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The United States, Japan, and the Global Economy

Remarks by

Richard H. Clarida

Vice Chair

Board of Governors of the Federal Reserve System

at the

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I appreciate this opportunity to speak today at the Japan Society, a respected institution dedicated to studying, advocating, and expanding interactions between the United States and Japan.[1] While the society's remit is broad and includes arts, culture, and education, I will, perhaps not surprisingly, focus my remarks on our two economies. Japan is an important economic partner of the United States, and our economies are linked through trade in goods and services as well as capital flows that affect interest rates and other aspects of financial markets. Through these channels, developments in Japan can affect economic conditions in the United States, and vice versa.

More broadly, beyond bilateral linkages, economic conditions in United States and Japan are tightly linked to global economic developments, and today I will discuss several of the global factors that are relevant to the outlook for both economies. First, I will review the current U.S. outlook and some key global risks to that outlook that we are monitoring at the Federal Reserve. I will next elaborate on the channels through which global factors affect domestic economic conditions in the United States and, in some cases, also Japan. I will conclude with some remarks about the monetary policy decision we announced on Wednesday.

U.S. Outlook

By many metrics, the U.S. economy is in a good place. The current economic expansion, now in its 11th year, is the longest on record, and the economy continues to advance at a moderate pace, with real gross domestic product (GDP) growth running at 2 percent over the past year and 1.9 percent in the most recent quarter. Growth has been

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[1] These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee. I would like to thank Joseph Gruber for his assistance in preparing this speech.

supported by the continued strength of household consumption, underpinned, in turn, by a thriving labor market. The unemployment rate is near a half-century low, real wages are rising, and workers who had earlier left the labor force are returning to find jobs. There is no sign that cost-push pressures are putting excessive upward force on price inflation, and to me, plausible estimates of the natural rate of unemployment extend from just above 4 percent to the current level. Core personal consumption expenditures (PCE) inflation over the 12 months ending in September, at 1.7 percent, remains muted, and headline inflation, currently running at 1.3 percent, is likely this year to fall somewhat below our 2 percent objective. Price stability, as I see it, requires that inflation expectations as well as actual inflation be stable and consistent with our 2 percent inflation target. We do not directly observe inflation expectations, and I myself consult a wide range of survey and market estimates. Based on these estimates, I judge that measures of inflation expectations reside at the low end of a range I consider consistent with price stability.

Although the baseline expectation for the U.S. economy is favorable, there are some evident downside risks to this outlook. Global growth has been sluggish since the middle of 2018. This slowdown in global growth as well as increased uncertainty about the outlook for global trade policy appear to be headwinds for manufacturing activity and investment spending in the United States and abroad.[2] Also another source of uncertainty in the global economy has been and continues to be Brexit. The global growth outlook

[2] Caldara and others find that increased trade policy uncertainty, independent of the actual effect of higher tariffs, can exert a significant negative drag on U.S. and global GDP. See Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2019), "The Economic Effects of Trade Policy Uncertainty," International Finance Discussion Papers 1256 (Washington: Board of Governors of the Federal Reserve System, September), https://www.federalreserve.gov/econres/ifdp/files/ifdp1256.pdf.

also depends importantly on the strength and sustainability of continued economic expansion in China. China is balancing its desire to curtail credit growth and promote deleveraging against its understandable aspiration to maintain a rapid pace of economic growth in a country of 1.4 billion people. Finally, global disinflationary forces remain and present ongoing challenges to many central banks in their efforts to achieve and maintain price stability.

In sum, global conditions present headwinds for the U.S. outlook, and, as my colleagues and I at the Federal Reserve have emphasized, these headwinds have been a prominent consideration in our recent monetary policy assessments. I would now like to elaborate on some of the channels through which foreign developments more generally might be expected to affect the outlook for the U.S. economy.[3]

Channels and Linkages

Perhaps the most direct link between economic conditions abroad and in the United States is foreign demand for U.S. exports. To be sure, exports account for a smaller share of the U.S. economy—about 12 percent—than the global average of about 30 percent. Even so, when foreign demand for U.S. exports falls, the effect on U.S. production is evident. The pace of economic expansion abroad is a key determinant of the demand for U.S. exports. Most recently, the International Monetary Fund projects foreign GDP growth in 2019 to have slowed to its weakest pace since the financial crisis. Largely as a result, real U.S. exports been about flat over the past year, an unusual development outside of recession. U.S. exports also have slowed as a result of a decline

[3] For further discussion, see Richard H. Clarida (2019), "Global Shocks and the U.S. Economy," speech delivered at the BDF Symposium and 34th SUERF Colloquium, sponsored by Banque de France and the European Money and Finance Forum, Paris, March 28, https://www.federalreserve.gov/newsevents/speech/clarida20190328a.htm.

in exports to China following the imposition of tariffs on U.S. goods and also more recently because of production-related disruptions in aircraft deliveries.

The pace of economic growth in our major trading partners affects the demand for U.S. exports not only directly, but also indirectly by influencing the value of the dollar. When foreign growth weakens and central banks abroad ease monetary policy to support their domestic economies, returns on dollar assets appear relatively more attractive, capital flows into U.S. markets, and these flows will tend to boost the foreign exchange value of the dollar. In addition, elevated uncertainties about the global outlook and/or other evidence of financial stress abroad can also drive up the value of the dollar, as investors flow into the safe haven traditionally provided by U.S. assets. A stronger dollar, for either reason, makes U.S. exports more expensive for foreign buyers, makes U.S. imports from abroad more attractive to U.S. purchasers, and thereby tends to lower demand for U.S. goods and services. That being said, I would note that the value of the dollar does not appear to play much of a role in explaining the decline in U.S. exports over the past year. The current level of the trade-weighted dollar is about where it has been, on average, over the past few years. However, looking back several years, the 25 percent appreciation of the dollar that occurred in 2014 was an important contributing factor to the previous noticeable decline in U.S. exports that took place in 2015 and 2016.

Global financial markets also link the United States to the global economy, and developments abroad can spill over into domestic financial conditions, with material effects on domestic activity. This is particularly evident during episodes of global financial stress, in which “risk-off” shifts in sentiment can depress U.S. equity prices and widen domestic credit spreads even as flight-to-safety flows push down U.S. Treasury yields. These global financial spillovers to the U.S. economy were notably pronounced during the 1998 Russian crisis, the euro-area debt crisis earlier this decade, and the China devaluation episode of 2015–16. Recently, global financial spillovers have contributed to the significant decline in U.S. Treasury yields that we have seen since the spring. Since the market for debt is global, low—and, in many cases, negative—yields abroad encourage capital inflows that put downward pressure on U.S. yields. Equity prices have also reacted to global developments and recently appear particularly sensitive to news about the outlook for U.S. international trade. Global factors have likely also contributed to the estimated decline in the neutral rate of interest, or r*, that we have observed in the United States and many other countries. Slow productivity growth and population aging have lowered potential growth rates in major foreign economies, decreasing demand for investment and increasing desired saving, both of which have contributed to lower equilibrium interest rates abroad, with spillovers to the rest of the world, including in the United States.[4]

Global developments influence not only U.S. economic activity and financial markets, but also U.S. inflation. Global factors—through their influences on U.S. aggregate demand and supply that I just described—can alter U.S. inflation dynamics. Foreign factors can also directly affect the prices paid by U.S. firms and consumers, particularly, but not exclusively, for imported goods. An appreciation of the dollar can

[4] See Richard Clarida (2019), "The Global Factor in Neutral Policy Rates: Some Implications for Exchange Rates, Monetary Policy, and Policy Coordination," International Finance Discussion Papers 1244 (Washington: Board of Governors of the Federal Reserve System, April), https://www.federalreserve.gov/econres/ifdp/files/ifdp1244.pdf. For one example highlighting demographics, see Etienne Gagnon, Benjamin K. Johannsen, and David Lopez-Salido (2016), "Understanding the New Normal: The Role of Demographics," Finance and Economics Discussion Series 2016-080 (Washington: Board of Governors of the Federal Reserve System, October), https://www.federalreserve.gov/econresdata/feds/2016/files/2016080pap.pdf.

lower the dollar price of U.S. imports, although empirically, this effect is less than one-for-one, as foreign exporters tend to keep the dollar prices of their goods comparatively stable relative to observed exchange rate fluctuations.[5] In addition, swings in global commodity prices influence U.S. inflation. Over the past year, the rise in the dollar and falling oil prices have been important contributors to the subdued pace of U.S. inflation.

Japan in the Global Economy

Up to now, I have focused on the U.S. economy. However, despite some important differences that I will note, the Japanese economy exhibits some notable similarities to the United States, both in terms of its overall performance and its exposure to the global economy. To begin with, Japanese growth, while slower than in the United States, has been running above the pace needed to absorb new entrants to the labor force, and its strong labor market is operating with an unemployment rate near multidecade lows at 2.2 percent. Also, as in the United States, weak exports have recently been a drag on Japanese growth. But, like the United States, Japan has been less exposed to the global slowdown than many other economies. Exports represent only 17 percent of Japanese GDP, higher than in the United States but well below the 30 percent global average I mentioned earlier.

In some respects, however, Japan is more strongly linked to the global economy than is the United States. One example is the relationship between episodes of global financial stress and the exchange rate. In times of stress, the dollar tends to appreciate as investors seek the safety of U.S. markets. The same is even more true for Japan, with the

[5] See José Manuel Campa and Linda S. Goldberg (2005), "Exchange Rate Pass-Through into Import Prices," *Review of Economics and Statistics*, vol. 87 (November), pp. 679–90; and Christopher Gust, Sylvain Leduc, and Robert Vigfusson (2010), "Trade Integration, Competition, and the Decline in Exchange-Rate Pass-Through," *Journal of Monetary Economics*, vol. 57 (April), pp. 309–24.

yen often recording even stronger appreciation than the dollar in times of increased risk aversion.

Other channels operate differently because of structural differences between the United States and Japan. One difference is in the currency used to invoice trade. In the United States, almost all trade, both imports and exports, is invoiced in dollars. One aspect of this, as mentioned earlier, is that changes in the value of the dollar tend to have a relatively limited effect on U.S. import prices and import demand. Despite the importance of the yen in global financial markets, a significant portion of Japan’s trade is also invoiced in dollars rather than yen, including not only Japan’s exports to the United States, but also its exports to other countries in Asia.[6] Some scholars have proposed that the importance of the dollar in Japan’s trade lessens the responsiveness of Japan’s exports to movements in the yen while making exports more sensitive to changes in the value of the dollar and, therefore, U.S. monetary conditions.[7]

Regarding inflation, through the considerable efforts of the Bank of Japan’s quantitative and qualitative monetary easing program launched in early 2013, Japan has emerged from almost 15 years of modest deflation and is now operating with a positive inflation rate. While the inflation remains below the Bank of Japan’s long-run objective of 2 percent, it represents a notable accomplishment given the difficulty of changing public inflation expectations after a long period of modest deflation in consumer prices.

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[6] See Takatoshi Ito, Satoshi Koibuchi, Kiyotaka Sato, and Junko Shimizu (2019), “Growing Use of Local Currencies in Japanese Trade with Asian Countries: A New Puzzle of Invoicing Currency Choice,” Vox, June 10, https://voxeu.org/article/growing-use-local-currencies-japanese-trade-within-asia.

[7] See Gita Gopinath, Emine Boz, Camila Casas, Federico J. Diez, Pierre-Olivier Gourinchas, and Mikkel Plagborg-Møller (2019), “Dominant Currency Paradigm,” NBER Working Paper Series 22943 (Cambridge, Mass.: National Bureau of Economic Research, March).

Conclusion

Returning to the United States, I would like to wrap up with a brief discussion of our monetary policy decision this week. At our meeting earlier this week, the Federal Open Market Committee (FOMC) lowered the target range for the federal funds rate by 1/4 percentage point, bringing the range to 1-1/2 to 1-3/4 percent—the third such reduction this year.[8] As Chair Powell noted in his press conference, the Committee took these actions to help keep the U.S. economy strong in the face of global developments and to provide some insurance against ongoing risks. The policy adjustments we have made since last year are providing—and will continue to provide—meaningful support to the economy. The economy is in a good place, and monetary policy is in a good place.

The policy adjustments we have made to date will continue to provide significant support for the economy. Since monetary policy operates with a lag, the full effects of these adjustments on economic growth, the job market, and inflation will be realized over time. We see the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook of moderate economic growth, a strong labor market, and inflation near our symmetric 2 percent objective. Of course, if developments emerge that cause a material reassessment of our outlook, we would respond accordingly. Policy is not on a preset course, and we will be monitoring the effects of our policy actions, along with other information bearing on the outlook, as we assess, at each future meeting, the appropriate path of the target range for the federal funds rate.

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[8] See Board of Governors of the Federal Reserve System (2019), "Federal Reserve Issues FOMC Statement," press release, October 30, https://www.federalreserve.gov/newsevents/pressreleases/monetary20191030a.htm

Thank you very much for your time and attention and for the invitation to speak at the Japan Society this afternoon.