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BUDGET OUTCOMES, DEBT, AND MONETARY POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at

"Toward a Restructuring of Federal Budgeting"
a public policy research program of
The Conference Board

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Relations between monetary and fiscal policy have run through a series of stages. At the present time, we face a situation where considerable economic effectiveness is generally ascribed to monetary policy, while fiscal policy seems to be more part of the problem than of the solution. It will be helpful to review earlier phases of this relationship, beginning with the 1920's when the Federal Reserve first had an opportunity to play a peacetime role as a central bank.

During those halcyon years, the concept of a flexible fiscal policy had, of course, not even been formulated. The budget was generally in surplus and the large debt accumulated during World War I was being reduced at a good rate. Income taxes were cut repeatedly. The government was a net supplier of

savings, and the long-term interest rate sometimes was below the short-term rate as generally high economic activity called for some degree of monetary restraint.

Monetary policy, of course, was oriented toward interest rates primarily, with considerable attention given to the balance of payments. Nevertheless, considerations that today would be called monetarist were not absent. Irving Fisher's quantity theory of money was the dominant analytical approach. The Federal Reserve's chief statistician Carl Snyder argued for a stable rate of money growth of 4 percent. Price-level stability was regarded as the principal objective of monetary policy, combined with a mild anticyclical orientation to deal with the moderate fluctuations of the period following 1921. Monetary policy generally was regarded as a powerful economic tool.

The 1930's brought the great depression and the advent of fiscal policy as a major policy tool. Monetary policy increasingly became downgraded. It had failed to stem the depression, and it seemed unable to bring the economy back to full employment. Banks were choked with excess reserves, the money supply (M1) was growing at 11 percent over the years 1933-40. Short-term interest rates were close to zero, long-term rates were dropping, with interruptions, to and even below the 2-1/2 percent level at which World War II was financed. Monetary policy ended up having no other function than to peg this interest-rate structure in order to facilitate Treasury financing.

It is difficult today to visualize the low opinion then held by most economists of the capabilities of monetary policy. Congressional hearings in 1952 again and again brought out the view that monetary policy

could do very little to curb inflationary pressures. Business and consumers were very liquid and thus protected against monetary restraint. Severe restraint, on the other hand, would cause serious difficulties in managing the public debt, perhaps cause the bond market to fall into a "bottomless pit." It was against broad-based resistance that the Federal Reserve finally broke loose from the obligation to support federal debt and Treasury financing. It was then able to restore gradually a monetary policy oriented toward price and cyclical stability.

This development marked the end of an important phase in the subordination of monetary to fiscal and debt policy. Even then, monetary policy for many years continued to be regarded as the junior partner in the fiscal-monetary team. This clearly was so during the vogue of the "new economics" of the 1960's. Nevertheless, with each succeeding business cycle, increasing evidence appeared of the power of monetary policy both to restrain and to stimulate.

The fiscal policies pursued during the 1960's were supported by a monetary policy oriented mainly toward interest rates, a combination which brought strong inflationary pressures. Inflation turned attention to the money supply. In the course of the 1970's, monetary policy shifted toward money-supply targeting. This powerful device significantly altered the balance of power between fiscal and monetary policy. It soon became apparent that fiscal policy was a powerful instrument only so long as monetary policy supported it by allowing the money supply to accelerate. Once it became the goal of monetary policy to avoid undue acceleration, the potential of fiscal policy was much reduced.

At the analytical level this change has been symbolized by the ascendancy of monetarism. Beyond that, the frustrations encountered by both monetary and fiscal policy have given rise to a new line of economic theorizing which says that neither fiscal nor monetary policy, as it has been pursued in the past, are likely to have any effect. If people have rational expectations, i.e., if they understand that the government, faced with unemployment will inflate and, when faced with inflation, will allow unemployment, they will act to protect themselves. Their protective action reduces the effect of government policy to mere changes in the rate of inflation without lasting impact on the real economy.

The Structure of the Federal Budget

To examine the relation between monetary policy, the budget, and the debt, a look first is needed at the general contours of budget and debt. Other participants in this symposium will examine the numbers of the budget in greater detail and with more authority. I merely want to indicate the general configuration that I have in mind as I assess the environment for monetary policy. I believe that we are looking today, for a considerable period, at a budget deficit of about 5 percent of GNP, of which something like 2 percent is structural, the rest cyclical. That is to say, at high employment, calibrated at about 6 percent unemployment, there would remain a deficit, making allowance for the 1983 midyear tax cut, of 2 percent or

\$55-65 billion. In all probability, this is much too large both in terms of long-run growth needs and of the smooth functioning of the economy in the intermediate future. I am not addressing myself to the very short-run problem of our present recession.

As regards long-run growth needs, they must begin at least at a theoretical level, with an assessment of the desirable level of our capital stock. A capital stock that is too small will not, over time, give us the maximum of consumption, because total output will not be large enough. A capital stock that is larger than optimal, on the other hand, will also hold down consumption because of the higher investment and, therefore, saving required to keep the stock growing and replacing its wear and tear.

A study made by the staff of the Federal Reserve Board suggests that the present capital stock is not seriously inadequate and that a higher rate of saving and investment than has prevailed on average in the past would not yield large benefits. I have some difficulty with this finding, because I think of the pace of technical change as being influenced by investment, so that more investment would accelerate growth also through that channel, which, in turn, would call for and justify a larger capital stock. In any event, however, the Federal Reserve study provides no justification for large structural budget deficits. At high employment, a balanced

budget or better a surplus, seems appropriate in terms of long-run growth needs. Given a cyclical economy, balance on average may mean surpluses at high employment.

If I may digress for a moment, in order to illustrate the situation of the U.S. economy, it is instructive to look at Japan. That country has a very high saving rate, quite possibly in excess of what its optimal capital stock requirements and indeed in excess of what the Japanese economy, at least under present conditions, can absorb. In a closed economy in the short run, this condition could mean unemployment, with the excess savings going uninvested despite low interest rates, while in the long run it would imply a wasteful level of investment. Actually, Japan is able to export its savings by investing abroad. In doing so, it depresses the yen, which generates an export surplus that effectuates the capital transfer and maintains high employment. The United States is likely to find itself in an opposite position. High absorption of savings by the government is making the supply of capital for the private sector inadequate. The result is a high level of interest rates that drives up the dollar and generates a current-account deficit. In that way, the United States becomes a capital importer.

To say that optimal growth of the American economy requires investment and, therefore, savings of some particular fraction of GNP does not, of course, necessarily imply that this level of investment would be forthcoming even if the savings were available. This is a question of investment

opportunities, of the responsiveness of investment to interest rates, of the tax system, of regulation, and of other aspects of the investment climate. About all of these factors we hear a great deal. In particular, there has been a continuing very adverse interaction between business investment and deficit spending. Government has run deficits, and on an increasingly large scale, in order to reduce cyclical and perhaps secular unemployment. But its policies seem to have been of a sort, not to elicit complementary private investment, but to discourage it. As a result, deficits have expanded and business investment has retreated from what it would have been. If deficits were to be eliminated, would business investment fill the void? Or would, perhaps, interest rates and, therefore, the dollar fall to a level at which the United States became a large capital exporter with a large export surplus? That would maintain full employment although it might not be optimal for growth of the capital stock. Or would the savings go to waste, with attendant unemployment?

These are questions concerning the basic resiliency of the American economy for which I have gut feelings but no statistical response. My gut feeling is simple: under favorable conditions as to tax treatment, regulatory treatment, appropriate monetary policy, and general investment climate, the private sector of the American economy should be able to absorb the full employment savings of the economy with the federal budget in balance and even in moderate surplus. Given a more realistic set of conditions, I fear that the private sector of the economy has been so debilitated that it may not in the short run at least be able to absorb full-employment savings.

That would imply the need for either a sizable export surplus or else a structural government deficit. Given the need of the developing world for more capital, it is obvious which way the choice should go. However, there is the question of how to finance a larger flow to developing countries of private or public funds which I cannot address at this point. I am left with the concern that we may have put ourselves in a situation where some structural high-employment budget deficit may be needed, although obviously much smaller than the present.

It will be helpful to set forth some of the magnitudes that are relevant to evaluating the kind of structural deficits that I have sketched. The gross saving of the economy (as conventionally measured to include personal and business saving, including corporate and noncorporate capital consumption allowances, and all government saving including the negative saving of the federal sector) are of the order of 17 percent of GNP. After capital consumption allowances in the neighborhood of 10 percent, there are left some 6 to 8 percent net saving to finance private domestic and foreign investment. (These data come from the National Income and Product Accounts, and the corresponding federal deficit measures do not exactly match the Office of Management and Budget numbers.)

To appraise the absorption of saving by the federal government and resultant crowding out, the difference between gross and net saving is important. From the point of view of the financial markets, gross flows are significant, at least in the short run, since part at least of capital consumption allowances accrues in liquid form and can enter the capital markets. But ultimately net saving is a more significant concept. It is

the size of the capital stock which ultimately determines the return on capital and the real interest rate that must on average be equated to it. Increases in the capital stock can come only out of net saving, after wear and tear has been made up. In the aggregate, making up wear and tear absorbs the capital consumption allowances, even though in terms of particular firms and households there is no precise replacement of worn out equipment.

Thus, present total deficits of about 5 percent of GNP and high-employment deficits of about 2 percent of GNP in the main must be weighed against gross saving several times larger but net saving not very much larger. Crowding out is therefore a very real possibility under the present budget structure. On the other hand, a balanced budget, if it were possible, would leave us with a need to increase investment by a very large factor. Hence, the probable need for a full employment deficit of some, hopefully modest, magnitude.

In addition to the size of the federal deficit, both structural and cyclical, it makes a difference, of course, at what overall level of federal spending a given deficit occurs. The federal government would absorb fewer resources and leave more for the private sector if it were to reduce its share in GNP by cutting both expenditures and taxes. The resources released by the federal government can be used by the private sector for both investment and consumption. In all probability, only a small proportion of resources released will be saved, the larger part going to consumption. Nevertheless, as we look at the absorption of resources by the budget, we should be aware that things can be improved not only by cutting the deficit, but by cutting the budget on both sides without reducing the deficit.

The Fiscal-Monetary Mix

The concept of the fiscal-monetary mix goes back to the period of the 1950's and 1960's when monetary policy was thought of primarily in terms of interest rates, and when inflation was analyzed principally in terms of excess demand. The quantity of money played a secondary role in either connection. It then seemed plausible to believe that a combination of a budget surplus and low interest rates would be favorable to investment, with the government supplying additional savings and monetary policy facilitating their investment. This mix seemed to have a desirable orientation toward faster economic growth. Alternatively, a combination of budget deficits and high interest rates could be designed that would produce the same degree of overall stimulation or restraint. It would do so, however, with less investment and a stronger balance of payments, since foreign capital would be attracted. This mix commended itself when there was a need to strengthen the dollar, even though at the expense of growth.

The analysis was not carried to the point of asking what would happen to the money supply under regimes of low or high interest rates respectively. It seemed sufficient to conclude that either mix could be made noninflationary by aiming at a nonexcessive level of aggregate demand. However, at low interest rates the money supply may be expected, other things equal, to be higher relative to GNP than at high interest rates. Thus, the relationship between the money stock and nominal GNP would develop differently under different mixes. Those who believe that in the long run this relation matters would have to conclude that the neutrality of alternative mixes with respect to inflation could hold only in the short run. In the long run, the

easy money/tight budget mix would be more inflationary than its opposite. That also would mean that initially low interest rates would eventually be pushed up by inflation.

Given the view that in the long run the stock of money matters, and that excess money must lead to inflation, it follows that monetary policy has lasting power only over nominal rates, not over real rates. Monetary policy can influence nominal rates by influencing the rate of inflation. Specifically, the sequence of events following an "easing" of monetary policy would be an initial drop in short- and long-term interest rates, then, as inflation began to accelerate, a rise at least in long rates while the central bank was holding down short rates. Eventually the whole rate structure would be forced up. In the opposite case of a tightening of monetary policy, interest rates first would rise; subsequently they would come down as inflation was reduced. Moreover, once the market had come to understand this mechanism, it might telescope the process via expectations. Knowledge that a policy of low interest rates with an attendant acceleration of the money supply was underway, long-term interest rates, which the central bank cannot easily control, would move up immediately, before higher inflation actually set in. Even more, the inflation itself would be anticipated by the market and prices and wages would move up before pressures on capacity began to be felt.

Under such circumstances, the central bank has lost control over real interest rates. It can only influence nominal rates, which, however, with a lag, will move in the direction opposite to that which it had intended. The only influence over real interest rates that can be exerted is that of fiscal policy. A budget surplus increases savings, a deficit absorbs them.

Interest rates, other things equal, will move accordingly. Instead of a fiscal-monetary mix, we then have fiscal policy as the sole control over real interest rates, with monetary policy determining nominal rates via the rate of inflation.

These are hypotheses about the behavior of markets. For the Federal Reserve, the critical question is how quickly the assumed processes work. If we are talking about a decade before a change in the relation of money stock to GNP makes itself felt in prices, there is plenty of time for temporary changes in the fiscal-monetary mix, provided they are reversed soon and are not allowed to affect the money stock permanently. This may have been the situation during the 1950's and may be the most appropriate interpretation to be given to then-emerging theories of the fiscal-monetary mix. Alternatively, if the effect of money on prices comes quickly, or worse yet if expectations cause this effect to be anticipated, there is little room for mix manipulation.

If the market is sophisticated, however, it should be possible for the central bank to enlist expectational effects on its side. In some countries, such as Germany and Switzerland, the market seems to believe that the central bank, or more plausibly the entire government, or still more plausibly the entire population, will not allow much inflation to occur. The market then will not interpret every change in the mix designed for a temporary problem as a decision for all time to go for higher or lower inflation. In a country where the market seemingly needs to be convinced by week-to-week and month-to-month adherence to a rigid money-supply target, temporary departures from target must remain much more limited.

Finally, in a cyclical framework, the optimal combination of fiscal and monetary policy is not necessarily a "mix" aiming at a constant degree of overall stimulation or restraint. Instead, there may be a need for simultaneous tightening or easing of both fiscal and monetary policy. The history of anticyclical policy has not been particularly creditable since the middle 1960's. Previously, however, so long as adequate efforts were made to prevent expansive phases from far outweighing contractive phases, there was a degree of success. The possibility of future situations in which both policies should be pulling in the same direction deserves to be borne in mind.

This form of interaction of fiscal and monetary policy also provides an explanation of historical circumstances conveying the impression that monetary policy was being dictated by the administration. Two policymakers looking at the same set of facts may well arrive at similar conclusions as to the need for stimulative or restraining action. It is a measure of the degree to which we have today become accustomed to wide differences in the thrust of fiscal and monetary policy that this obvious interpretation sometimes is overlooked.

Monetary Policy and the Structure of the Public Debt

Long gone are the days when the structure of the public debt was regarded as a major determinant of the effectiveness of monetary policy. In the late 1940's and early 1950's, banks, corporations, and the general public held large amounts of short-term debt that provided a liquidity cushion. It was not obvious that a rise in short-term rates from one percent to 1-1/4 percent

would greatly reduce that liquidity. Neither was it very apparent why exchanging a 90-day Treasury bill for a bank deposit, with an attendant increase in the money supply, would significantly increase liquidity. Today these questions have disappeared. Few transactors hold demand deposits of any size. Most forms of money yield high interest rates. Short-term Treasury securities, although they constitute 7 percent of the Federal Reserve's broadest money-supply measure (L), do not seem to influence much the behavior of that variable. Under these conditions, the structure of the public debt, and especially the proportion of short-term debt, seems to matter a great deal less for monetary policy than it did at one time.

Gone also is the influence that "even-keeling" of Treasury issues had on the volume of money and bank reserves. In days of smaller deficits and little inflation, the Treasury was in the market perhaps once a quarter trying to sell a mixed bag of securities at a fixed price. The Fed helped to the extent of not making major changes in monetary policy before and shortly after the issue. Under a regime of interest rate targeting that meant pretty much keeping rates stable. The danger of unintended debt monetization from that source has passed now that the Treasury, while it is in the market almost constantly, operates on an auction basis.

The heavy short-term component in the government's debt, which the Treasury has valiantly tried to hold down, has implied wide swings in interest costs for the Treasury. This can lead to unhappiness on the part of the Secretary of the Treasury and the Director of the Budget. By and large, however, it has been seen as a necessary cost of a firmly restraining monetary policy.

On the other hand, wide swings in interest rates have shown themselves to be a serious burden for the private sector, both for business and for financial institutions. Corporations today are acutely aware of the need to increase the liquidity of their balance sheets by funding short-term obligations. Thrift institutions and even banks have suffered from a mismatch of the maturities of their assets and liabilities. Accordingly, there appears to exist another mismatch, in the form of the allocation of relatively scarce long-term funds to the users that need them least. Given that the Treasury seems better able to bear the uncertainties inherent in short-term debt, something would seem to be gained by reducing its competition with the private sector for long-term funds. The danger that the private sector might lock itself into high coupon issues with long maturities to an undue extent would be minimized by the fact that corporate issues typically provide only five- or ten-year call protection, in contrast to the almost complete call protection of Treasury issues. The task of monetary policy would be eased if the impact of tightly restraining money-supply targets on business interest costs could be softened.

The role of the public debt, and the impact of debt creation on the economy and on monetary policy, is obscured and complicated by inflation. At a high rate of inflation, part of the debt is inflated away each year. If one were to ignore other inflation-related adjustments, such as the indexing of unfunded social security liabilities, one could arrive at the conclusion that, on an inflation-adjusted basis, the deficit was much smaller than appears or possibly nonexistent. Alternatively, one could say that the

inflation premium contained in the interest on the public debt was a form of debt amortization. In that view, a considerable part of the \$90 billion of net interest payments on the federal debt really would represent debt repayment, i.e., is not part of the deficit. Analogous statements could be made, of course, about corporate and other private debt. On the other hand, the inflation premium is taxed. Furthermore, it is not clear whether the recipients of high interest payments correctly separate out the inflation premium and add it back to principal, in which case their real interest rate after tax in many cases would be negative. Taxability and tax deductibility of the inflation premium tend to push up interest rates. Among the victims are interest payers who cannot deduct interest and the central bank which must count with wider interest-rate swings than a money-supply target would otherwise imply.

Debt Monetization

I have already noted that the importance of debt monetization depends on how significant is the distinction between monetary and nonmonetary assets under prevailing conditions. Under present-day conditions, the evidence seems to show that it is substantial. Historically, debt monetization has often been a cyclical phenomenon. Banks bought Treasury securities in recessions to replace business loans that were being paid off. Given adequate control over the money supply, this has not been an inflationary development.

Finally, the absence of monetization of public debt is no assurance against excessive money creation if other financial assets are acquired by the banking system. The reason why there is concern about monetization of public

debt in the presence of the large deficit is the fear that the debt could not be placed outside the banking system. In many countries other than the United States, this fear is well-founded, owing to limitations of national capital markets. Where nonbanks do not possess a highly elastic demand for government paper, especially short-term, this paper necessarily gravitates into the banks. In the United States, an extensive nonbank market exists for short-term government paper, making the monetization of this debt a good deal less than inevitable. On the other hand, the accumulation of short-term paper in nonbank hands can represent an increase in liquidity which, in circumstances less liquidity-constrained than the present, could quickly become inflationary.

Under these circumstances, monetization or nonmonetization of public debt remains a decision for Federal Reserve policy. Adequate control over the growth of the money supply prevents or limits monetization. Refusal to monetize debt, to be sure, raises interest rates. But so does monetization, although with some lag until the inflationary consequences are perceived. The difference between monetization and nonmonetization of a large deficit is that if debt is not monetized, interest rates will rise, and if it is monetized, they will rise too, but a little later, and possibly much higher.

Deficits and Inflation

Do deficits cause inflation? It is a fairly safe bet that a simple correlation between inflation and deficits would show them to be negatively related. Deficits, after all, mount during recessions, when inflation tends to go down. This says little about their causal relation. But it makes

suspect econometric evidence that claims not to find a positive relation, because it is not easy to control for the joint effect of the business cycle on both variables.

It is widely believed that deficits cause inflation. This view receives support from the basic Keynesian analysis which identifies deficits with an increase in aggregate demand and takes for granted that monetary policy will finance the deficit. The popular view also reflects frequently repeated assertions by businessmen and bankers (including central bankers) and some politicians, many of whom find this a convenient alibi. The popular view is helpful to the Federal Reserve, because it imposes some constraint on political spending in a world where little such constraint sometimes seems to be left.

Analytically, it is just as wrong to say that deficits are necessarily inflationary as to say that deficits have no adverse consequences of any kind. Deficits are expansionary, those resulting from expenditure increases more so than those resulting from tax cuts. Their expansionary effect can be contained by a restraining monetary policy, as is happening now in the United States. Deficits raise interest rates, other things equal, owing to the government's increased demands on the financial markets. Higher interest rates increase monetary velocity and so can cause inflation with a given money-supply growth, unless the Fed counteracts this by appropriately slowing the money supply. Deficits can also cause inflation simply because people believe they do. In that case, expectations will engender actions that cause prices and wages to go up even when there is no immediate pressure.

Deficits and Interest Rates

Much the same can be said of the relation between deficits and interest rates. The simple correlation probably is negative, because deficits rise in recessions when interest rates tend to fall. Ergo Obviously it does not follow that deficits reduce interest rates. The question is by how much they raise them.

As pointed out earlier, the federal deficits projected for 1983 and succeeding years will absorb a significant portion of the economy's gross savings and a very large part of its net savings. I have also noted that gross savings may be more relevant in evaluating the effect of deficits on interest rates, because at least part of the amortization allowances which differentiate gross from net savings is likely to reach the financial markets in one form or another. However, the very high absorption of net savings makes the prospect more ominous still.

At issue, of course, are real interest rates more than nominal. The government's demands on the financial markets are likely to raise both by the same number of basis points, except as the deficit also raises the rate of inflation. A given number of basis points means more with respect to the real rate, of course, than the nominal rate.

Since our present and prospective deficits are the results mainly of tax cuts rather than of expenditure increases, their impact on interest rates may be somewhat mitigated. From the income restored to the taxpayer, some fraction will be saved. It would be highly optimistic, however, to expect this fraction to be very large. In the absence of wealth effects, the marginal saving out of incremental income is of the order of .3 for most income brackets.

If higher interest rates depress the price of assets, the resulting negative wealth effect may encourage some additional saving because people want to restore their wealth.

For the Fed, the deficit creates a problem not only in terms of higher interest rates in and of themselves, but also in terms of the crowding-out effect to which they give rise. Crowding-out is the nature of the market. Somebody will be crowded out. It occurs even at low interest rates. However, the supply of funds becomes more inelastic the higher rates go. Crowding-out then becomes more severe. The conflicting claims of different borrowers generate pressures, both of a financial and a political kind. The Fed does not allocate credit, but it does have to be concerned about the way the markets operate, and what consequences for the allocation of credit ensue. It also needs to be concerned with the safety and soundness of financial and nonfinancial institutions all of which are affected by interest rates. The absorption of so large a part of the available saving flow in a country where both gross and net saving already are very low in international comparisons constitutes a serious problem.

The Deficit and the Dollar

The deficit impinges upon the exchange value of the dollar through a complex sequence of reactions, the final outcome of which is not fully discernible at this time. To begin with, higher interest rates attract foreign capital and, in a floating exchange-rate system, tend to raise the value of the dollar. The proper measure of interest rates for this purpose,

in the United States as well as abroad, are real interest rates. An increase in nominal U.S. interest rates accompanied by an even greater increase in the rate of inflation, implying a decline in U.S. real interest rates, would not make the dollar attractive to foreigners. The rise in the dollar by itself helps to reduce the rate of inflation which is a significant advantage. This in turn helps to make the dollar still more attractive internationally.

But a high dollar, as we are observing every day, hurts exports, encourages imports, and pushes the current account of the balance of payments toward deficit. To the extent that such a deficit emerges, which seems very likely for 1983, the United States becomes a net importer of capital. Imports of capital, in real terms, are possible only through a net transfer of goods and services. The rise in the dollar and the creation of a current-account deficit is the mechanism that generates the real transfer.

To the extent that the budget deficit in this manner is financed abroad, some of its domestic repercussions diminish. It is tempting to think that the United States might lay off a good part of its budget deficit on other countries, by running a balance-of-payments deficit. The magnitudes of the two deficits, however, at least in historical terms, are very different. U.S. current-account deficits have never exceeded \$15 billion. It would take an implausibly large payments deficit to make much of a dent in the financing of our budget deficit. This quite aside from the question of whether it is economically and politically appropriate or even feasible for the richest country in a capital-short world to expect others to so finance its budget deficit.

There is the further question, however, of what large payments deficits would do to the dollar. Theory and experience indicate that currency values are depressed by large payments deficits, probably because the market believes that the continued financing of such a deficit would be difficult. To be sure, when the payments deficit has arisen in the first place out of a strong desire of foreign investors to get into the dollar, it is not immediately clear why the deficit should discourage further capital inflows. The good inflation performance of the dollar (a synonym, in this case, for high real interest rates) may lend further support to our currency.

At the same time, a current-account deficit works against economic recovery. Net exports, as a component of GNP, can swing from positive to negative and seem to be in the process of doing so. Getting part of our deficit financed abroad, therefore, is costly in terms of domestic output and employment so long as the economy operates at low levels anyway.

The Fed, even though it does not target on exchange rates any more than on interest rates, cannot ignore exchange-rate effects. Wide swings in exchange rates are damaging to our economy as well as to those of other countries. Insofar as the budget deficit contributes to them, it involves an additional cost.

Concluding Remarks

I have tried to show in this essay that while monetary policy can cope with the consequences of a large budget deficit, it can do so only at considerable costs. These costs in the aggregate are likely far to exceed any benefits derivable from a deficit, at least in the foreseeable future. A lower

level of investment, lower economic growth, greater difficulty in bringing down inflation, and international disturbances are the main consequences. This does not mean that an instant reduction of the deficit, in the face of a deep recession, would bring an immediate improvement. It is the forward-looking character of the deficit, the difficulty, under present conditions, to anticipate a significant reduction, that creates the most serious difficulties for monetary policy and, of course, for our economy as a whole.

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