Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

The Foreign Dimension

Over the past year, the "foreign dimension" of U.S. economic policy has become increasingly prominent. In November 1978 and again last October, the Federal Reserve took dramatic steps to reduce money growth and slow inflation, spurred in part by the adverse verdict rendered by the foreign-exchange markets on U.S. economic policies. While safeguarding the soundness of the dollar has always been a U.S. policy objective, recent events have made it a matter of more explicit and immediate concern.

In this situation, U.S. policymakers are likely to give more weight to foreign economic policies in formulating their own. After all, the foreign-exchange value of the dollar depends upon policies taken abroad as well as those pursued here at home. Ten-percent inflation in the U.S. need not mean a falling dollar if foreign inflation is the same—but a fall can scarcely be avoided if the foreign inflation rate is only five percent. This consideration looms particularly large as policymakers attempt to deal with the latest round of oil price increases. The consequences for the dollar of U.S. policies will depend critically upon how foreign governments choose to deal with that price surge—superficially, whether they choose to fight its inflationary effects or whether they try to combat its adverse impact on real growth.

Past record

To a large extent, current and future macroeconomic policies abroad reflect the reverberating impact of 1974's quadrupling of oil prices. This increase led to a sharp rise in inflation rates in Japan and Europe in 1974 and 1975, accompanied by the most severe recession of the post-war period. As in the U.S., foreign governments at first reacted to the increased inflation by tightening monetary policy, even while applying fiscal stimulus to raise real growth. Their fiscal measures were largely unsuccessful, however, and so they eased monetary policy later in 1975 in a further attempt to alleviate the recession.

Thereafter, economic policies here and abroad diverged somewhat. In the U.S., money growth continued to accelerate while real output recovered fairly steadily from its 1975 trough. Increased money growth in turn led to a fairly steady acceleration in U.S. inflation following its 1976 trough. In contrast, foreign monetary policy remained cautious, with money growth actually slowing in 1976 in most European countries and in 1977 in Japan. By 1978, these policies had generally succeeded in reducing foreign inflation rates well below 1974-75 levels. (Indeed, in Germany and Japan, consumer-price inflation fell to 3.5 and 2.5 percent, respectively, in 1978.) Partly as a result of these policies, foreign economies remained relatively sluggish: after a strong but abortive recovery in 1976, real growth slowed substantially in 1977, leaving unemployment rates very high by pre-1973 standards.

Road to '79 . . .

Apparently successful in lowering inflation but faced with continued high unemployment, foreign governments eased policy in late 1977 and 1978 in an attempt to stimulate output. All of the major foreign industrial nations increased their government budget deficits following the adoption of tax cuts and other stimulus measures. In Japan, for example, the budget deficit reached 5 percent of GNP in 1978—this in a country that had not experienced any significant budget deficits until the early 1970's. (In contrast, the U.S. budget deficit in the 1970's generally remained under 3 percent of GNP—and never exceeded 4 percent.) Except in the U.K. and Canada, fiscal stimulus was accompanied in 1978 by an acceleration of money growth, although for external as well as domestic reasons. German, Japanese and Swiss central banks in particular made heavy purchases of dollars in

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order to support the dollar's sagging value on the foreign exchanges. As a result, money growth in these countries in 1978 substantially exceeded official targets or (Japan) projections.

Whatever the reasons, the results of these policies were largely the same. Real growth averaged 3.3 percent in the ten major foreign industrial countries in 1978—compared to 2.9 percent the previous year—and apparently was about the same in 1979. This improvement in real growth led to significant reductions in unemployment, but the accompanying easing of policy left government deficits bloated in several countries and rekindled inflationary pressures.

In 1979, foreign industrial countries experienced sharply accelerating inflation, traceable to their previous monetary expansion but also to sharp price increases for oil and other basic commodities. Consumer prices rose nearly 8.0 percent (on average) in the 10 major foreign industrial nations, compared to 1978's 5.4-percent average increase. Mindful of their earlier success in containing inflation, governments generally responded quickly and decisively to this acceleration by slowing money growth and raising domestic interest rates. For example, Japan raised its central-bank discount rate three times last year, from 3.5 percent to 6.25 percent, while Germany raised its central-bank rate from 3 to 6 percent over the same period. Foreign money-market rates increased apace (see chart). Indeed, interest rates in Germany and Japan have increased more in real terms (relative to inflation) than they have in the U.S. Largely as a result, money growth abroad has slowed over the last year, while some foreign governments also have moved to tighten fiscal policy.

. . . and 1980

Until the latest round of oil price hikes, last year's policy tightening promised some reduction in 1980 inflation—but at the cost of lower real growth. According to the December 1979 *Economic Outlook* of the Organization for Economic Cooperation and Development (OECD), real GNP in 1980 was expected to grow by 2.25 percent in Germany and by 4.75 percent in Japan (considerably below their 1979 performance of 4.25 and 6.00 percent, respectively), and was expected to fall by about one percent in the U.S. Even those unfavorable forecasts assumed that oil prices would rise by no more than 10 percent over those prevailing at the end of 1979.

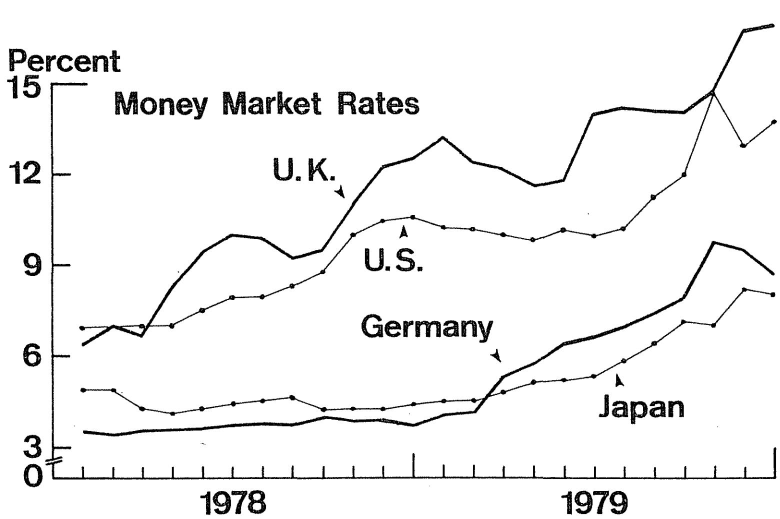
This expected slowdown could halt, and in some cases partially reverse, the recent progress in lowering unemployment and excess capacity. Nonetheless, foreign governments seem unlikely to relent from their stance of restraining inflation through tighter monetary and fiscal policies. As in the U.S., their concentration on fighting inflation appears to reflect a public consensus that inflation is the number-one economic problem.

To what extent are these prospects now altered by the oil price increases of the past several months? With oil prices rising this year, not by 10 percent, but by nearly 30 percent, the outcome is likely to be even lower growth and higher inflation than previously anticipated. Whether governments now ease policy is likely to depend crucially upon how those price increases affect real growth throughout the industrial world.

According to recent OECD estimates, the latest oil-price hikes could reduce real GNP in the industrial countries by an average of about one percent in 1980. This could mean stagnation or worse, especially in view of the fact that real GNP was already expected to grow very little in most foreign countries. Still, any downturn would probably not be as sharp as that occurring in 1974 and 1975, when real output fell sharply in most major industrial countries. Furthermore, estimates of the growth effects of these oil-price increases may be overstated, because they are based on past reactions of industrial economies to such shocks. In light of the experience gained by the oil-importing nations over the past six years, the disruptive effects of further price increases may be smaller and less protracted now than in the past. On balance, then, it seems likely that unemployment abroad will remain at painful but probably not intolerable levels during 1980. If so—and in view of the inflation impact of the latest oil-price increases—policies abroad may continue to be directed toward containment of inflation.

This prognosis, if correct, has important implications for U.S. policy. In the last fifteen months, the U.S. has twice succeeded in relieving pressure on the dollar by taking steps to restrain money growth—and hence ultimately to reduce inflation. Given the move toward more restrictive policies abroad, and given the lower average levels of foreign inflation rates, continued stability of the dollar is likely to depend upon a public perception that U.S. policy remains on its announced course of checking inflation. In other words, America's room to "accommodate" the oil price increases will be constrained by policy decisions made abroad if further pressure on the dollar is to be avoided. The foreign dimension of U.S. policy thus seems likely to remain prominent for some time to come.

Charles Pigott



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/30/80	Change from 1/23/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	137,161	+ 151	+ 16,637	+ 13.80
Loans (gross, adjusted) — total#	114,423	+ 101	+ 16,043	+ 16.30
Commercial and industrial	32,765	+ 92	+ 3,965	+ 13.80
Real estate	44,145	+ 129	+ 8,648	+ 24.40
Loans to individuals	24,700	+ 121	+ 4,206	+ 20.50
Securities loans	1,303	− 68	− 304	− 18.90
U.S. Treasury securities*	7,199	+ 32	− 391	− 5.20
Other securities*	15,539	+ 18	+ 985	+ 6.80
Demand deposits — total#	43,346	+ 352	+ 2,872	+ 7.10
Demand deposits — adjusted	32,111	+ 520	+ 2,573	+ 8.70
Savings deposits — total	28,130	− 248	− 1,670	− 5.60
Time deposits — total#	59,100	− 223	+ 7,970	+ 15.60
Individuals, part. & corp.	50,272	− 188	+ 8,814	+ 21.30
(Large negotiable CD's)	21,323	− 319	+ 2,344	+ 12.40

Weekly Averages of Daily Figures	Week ended 1/30/80	Week ended 1/23/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 5	0	77
Borrowings	336	69	56
Net free reserves (+)/Net borrowed(−)	− 341	− 69	21
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+1,526	+1,139	+1,363
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	− 436	− 306	+ 616

* Excludes trading account securities.
# Includes items not shown separately.

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