DEFICITS, DEBTS AND DOLLARS

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Annual Goldman Sachs Exchange Rate Conference
St. Regis Hotel, New York City
May 28, 1987

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The title of this conference, Deficits, Debts and Dollars is not only most timely but also unusually compact. I trust that the term "deficits" refers to both the federal government deficit and the trade deficit; that "debt" includes not only our mounting domestic but also our international debt; and that the "dollar" refers both to the domestic purchasing power of the currency and its international exchange value. Moreover, all these issues are linked and are mutually interdependent.

Consequently, it is difficult to find an appropriate starting place for my remarks. Conceptionally, it is the budget and trade deficits that are driving the buildup of the government debt and the external debt.

However, the relationship between the deficits, debt, and the dollar is more complex. My fellow economists have not yet agreed whether it is the flow variables measured in the national income and balance of payments accounts that determine the value of the dollar or whether the dollar's value is determined in domestic and international asset markets.

Standing in front of a group that includes so many foreign exchange traders, I cannot resist the temptation to ask whether it is the flow of customer orders or the position sheet in front of you that determines the next quote that you will give when the phone rings.

What makes the relationship between deficits, debt and the dollar even more complex is that there is not only a direct linkage between the federal government deficit and the government debt buildup, but also between the government deficit and the trade deficit and consequently also between the government debt and the external debt of the nation. Put differently, the income statement and the balance sheet of the government and the nation are all four inexorably intertwined. In turn, the value of the dollar is determined by this complex interplay of variables.

Speaking as an economist, I am tempted to argue that the value of the dollar, like everything else, is determined in a general equilibrium framework.

Speaking as a former forecaster and banker, I know that the relative importance of the different variables changes. Sometimes one and sometimes another variable seems to drive events in the foreign exchange market. If I may make a broad generalization, I believe that the variable which is currently most out of long-term equilibrium probably gets the largest amount of attention by the market. Incidentally, economists also tend to subscribe implicitly to that generalization. In their regression estimates they tend to give an inordinate weight to outlying variables and to deviations from the norm. They do so by having the square of the deviations from the average enter into the regression equations. Besides the obvious computational convenience of eliminating all the minus signs, I have never heard of a convincing reason for this standard practice. But if the observation that extraordinary deviations from the norm get the most attention is true, there may be some justification for this procedure.

Today I would like to explore the relative merits of the alternative policies that we and our trading partners might pursue to rectify our current imbalances. I will pay particular attention to policies to stimulate foreign economic growth, fiscal policies to reduce our federal budget deficit, monetary policy, and exchange rate policy.

We all learned in our basic economics course that the sources and uses of national income and product must balance in an accounting sense. The government deficit and its financing requirement must therefore be reflected either in a surplus of domestic saving over investment or be financed by an inflow of foreign capital. This capital inflow in turn will be accompanied by a trade, or more precisely, a current account deficit. That all under the assumption that domestic saving and investment largely match each other.

The evidence available confirms the basic proposition that the federal government deficit has been largely reflected in our current account deficit. During the 1960s government deficits of a few billion dollars were accompanied by very small current account surpluses. It was only during the Viet Nam buildup of the early '70s that the federal deficits mounted to $25 billion and turned the current account balance negative. As the government deficit was reduced to $5 billion in 1974, the current account returned again to a small surplus position. But in the mid 1970s, the federal deficits began to grow rapidly. And with a moderate lag the current account deficits began to mount as well. Last year, a $203 billion federal deficit was reflected in $141 billion current account deficit. If one considers that the state and local governments ran a surplus of $63 billion, the ac -

counting comes out just as expected.

But before concluding that the federal government deficit is the sole determinant of our external imbalance let me raise at least the question whether it might also be the other way around. Could we argue that the large trade deficit and the accompanying capital inflow is the cause of our government deficit? To argue this way would imply that we are not the sole masters of our destiny; but it is undoubtedly true that if the rest of the world were to import more from us we would experience a multiple expansion of our own GNP. In turn, the government would share in that expansion through higher tax receipts and this would result in a lower federal deficit as well. It is here that slow economic growth in Europe, Japan, and the developing countries makes a resolution of our trade deficit and of our government deficit more intractable.

This difference of view may lie at the heart of our differences with our trading partners. While we argue that a swifter economic expansion by the surplus countries of Germany and Japan would return the world economy to balance, they argue that all would be well if only we were to eliminate our budget deficit. Both views are correct in a purely arithmetic way. Which one is the preferable policy to be implemented depends on the state of the world economy.

If the world economy is operating at or near capacity, and if global inflationary pressures are present, a reduction in aggregate demand would be called for. Under those circumstances reducing the US budget deficit would be the most appropriate way to proceed.

But in a situation of excess capacity in industrial and agricultural markets, it may well be argued that an expansion of economic activity in the surplus countries of Europe and Japan would be more beneficial. In that way Europe and Japan could keep their export industry working at the present level,they would maintain their employment, and producers would earn a return on the investments that they undertook in the last few years. In addition, consumers in Europe and Japan would enjoy the benefits of higher living standards brought about by more imports. In such a scenario everybody would be better off.

Alternatively, if we in the U.S. would initiate sharply restrictive policies of austerity, the US external imbalance would be eliminated through a reduction of imports and not an expansion of exports. Reducing our imports would mean less exports for Europe and Japan. These countries would lose their export markets and unemployment would surge. Foreign investors would experience a reduction in the value of their investments and stock markets might decline. In all, this policy does not present a very attractive picture.

Of course, the US government deficit should and would not continue at its present level if foreign countries were to grow more rapidly. If our exports are to expand, resources must be made available for export. That is, ideally a federal government budget deficit reduction will go hand-in-hand with the improvement in our trade performance. Notice that I haven't said anything about monetary policy or the exchange rate so far. Both can remain neutral under this scenario.

But if our trading partners are unwilling to take the necessary expansionary action? I would argue that under these circumstances we should take the lead by taking aggressive action to reduce our federal deficit. This should be accomplished preferably by spending reduction rather than tax increases. Under this scenario the reduced fiscal stimulus can then be offset by a more accommodative monetary policy if this should prove to be necessary.

Reducing the federal deficit would be beneficial in its own right as it would bring domestic capital markets into better balance by easing the financing requirements of the federal government. Interest rates would therefore have a tendency to fall.

Adhering to the Gramm-Rudman targets and fulfilling the commitment made by the US government as part of the Louvre Agreement in February of this year and reaffirmed in April at the Washington meetings of the G7 Ministers is an essential part of our economic policy. The only question is whether we should go it alone or act in a coordinated fashion with our trading partners. I am arguing that the coordinated approach would be more effective and appropriate in the current world economic environment.

One way or another our federal deficit must be reduced and eventually eliminated. Otherwise we will never come to grips with the domestic and external debt problems.

There is also the option of dealing with the trade deficit through a tighter US monetary policy. At least initially, dollar interest rates would be higher. This would tend to restrain investment and lead to a general slowdown of the economy. As a result, imports would also tend to fall and thereby move the external accounts towards balance.

I do not believe that such exclusive reliance upon monetary policy would be an effective way to reduce our external imbalance. Such a policy might place strains on our own financial markets by driving up interest rates. Consequently, investment would be constrained and economic growth might well slip precipitously. Finally, the high interest rates experienced under this scenario might also have adverse affects on the heavily indebted developing countries. In my view, monetary policy cannot do the job of rectifying our external imbalance alone.

Let me add a word of caution at this juncture. Some people argue that we should maintain high interest rates in this country to assure a continued capital inflow. Clearly, if we want to reduce and eventually eliminate our trade - or better our current account deficit - we will also have to rely on less net capital inflows. The simple arithmetic of balance of payments accounting assures that one will go hand-in-hand with the other. Maintaining interest rates so high that capital will continue to flow into the country may prevent the trade adjustment that we all seek.

So far, I have said nothing about the exchange value of the dollar. The point is that further exchange rate changes are neither a necessary nor a sufficient condition to bring about a better balance in our external accounts. Just yesterday President Reagan stated that "the dollar is at the place that it should be."

Just like monetary policy should not shoulder the burden alone, I believe that exchange rate policy cannot do the job alone.

One factor that is often neglected in assessing the relative merits of the various policy tools are the terms of trade and balance sheet effects of an exchange rate change. A dollar depreciation implies that all US assets are reduced in value in terms of the appreciating currencies - let us say, Japanese yen. At the end of last year the total value of US equities was approximately $2.4 trillion. At an exchange rate of 162 yen per dollar this translates into 389 trillion yen. If we still had the exchange rate prevailing in the spring of 1985, it would have taken 624 trillion yen or 60 percent more to buy the same US equities. It is little wonder that the US has lost in relative importance in the world economy in the eyes of foreign observers.

One may argue that the value of US assets expressed in terms of Japanese yen is largely irrelevant for US based investors. Yet the argument is the same if we change the base currency. Today it would cost us roughly $1.8 trillion to buy the entire value of the Japanese stock market. At the exchange rates prevailing two years ago we would have had to spend only $1 trillion. These are rather large magnitudes in view of the fact that our exports to Japan amount to only about $25 billion per annum and that our imports from that country are roughly $75 billion.

While we worry much about the trade imbalance, one wonders whether the real battle is not being waged in the asset markets of the world. It is here that national wealth is being traded and where valuation adjustments through exchange rate changes can easily outweigh the hard won gains in the trade balance. I believe that we should take all these factors into account in designing our economic strategy.

Let me conclude by reiterating that the problems of excessive fiscal and trade deficits and the surging debt at home and abroad are all intertwined. Clearly, the dollar alone cannot and should not be the sole equilibrating variable.

Focusing economic policy on just one variable places too much burden on that instrument alone and runs the risk of introducing additional instability somewhere else in the economic system. Only a judicious and coordinated approach that takes account of the economic environment and the adjustment costs associated with alternative policy measures is apt to bring about victory over the multiheaded hydra now threatening the health of the world economy.