FOR RELEASE ON DELIVERY
MONDAY, DECEMBER 10, 1984
6:15 P.M. LOCAL TIME (12:15 P.M. EST)

THE FOREIGN IMPACT OF THE U.S. BUDGET DEFICIT

Summary of remarks by

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

to the

Swiss-American Society Basel

Basel, Switzerland

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1. The strong performance of the U.S. economy has brought important benefits also to other countries. Rapid growth of economic activity, stimulated by a large budget deficit and favorable tax changes, has increased U.S. imports. The large budget deficit, by raising dollar interest rates, has caused the dollar to appreciate, further stimulating imports.

2. High dollar interest rates have to some extent counteracted these beneficial effects in the rest of the world. But the importance of U.S. interest rates for interest rates abroad can easily be exaggerated. Major countries have been able to uncouple from U.S. interest rates. Many countries, moreover, have had reasons of their own for high domestic interest rates, such as large budget deficits and some degree of inflation. One piece of evidence of this is that, as U.S. interest rates have come down recently, interest rates abroad have declined much less if at all.

3. The inflationary effect for other countries of a high dollar also can easily be overrated. Prices quoted in dollars are not necessarily prices determined by U.S. supply and demand but often, as in the case of oil, by

world supply and demand. A high dollar means downward pressure on such world market commodities, as can be observed by the behavior of the prices of oil and of many internationally traded commodities.

4. It has been argued that the United States is draining much-needed capital from the rest of the world through its external deficit which must be financed by corresponding capital imports. This would be a serious matter if the rest of the world were close to full employment. In that case, there would be no room for expanding the supply of savings through a rise in income. At present very high levels of unemployment and excess capacity, savings would increase if income rises, for instance, as a result of higher exports. A capital flow to the United States means that other countries are obtaining an export surplus (or a reduction in their external deficits) which helps generate the savings that they transmit to the United States. Most countries seem to welcome this improvement in their current account. Of course, such an improvement necessarily implies an export of capital.

5. The high dollar has been a cause of widespread concern. By all the theories and behavioral rules of the exchange market, it is difficult to explain the level of the dollar in terms of economic fundamentals. Current purchasing-power parity has long been left behind by the dollar; otherwise, the U.S. current-account deficit would not be anywhere near as large as it is. Superior inflation performance does not explain the dollar's level, since countries like Japan and Germany have performed even better and some others have performed not much worse. Such a large external deficit in any other country probably would mean a weak rather than strong currency. Interest-rate differentials have been substantial and the dollar's behavior has been

broadly in accordance with movements in these differentials. Nevertheless, when interest-rate differentials diminished significantly in recent months, the dollar remained high and even advanced against some major currencies. It is not surprising that some market participants, unable to discern visible sources of support, speak of a levitation act.

6. The good investment climate of the United States has often been cited as a reason for the strong capital inflow into the United States and for the resultant high dollar. The inflow indeed has overfinanced the deficit that would have come about had the dollar not appreciated, and so has driven up the dollar. A smaller inflow would have been sufficient to finance the external deficit at a constant exchange rate.

7. It seems apparent that the United States does indeed have a good investment climate. Important tax changes were made in 1981 to raise the return on business investment, although some of these were modified in 1983 and others might be removed under the Treasury's late-1984 tax reform proposal. The dynamism of the economy is generally recognized; a pro-enterprise spirit prevails, labor markets are flexible, wage trends moderate.

8. Nonetheless, corporate profits, although much improved, especially in economic terms (i.e., after adjustment for inventory profits and underdepreciation), are lower, as a share of GNP, than they were, for instance, during a good part of the 1950's and 1960's. Gross business fixed investment -- although at a historical high of 12-1/2 percent of GNP -- in net terms, i.e., after depreciation, at 3-1/2 percent is not significantly above longer term experience. Because a larger part of gross investment than formerly takes the form of short-lived equipment, depreciation

therefore is higher and growth of net business fixed investment as a share of GNP is not much above the historical average.

9. Examination of the U.S. capital account reveals, furthermore, that the bulk of the recorded inflows are not what one would normally think of as investment type. Much of them essentially takes the form of short-term banking flows. Corporate flows reflecting U.S. corporate borrowings through the frequently cheaper Eurobond market also seem to have more a financial than an investment character. Inflows reflecting an investment purpose, especially direct investment and purchases of equities, have not been overly strong. Certainly they have not dominated the totality of the flows.

10. The particular form of an investment does not necessarily reflect its purpose. Most securities, even long-term, have a high degree of liquidity and positions can readily be reversed. On the other hand, the item "errors and omissions," which in some years has been substantial, may contain investment-type flows. All in all, however, examination of the U.S. capital account suggests that the great bulk of the flows has been of a financial rather than investment nature, including particularly banking flows. This suggests that the main driving force behind the high dollar has been a difference in real interest rates, even though month by month that differential does not seem decisive.

11. The size of total capital inflows appears understated if recomputed on the basis of cumulative current-account deficits instead of recorded capital transactions. On the other hand, certain discrepancies in international payments statistics imply that aggregate world deficits may have

been overestimated. Thus, it is possible also that the U.S. current-account deficit is exaggerated, resulting in an overestimate of the capital inflow.

12. The safe-haven aspects of the American economy seem to be viewed by the market as an important feature of strength for the dollar. So does the greater ease of all forms of investment in dollar assets, thanks to the wide range of available assets and their relative liquidity. The perplexed and possibly apprehensive portfolio manager, particularly when placing highly liquid funds, may find the U.S. dollar the most convenient parking lot for his assets.

13. Continuation of large U.S. external deficits would produce a rapidly mounting accumulation of dollar holdings in foreign portfolios. The additional interest due each year would raise the current-account deficit. So would the widening gap, in absolute terms, between U.S. imports and exports even if both grew at the same percentage rate.

14. Such an increase in world dollar holdings, however, would come on top of already very sizable international asset and liability positions of the United States. At the present time, allowing for uncertainties surrounding these statistics, U.S. foreign assets and liabilities (including equity) probably balance each other at about $1 trillion. A $100 billion current-account deficit, while it would make the United States a net debtor country, would not grossly imbalance the relation of assets and liabilities.

15. Moreover, the world's portfolio of dollar assets and dollar liabilities probably exceeds the world's claims on and liabilities to the U.S. economy

by hundreds of billions of dollars. Claims on and liabilities to the Eurodollar market must be taken into account, as well as the Eurobond market, claims and obligations arising out of trade and LDC debt in dollars, and other third-country dollar assets and liabilities. These additional amounts do not affect the net position of the United States. They are indicative, however, of the world's willingness to hold dollar balances.

16. The addition of an annual $100 billion or even more to the asset side of this world portfolio of dollar assets and liabilities does not change the balance much in the short run. The rise of the dollar over the last few years has increased the value, in nondollar currencies, of the world's dollar portfolio by more than the U.S. current-account deficits of recent years. Yet this shift toward a larger dollar component in world assets and liabilities has not caused dollar owners and dollar debtors to move out of dollars. As the world develops a net dollar-asset position, the probability of such portfolio shifts is bound to increase. But resting on so enormous a base of roughly balanced dollar assets and liabilities, it is very difficult to guess at what point in the evolution of a net world dollar position investors would begin to regard this position as excessive.

17. Investors can be expected to focus, not on the increase in U.S. liabilities during a single year, but on the prospect of a string of years of possibly mounting external deficits. Such expectations could weigh heavily on the dollar even before the deficits had materialized. But an investor who also expects the present favorable interest differential between dollar and other assets to continue into the indefinite future can accept a

prospect of moderate dollar depreciation so long as it does not, on average, exceed the interest differential.

18. It has been argued that greater stability and predictability of exchange rates would be expected from worldwide progress toward internal price stability. Expectations of future inflation as a factor affecting the dollar and other currencies would then disappear. But a wide range of other factors remain, including differences in the mix of national fiscal and monetary policies, that could destabilize exchange rates even at minimal rates of inflation everywhere. Wide exchange-rate movements remain a distinct probability. None of these considerations provides a meaningful basis for a projection of the future of the dollar. What they do is to underline the wide margin of uncertainty and the unpredictability of the influence of any one factor.

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