

For release on delivery  
expected at 10:00 A.M., E.D.T.  
June 14, 1984

Statement by  
Paul A. Volcker  
Chairman, Board of Governors of the Federal Reserve System  
before the  
Subcommittee on International Finance and Monetary Policy  
Committee on Banking, Housing and Urban Affairs  
U.S. Senate  
June 14, 1984

I am pleased to have this opportunity to discuss, as you requested, the dollar, the international debt situation, and our growing international trade deficits, in the light of our budgetary deficit.

In approaching these issues, I believe it is right to emphasize, first, that the past year and more has been one of vigorous economic advance in the United States. That in turn has been a powerful force assisting growth in other industrialized countries and easing the difficult adjustment problems of much of the developing world. At the same time, that progress has been accompanied by some obvious and serious imbalances in the international economy and financial system. Those international strains are a reflection, in considerable part, of problems in internal policy here and abroad.

One aspect of those problems that has received a great deal of attention, internationally as well as domestically, is the high level of interest rates in the United States. Those interest rates have risen over recent months under the pressure of rising private credit demands, as the economy has grown, superimposed on the need to finance an already huge federal deficit. High interest rates have helped attract a growing inflow of capital from abroad, and that inflow has, for the time being, helped to reconcile rising investment with the need to finance the deficit.

But that capital inflow is not without heavy cost to us and to others in the short and long run. The essential counterpart of a net capital inflow is a massive trade and current account deficit partly

related to an appreciating dollar. Increases in our interest rates directly add to the strain on the external payments of heavily indebted developing countries. And, over time, the capital flows and trade imbalance will not be sustainable, posing the risk of further financial disturbances in the absence of needed policy adjustments.

If we are to restore better balance in our international trade accounts and relieve the pressures on our internationally exposed industries, and if we are to mitigate the burdens that high interest rates place on borrowing countries without undermining other objectives -- including stability and growth at home -- we cannot, in my judgment, escape the need for decisive action to reduce our federal budget deficit. The more slowly we proceed in correcting our internal imbalance, the greater are the risks not only to our international trade position, but also to the health of our domestic economy and our financial markets.

Congress is in the process of taking a first step toward dealing with the problem over time, and I welcome that effort. Reducing a substantial budget deficit, in the United States as elsewhere, is not easy. Popular support for painful adjustment is particularly difficult to win when the consequences of inaction are prospective rather than immediate. That, to many, has appeared to be the case over the past year and a half as our economy has performed remarkably well. From the fourth quarter of 1982 through the first quarter of this year, our gross national product has expanded at an average annual rate of 6-3/4 percent in real terms, while the unemployment rate has declined from its 10-3/4 percent peak at the end of 1982 to 7-1/2 percent in May. Moreover, the recovery has brought

healthy rates of investment in producers' durable equipment, in nonresidential structures, and in housing.

Of course, these gains started from a low level, and for a time it could be argued that an expansionary thrust from the budget deficit could be helpful. But, as the forward momentum of the economy continues and private spending and borrowing increase, the consequences of the continuing structural budget deficit are apparent.

That is perhaps most apparent in the deterioration of our trade position. One counterpart to the continuing federal budget deficit at a time of growing economic activity has been the growing net inflow of capital from abroad and its counterpart, the widening deficit in our current account transactions with other countries. In essence, that growing deficit has permitted us to consume, to invest, and to buy "more government" than provided by the increase in national output -- the GNP. In fact, all domestic demands have expanded since the fourth quarter of 1982 at an annual rate of 8-3/4 percent, about 2 percentage points faster than our gross national product. Looking at the financial side of the equation, the net inflow of capital that we have attracted from abroad is supplementing internal savings by about one-quarter -- or by more than 2 percent of the GNP -- enabling us to finance our large federal deficit while private spending on consumption and investment goods has also been growing rapidly.

Whatever the net benefits and difficulties of this process to date -- and both have been present -- the issue for the future is how to promote a sustainable pattern that meets our interests in stable and

sustained growth at home in a context of growing world trade and financial stability. In analyzing these prospects, it is useful to review developments with respect to our external position since the fourth quarter of 1980, when the dollar began its extraordinary appreciation. From that period through the first quarter of this year, our trade balance has deteriorated by roughly \$75 billion, despite a sizable reduction of about \$25 billion in our imports of oil. The adverse swing in the non-oil trade balance has thus amounted to about \$100 billion. To put that figure in perspective, the additional \$100 billion annual sales that our tradable goods industries might have retained or captured in the absence of shifts in our non-oil trade flows is two-thirds the size of the entire annual output of our residential building sector, which measures around \$150 billion in the GNP accounts.

Plainly, the deterioration in our trade position has had profound effects spread through many firms and farms in all parts of the United States. Those engaged in foreign trade or competing with imports have not shared proportionately in the strong expansion of the U.S. economy, and some important industries are still operating well below 1980 levels. Exports of all major categories of goods have declined since the fourth quarter of 1980. Measured in real terms or at constant base-period prices, exports of agricultural goods declined by 4 percent on balance, while exports of nonagricultural goods declined about 15 percent. Among the leading categories of nonagricultural goods, exports of both machinery and industrial supplies declined nearly 20 percent. The longer our exports remain depressed, the more difficult it becomes to maintain marketing

networks, and the more costly and difficult it becomes to recover foreign sales.

The strong expansion of aggregate demand in the United States relative to aggregate demand in foreign industrial economies has contributed importantly to the widening of our trade deficit. In that sense, some of the deterioration in our trade position is cyclical and reflects not the loss of markets at home or abroad, but rather the absence of proportionate gains. In addition, exports have dropped sharply to developing countries that are burdened with large external debts and are in the process of readjusting their economies and their balance of payments positions. This is particularly true with respect to our neighbors in Latin America; our exports to that area have dropped by \$15 billion since the fourth quarter of 1980. Together, the change in our cyclical position relative to foreign industrial countries and the decline in our exports to debt-burdened developing countries appear to explain one-third to one-half of the adverse swing in our non-oil trade balance.

The dramatic appreciation of the dollar has also had an important effect. Since the fourth quarter of 1980 the value of the dollar has appreciated about 45 percent on average against the currencies of foreign industrial countries. Over the same period, U.S. price performance has been somewhat better than the average in foreign industrial economies, but even allowing for the differential in inflation, the dollar has appreciated substantially. No doubt that appreciation of the dollar has helped to maintain the progress made against inflation during a period of vigorous recovery. But, if it proves inconsistent with a more sustainable trade

position, we cannot count on the current strength of the dollar to persist indefinitely.

The dramatic appreciation of the dollar reflects a number of forces, and the outlook for the dollar is difficult to predict. Apart from the relatively high level of interest rates in the United States, the performance of our economy and a sense of confidence in our political stability have helped encourage capital inflows, particularly when tensions have increased abroad. The degree to which these forces will continue in the months and years ahead cannot, of course, be assessed with certainty, but the point is often made that, in a purchasing power sense, the dollar is now "overvalued." Such calculations are necessarily imprecise. They differ depending upon the particular type of price index that is used -- consumer prices, producer prices, export prices, etc. -- and upon the time period that is chosen as the base period for the calculations.

There can be no doubt, however, that the dollar has risen in recent years substantially more than in proportion to movements in relative price levels here and abroad. Thus, the value of the dollar is substantially higher today than would be warranted solely on the basis of changes in the relative levels of U.S. and foreign price indexes.

But exchange rates are clearly influenced -- in the short and even in the longer run -- by factors other than relative rates of general price inflation. This often is the case when there has been a substantial change in the relative levels of interest rates, as has been the case between the United States and its trading partners in recent years. In principle, large capital inflows could persist for some time ahead even

though the United States is now becoming a net debtor internationally. But there is a serious question as to whether the situation is in our best interest or that of other countries. High interest rates pose severe problems for important sectors of the domestic economy and certainly for the indebted countries. Moreover the sustainability of our trade deficits and net capital inflows over a prolonged period are questionable, to say the least.

A precipitous large decline in the dollar, whatever its immediate cause, would not be in our interest. If related to a reduced willingness to invest in, or lend to, the United States, the burden of financing the budget deficit, in competition with private needs for credit, would be increased. Domestic prices and costs would be affected. And, the prospects for achieving lower interest rates would be further clouded.

All of that emphasizes the key importance of maintaining confidence in our economic policies and outlook. There are implications for monetary policy because that confidence must be rooted in a sense of conviction that inflation will remain under control. And there are clear consequences for fiscal policy as well because of understandable concerns that excessive fiscal stimulus may regenerate inflationary forces or stronger financial market pressures, or both.

There is a straightforward and constructive way to deal with concerns of the kind -- a way fully consistent with purely domestic needs. I am thinking, of course, of credible action to put the structural budget deficit on a course that is headed toward balance within a reasonable time period. Apart from the direct benefits of taking pressures off financial markets and reversing recent increases in interest rates, we would become

less dependent on inflows of capital from abroad to balance our savings with our investment needs. Over time, the dollar should move into an equilibrium consistent with a stronger, and sustainable, trade position. And, the risk of disturbingly large declines in the dollar should be ameliorated because U.S. policies would earn the continued respect and confidence of the financial community.

While I will not try to suggest an appropriate "equilibrium" value of the dollar over time, I do believe that balance will be struck at a higher level, and the risks of sharp and abrupt changes reduced, to the extent that we can build upon the progress against inflation. I also believe it is not in our interest to see abnormal, and ultimately temporary, strength in the dollar when such strength is really a reflection of imbalances in our domestic policies and markets.

Sometimes it is suggested that intervention in exchange markets can be useful to smooth these fluctuations, or as some would suggest now, to depress the dollar in the interests of our trade position.

In my judgment, exchange market intervention can play a useful role in dealing with disturbed market conditions or, occasionally, in signaling the desires or policy intent of the financial authorities in various countries, particularly when the approach is coordinated among them. But its role is subsidiary: experience strongly suggests that intervention alone is a limited tool that cannot, itself, greatly or for long change market exchange rates unless accompanied by changes in more basic policies. In present circumstances, as I have indicated, we have come to rely on inflows of capital to finance our domestic needs. So long

as the fiscal situation is unchanged and private credit demands are high, an intervention approach that resulted directly or indirectly in curtailing that flow would risk undesirable consequences for interest rates. Those risks would be particularly great if the United States were seen to be embarking on a deliberate policy of depreciation.

Others suggest we attack our external deficits directly, either by erecting barriers to capital flows or by restricting imports. Again, such measures do not go to the root of the difficulty.

To the extent direct measures were successful in reducing the net capital inflow, real interest rates in the United States would presumably rise, other things equal, as part of the process of replacing the lost saving from abroad with an increase in private domestic saving or a reduction in private domestic investment. The burden of our budget deficit on interest-sensitive sectors of the U.S. economy would be intensified; the problem would be shifted without resolving it. That would be true quite apart from the other compelling considerations against direct controls, which would be administratively difficult and contrary to our basic interest in open markets.

Yielding to the pressures for intensified import restrictions also could only complicate our problems. Beware, in particular, of arguments suggesting that import restrictions designed to benefit one industry or another will produce more jobs for the economy as a whole. To an individual firm or industry, shutting off import competition offers immediate advantages; more generally, it is argued that each billion dollars of the trade deficit represents a billion dollars of domestic

output foregone, other things equal. Using the rule of thumb that each billion dollar's worth of domestic output requires about 25,000 workers, it is then calculated that one million jobs could be created by reducing the trade deficit by \$40 billion.

The pitfalls in such reasoning should be clear at a time when the economy is already expanding strongly: a more rapid growth of output and employment than we have experienced over the past year and a half, combined with reduced capital inflows, would likely have been reflected in more pressures on financial markets at the expense of other sectors of the economy.

More generally, it should not be overlooked that the decision to protect one industry invariably imposes costs elsewhere. It is costly to other industries if foreign countries retaliate against U.S. exports, if import restrictions lead to higher dollar exchange rates than would otherwise prevail, or if costs rise. Protection typically leads also to higher prices and less choice for consumers and can be politically difficult to terminate, as exemplified by the current export restraint program on Japanese automobiles.

Still another essential reason for resisting protectionist pressures is the adverse implications of protection for the export earnings of the developing countries. We encourage those countries to take effective measures to build their productive structures over time, and we urge strong steps to adjust their economies in the short run to generate the payments due on their debts. But those processes cannot ultimately succeed if the United States and other industrial countries protect their own markets from the competitive exports of the developing countries.

Those developing countries have traditionally been an important market for our exports, and they have the potential to be much larger. That process of two-sided trade is fundamentally a healthy one -- a process that raises our own average productivity and real income over time at the same time that it promotes growth in the developing countries. In a context of growing economies, we should be able to adjust to international competition so that we can ease the process of transition for impacted workers and firms.

That, of course, is more easily said than done. It is particularly difficult to anticipate adjustment and to accept the pressures of international competition in an environment of large and fairly rapid swings in exchange rates. Moving toward a healthier process of international development and competition over time requires that we discipline our fiscal and monetary policies to provide the conditions for more stable exchange rates.

This brings me back to the central thrust of my remarks -- the need here and elsewhere to achieve better balance in our basic policies and a more sustainable pattern of external transactions.

Much has been achieved in these last few years to put the economy on a sounder footing -- too much, at too great a cost, to see it all jeopardized now. Our recovery has been proceeding rapidly, with little acceleration of inflation. But the combined credit demands of the Federal Government and the private sector have generated disturbing pressures on interest rates, on developing countries, and on exchange rates.

In concept, we can visualize an economic expansion characterized by relatively high interest rates and by strong private consumption and a large budget deficit. That is what we are having. But it has costs -- costs reflected in huge trade deficits and net borrowing from abroad, potential problems for housing and other interest-sensitive sectors, and risks of exchange rate and financial instability.

What is at issue is the sustainability of growth here and abroad, and our prospects for further progress toward price stability. In the end, I know of no way to deal with these risks, and to provide solid assurance that we can build on the real progress of the past, other than to carry through on the efforts to deal with the federal deficit.

\*\*\*\*\*