

The Economy in Perspective

Sentimental fools? ... According to the Conference Board's Survey of Consumer Sentiment, U.S. households are now more confident about the economy's health than at any time since 1969. This should be sobering news to those who remember what followed in the 1970s (three recessions, double-digit inflation, gasoline pump queuing, severe slumps in productivity growth and stock prices, and soaring interest rates) and in the 1980s (the less-developed-country debt crisis, soaring federal budget and trade deficits, sharp appreciation and depreciation of the U.S. dollar's foreign exchange value, and the collapse of the thrift industry). What went wrong, and how relevant are these events today?

During the 1960s, inflation was low and economic growth was exceptionally vigorous. But the government discounted the dangers of inflation and became fixated on managing the business cycle by fine-tuning monetary and fiscal policy. In the latter half of the 1960s, a confluence of political pressures and economic doctrine eventually produced an escalating inflation rate—one that would last for another decade despite attempts to arrest it through various means, including wage and price controls.

Inflation control became more challenging during the 1970s because many of the world's largest oil exporting countries formed a cartel that significantly raised the price of crude oil several times. Although these circumstances affected all oil importing countries to some extent, they had a dramatic impact on the United States, since our energy imports were large, our energy efficiency was low, and our commitment to price stability was weak.

The industrialized countries at that time had organized an international monetary system based on a gold standard, but employing the U.S. dollar as a reserve currency. Other countries managed their domestic monetary policies to maintain some stability in relation to the U.S. dollar, although the degree of stability varied from time to time and from country to country. When the United States inflated its money supply and depreciated its own currency's domestic purchasing power, it also threatened the stability of the foreign exchange rate system by increasing the likelihood that the dollar might be devalued. In response, some other industrialized countries expanded their money supplies as well, dampen-

ing the exchange rate consequences, but at the cost of importing U.S. inflation.

The United States suffered from its decision to tolerate inflation in a number of ways, each initially unforeseen. First, it discouraged investment in productivity-enhancing capital and encouraged speculation in housing, precious metals, art, and other similar assets. This development compromised longer-term growth. Second, the dollar became less trusted as a currency that would hold its value over time, and the terms of trade shifted against the United States. In effect, Americans had to export more goods and services to obtain a given amount of imports.

Finally, poor U.S. economic performance and uncertainty about future economic policies contributed to a belief among global investors that opportunities abroad, particularly in Mexico and South America, would now provide acceptable risk/reward trade-offs. These areas were regarded as a new source of oil and other natural resources thought to be in perennially short supply. Capital flows from the rest of the world to these parts of the Western Hemisphere expanded in the latter part of the 1970s, but within a few years it became evident that this speculative fervor was misplaced. As inflation rates declined around the world, commodity prices collapsed, and the developing nations struggled to repay their significant debts.

More than a decade has passed since then. In the United States, inflation and federal budget deficits have been nearly eliminated. Yet, the international trading and financial systems on which we depend are clearly unsettled. The latest round of difficulties, exposing severe problems in an arc from Indonesia to Japan, provides yet another reminder of how interconnected markets have become: The collapse of the South Korean won may prove more important to U.S. consumers than would a shortage of freight cars in Kansas.

The U.S. commitment to price stability, prudent fiscal policy, and free trade will almost certainly be tested in the coming decade; in some respects, it is being challenged today. Have we learned that abandoning our economic principles in the face of unforeseen events will likely bring unforeseen consequences as well? Are we as confident about our economic prospects today as we were 30 years ago because we have learned so much, or because we have learned so little?