains to illustrate some of the complexities facing the Fed (and its counterpart, the U.S. Treasury). What is observed is the growth of both the external payments deficit and the growth of the U.S. fiscal deficit. Linking them as "twins" suggests they have common parents, but as Greenspan takes great pains to explain, the lineage is anything but precise. His analysis begins by noting the increasingly large swings in external imbalances as globalization proceeds, lessening the 'restraints on cross-border financial flows as well as on trade in goods and services." Next, he attributes the apparent ease that the U.S. has to both excessively consume and finance the external imbalance to rising rates of U.S. productivity growth.

Rising productivity lifts real rates of return, making U.S. assets more attractive throughout the world and

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drawing savings from many different countries. Rising inflows strengthened the dollar and weakened the U.S. current account. Even with the seeming reversal of the dollar's rise, the reduction in current account imbalances has been slow, if not entirely retarded. Greenspan's analysis pivots on the behavior of gross margins experienced by foreign exporters to the U.S. First gross margins expanded; then, as the dollar declined, foreign exporters were reluctant to pass through export price changes (in dollars). Greenspan correctly notes that this profit giveaway cannot last indefinitely and that he expects that U.S. import growth will slow while U.S. export growth will rise.

What is key is that some equilibrating changes have been set into motion implicitly suggesting that if the rest of the world would begin to grow faster the rectification in the U.S. current account would proceed faster. Unfortunately, he glosses over the problem of the dollar as a superior good. If rapid growth overseas induces even larger amounts of saving, some portion of that larger savings total could well wind up as purchases of U.S. dollar assets.

One might ask why Greenspan doesn't focus on the potential development of other alternatives for holding foreign savings? In the longest of runs, if foreign asset preferences could be partly satisfied by say Euro or Yen or RMB assets, the dollar could (and undoubtedly would) depreciate more and stimulate a more rapid closing of its external imbalance. Alert readers will note, however, that the "Stock-Flow" problem inherent in this solution could well be de-stabilizing to the structure of exchange rates around the world. Asking the world to have an enlarged set of preferred savings vehicles is one thing, but a rapid conversion of existing dollar holdings into other currency assets could be very shocking to U.S. firms, consumers and the government itself, not to speak of the huge shocks to countries with export led growth policies.

Greenspan's "low pass through" model may give some hope that the ultimate adjustment of the current account imbalance can take place benignly, but Greenspan is pinning his other hopes on an adjustment in the U.S. fiscal deficit. What he wants is an increasing degree of national savings, and for aggregative economic purposes, it does not matter whether that increase comes by households saving more, firms saving more or Government dissaving less! His political economy suggests that he would much enjoy the latter, as his advocacy of PAYGO long attests. He would also like to see slower mortgage debt growth in the U.S., largely because U.S. capital markets allow rather easy conditions for tapping home equity and thereby larger consumer resources available for current consumption. Again, the contrast between U.S. capital markets and those of its foreign trade partners means the U.S. is much more 'deficit prone' and foreigners more 'surplus prone.' A vulgar translation might be that Greenspan wishes to see an alteration of the balance between hedonism at home and parsimony abroad. If export driven growth overseas gave way to elevated rates of growth in domestic consumption, more equilibration in the current account imbalances could be expected without disturbing shocks to employment and output overseas.

As we have pointed out many times before, Greenspan's "assignment" continues to apportion some 'blame' for the external imbalance to excessive internal imbalance. While he may not be a devout with regard to the Twin Deficit conception, effectively he is willing to be an advocate of some of the policy implications of that view. We should expect to see a much more strenuous appeal to the Congress to cut expenditures at his forthcoming Humphrey-Hawkins testimony. By touting fiscal deficit reduction, it should be noted, he exonerates the Fed for assigning itself some responsibilities for external balance. Not by accident, in our view, Greenspan pins the tail on someone else's donkey and leaves the Fed's assignment clearly focused on price stability. The Fed is likely to be much more focused on domestic price stability in the months ahead, even though that focus is not made explicit in this Greenspan speech. Many Fed watchers aver a 2-3% target range for domestic inflation, but that target would be surely narrowed if the trend toward rising productivity were to abruptly halt. In the meanwhile, Greenspan has taken steps to commit to a lower inflation posture---a commitment that may be necessary in keeping the stock of dollar holdings abroad quiescent.

Labor markets are tightening, as the Fed well knows; second, continuous public attention focused on recently rising domestic prices will tend to dampen the development of inflationary expectations, making rising interest rates bite more firmly. Finally, by stating the Fed will be paying even more attention to issues of price stability, other Central Banks holding large amounts of dollars can be deterred from rushing to convert them into other currencies and perhaps triggering a rise in interest rates in the U.S. that would abort U.S. domestic growth. Greenspan has told his fellow Central Bankers that he is standing watch on the development of U.S. inflation and is implicitly telling them that they can be comfortable with their holding of 'excessive' U.S. dollar balances. He is also telling the Congress and the President, that they have an "assignment" as well!