

# Preface

**T**he papers and comments presented at the Federal Reserve Bank of St. Louis's Tenth Annual Economic Conference are contained in this book. The topic of this conference, held on October 12–13, 1985, was “How Open Is the U.S. Economy?”

Recent events suggest the need to reassess previously held ideas about the insulation of the U.S. economy from external events. The appreciation of the U.S. dollar and that appreciation's subsequent effects on various sectors of the U.S. economy have shown that the world has become a much more open marketplace. Competition for goods and services comes from domestic and increasingly from foreign challengers. Not only are producers affected, but labor also is cognizant of the foreign competition for its services. Indeed, the wave of protectionist sentiment in the United States is but one outward manifestation of this changing environment.

The changing nature of the world economy and the role of the United States also are evident in the policymakers' growing recognition of foreign influences. Failure to achieve expected domestic policy goals may stem from the fact that policy actions no longer influence only the U.S. economy, but have both direct and indirect effects on other economies as adjustments in exchange rates, foreign prices, and financial yields. Indeed, calls for coordinated policy actions, exemplified by the Group of Five (G-5) announcement, increase the awareness among policymakers that their actions must be considered in a context broader than the domestic economy alone.

This book is divided into three parts. Part I provides a background on the increasing openness of the economy and an analysis of the effects of such openness. The chapters in part II explore the macroeconomic effects of this integration, and part III deals with policy reactions to increased openness.

In “The United States as an Open Economy,” Richard N. Cooper examines the reasons, effects, and implications of an increasingly open U.S. economy. He notes that a major factor explaining increased foreign interaction is technological advances in communications and transportation. As lower transactions costs are realized, the volume of transactions correspondingly

rises. Because of this, there is evidence of a loss of insulation of the economy to external events, such as the OPEC oil price shocks of the 1970s. More recently, Cooper notes, increased openness has broadened the base of competition that domestic firms must face, thus influencing wage and price developments in some sectors. Cooper comments that greater interdependence allows foreign events to impact the domestic economy, but also that domestic events have results much faster in the rest of the world. These factors may influence not only domestic policy multipliers, but also the usefulness of policy recommendations once followed under a more closed economy.

Peter B. Kenen provides a different view of economic integration in his comments on Cooper's chapter. He notes that in contrast to financial markets, goods markets may well have become less integrated among developed countries. Rather, a greater integration has taken place between developed and less-developed countries, as the former become increasingly dependent on the latter's raw materials. Much of Kenen's discussion focuses on the effects of floating exchange rates on the conduct of domestic policy. He notes that many formal models' predictions of the change from fixed to floating rates have not adequately captured the importance of increased capital mobility. While Kenen generally agrees with Cooper's assessment of the failure of these models to predict what actually occurred, he does not find Cooper's argument about the impact of foreign interest rates on domestic U.S. money demand convincing. Kenen also raises some questions with regard to the dominance of the United States in world monetary affairs, a position argued by Cooper.

Jeffrey A. Frankel examines the contention that "the U.S. economy has become so open financially as to be characterized by perfect capital mobility." In his chapter, "International Capital Mobility and Crowding-out in the U.S. Economy: Imperfect Integration of Financial Markets or of Goods Markets?," he investigates this belief by reconsidering the observation of Feldstein and Horioka that investment rates and national savings rates are highly correlated, implying low capital mobility. Based on U.S. data for a variety of periods and using several econometric techniques, Frankel's evidence corroborates the argument that "international capital mobility does not fully prevent exogenous changes in the government budget or in private saving from crowding out domestic investment." More important, Frankel finds that among the several definitions of perfect capital mobility, the failure of real interest parity automatically explains the findings of crowding-out. Thus, he concludes that crowding-out takes place not because of imperfect integration of financial markets, but because of imperfect integration of goods markets.

In his comments on Frankel's chapter, Frederic S. Mishkin argues that the evidence from the Feldstein-Horioka test is not convincing. The reason is model misspecification, with Mishkin questioning the notion of the invest-

ment rate modeled as a function of the savings rate. He also notes that the most relevant evidence for the question of capital mobility concerns the tests of real rate equality. Mishkin argues, however, that other evidence indicates that complete crowding-out does not occur, as Frankel's results may suggest. Thus, Mishkin maintains that, among other things, international capital lessens the negative effects of large budget deficits on the domestic economy, and that supply-side policies aimed at stimulating private savings to increase domestic capital formation may, based on the evidence, be less than successful.

John Kuszczak and John D. Murray use vector autoregressive (VAR) procedures to investigate the relationship of the domestic economy to foreign influences in their chapter, "A VAR Analysis of Economic Interdependence: Canada, the United States, and the Rest of the World." Through their extensive empirical analysis, the authors find that U.S. variables are affected by international variables to a greater extent than many would think. An example is the sensitivity of domestic money demand to movements in foreign interest rates and in exchange rates. An important finding in their work is that the shift from a fixed exchange rate regime to a flexible exchange rate regime does not statistically influence the time series properties of the variables studied. This finding, along with other results reported in their chapter, lead Kuszczak and Murray to state that "international economic interdependence need not preclude independent policy action by small open economies."

Georg Rich's comments on the chapter by Kuszczak and Murray focuses on the difficulty of interpreting the VAR evidence in terms of policy recommendations. As Rich notes, the astructural nature of VAR models may generate misleading policy signals to the monetary authority. Indeed, this problem of interpreting the empirical evidence is recognized by Kuszczak and Murray in their discussion of the finding that the Canadian money supply is quite sensitive to changes in U.S. interest rates. While the empirical finding may reflect the existence of currency substitution, the economic cause of the empirical relationship is obscured in the VAR framework.

Rich also comments that the diversity of economic experience and institutional makeup argues against the broad application of the conclusions reached by Kuszczak and Murray. In their chapter, they test the relationship between the United States and a composite of industrial countries. Rich disagrees with such a procedure for the basis of policy recommendation, by noting the disparity between the authors' conclusions and those reached by Genberg and Swoboda in a similar paper focused on the response by Swiss economic variables to changes in foreign macroeconomic variables. Such case-by-case studies, Rich notes, may be necessary to understand existing economic relationships and to provide a firm foundation for the implementation of policy decisions.

An increasing net capital inflow “has become the outstanding failure of U.S. macroeconomic performance in the 1980s.” The effects of this imbalance are the subject of the chapter “Implications of the U.S. Net Capital Inflow,” by Benjamin M. Friedman. He notes that the massive inflow of capital from abroad has been a key factor in equilibrating savings and investments in the United States despite large federal government deficits. Friedman argues that financial activity will shift away from capital formation as the increased foreign ownership of U.S. financial assets increases the “expected return premium on long-term debt.” The policy implications Friedman derives are that easing monetary policy would reduce the capital inflow and, therefore, stimulate capital formation. In terms of fiscal policy, he argues that a similar outcome would arise from a tightening of fiscal policy, most notably through a reduction of large federal budget deficits.

John Huizinga agrees with the general thrust of Friedman’s chapter, namely, that the recent transformation in the United States to net debtor status may have far-reaching effects on our economic well-being and future policy decisions. Huizinga notes, however, that two important considerations of the recent capital inflows have been slighted. The first aspect is the fact that more of the capital inflow has been “bank reported” than that associated with foreign net purchases of U.S. Treasury obligations. This suggests that domestic policies to influence the confidence of foreign investors increasingly may focus on the U.S. banking system.

Another aspect of the recent capital inflow is its possible effect on domestic inflation policy. Because most U.S. liabilities are nominal and denominated in U.S. dollars, creation of unexpected inflation would reduce the real value of the indebtedness to foreign holders. As Huizinga notes, “the incentive to inflate away our foreign debt might well be one of the more important consequences of continued capital inflows for U.S. economic policy.”

Huizinga also raises some doubts regarding the usefulness of Friedman’s empirical evidence on the appropriate policy to curtail the inflow of capital. Friedman’s evidence argues for increased money growth and decreased government expenditures, or for increased tax collections. Huizinga argues that the reliability of these results as the basis for macroeconomic policy are questionable not only on the grounds of the endogeneity of the policy variables—a concern shared by Friedman—but also because of the uncertainty surrounding the stability of these estimates during the sample period used and in the future as policy regimes change.

The effect on policy of increased openness is the subject of Jacob A. Frenkel’s chapter, “International Interdependence and the Constraints on Macroeconomic Policies.” Focusing primarily on monetary policy, Frenkel shows that the combination of a more open economy and a flexible exchange rate regime quickens the effects of monetary changes on prices and wages. Moreover, he argues that using a policy guide such as purchasing power parity

serves to keep domestic price and exchange rate behavior in perspective. That is, domestic policies to influence the domestic price level will also affect the exchange rate. Thus, Frenkel suggests that the monetary authority's main consideration should be the achievement of price stability and that by reducing the variability of monetary expansion, the monetary authority can positively contribute to reducing costly exchange rate fluctuations. With regard to policy in the current environment, Frenkel argues that "it makes no sense to agree just on real exchange rate targets without accompanying such an arrangement with a similar agreement about other targets for macroeconomic policies including, of course, fiscal policies."

William Poole's discussion of Frenkel's chapter focuses on several issues. For example, he argues that policy coordination between monetary and fiscal authorities fails if one party is unable or unwilling to "set its policy instruments appropriately." In light of recent developments, trading off monetary policy for fiscal policy—that is, changing money growth to offset budget deficits—may exacerbate one set of policy errors with another. Poole agrees with Frenkel that, as a long-run proposition, the exchange rate system does not have a great influence on policy opportunities. The existing regime does, however, influence the short-term adjustment process among the different sectors. This effect, he suggests, may arise from the changing character of certain sectors, changing them from ones in which prices are determined in auction markets to ones in which changes are discrete.

Unless there is a move toward greater international monetary policy coordination, sharp exchange rate fluctuations are inevitable. This is the focus of Ronald I. McKinnon's chapter "The Dollar Exchange Rate and International Monetary Cooperation." The basis for this position is the fact that under a floating exchange rate regime, governments are not required to follow common monetary policies, a condition that generally characterizes a fixed exchange rate regime. Because of this, investors seeking the best investment must continually guess which of the many fiat currencies to hold. Thus, in such a world, McKinnon argues, large swings in exchange rates will occur because the speculative forces that would restore equilibrium to the exchange rate market are weakened in a world of nonaligned national monetary policies. These exchange rate fluctuations give rise to protectionist pressures that supporters argue will protect domestic industry and insulate domestic prices. To avoid this chain of events, McKinnon argues that a stable international monetary system is required to assure free trade of goods and services. In his analysis, the main participants of such a new order would be the Federal Reserve, the Bank of Japan, and the Bundesbank. To achieve exchange rate stability, McKinnon suggests that these three monetary authorities establish a four-point program that, among other things, coordinates their domestic monetary policies along with explicit intervention in markets to achieve certain target exchange rates.

Roger E. Brinner is in general agreement with McKinnon's hypothesis that the exchange rate could be stabilized through coordinated intervention and policy actions by central banks. In contrast to McKinnon's analysis, however, Brinner argues that such a coordination of monetary policies during the early 1980s likely would have led to faster price-level increases than those which actually occurred. Based on simulations from the DRI econometric model, Brinner finds that if the United States had followed McKinnon's preferred combination of stimulative fiscal and monetary policies, U.S. inflation would have increased, unless Europe and Japan had chosen to engineer severe economic recessions. Even in this scenario, Brinner argues that the United States still would have faced a real appreciation of the dollar, thus leading to the same basis for protectionist pressures that such a policy is theoretically designed to avert.