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Our Internal and External Deficits And  
The Relationship Between Them

Remarks by

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During the first quarter of 1984, the balance between our receipts and expenditures on merchandise trade with other countries registered a deficit of over \$100 billion at an annual rate. In April, that external deficit increased substantially further.

During the first five months of 1984, the Treasury borrowed \$74 billion, on its way to financing a gap between Federal receipts and expenditures--both on and off budget--that will probably total about \$195 billion during this calendar year.

I would like to talk with you briefly today about our internal deficit--that is, the deficit in the Federal budget--and our external deficits--the deficits on merchandise trade and current account--and the relationship between them. Five years ago, I would not have dreamed of making such a talk here today, and you would probably not have wasted your time listening. But the issues at stake are vital to the health of individual industries, to the stability of financial markets, to the ability of developing countries struggling to make progress in managing debt problems of enormous magnitude, and to the economic welfare of people throughout our nation and around the western world.

Deficits in the Federal budget, and in our merchandise trade and current accounts, are not, per se, unmitigated evils. For example, the fiscal stimulus of rising Federal deficits has made an important contribution to the strong economic recovery that we have enjoyed since late 1982. Similarly, the rapid rise in U.S. imports has helped fuel recovery abroad and has enhanced the export earnings capacity of developing countries. The availability of imports from other countries at relatively low prices, moreover, has been one of the factors holding down inflation in the U.S. And the counterpart of large current account deficits has been a sizable inflow of foreign capital that has facilitated the financing of large Federal budget deficits at lower interest rates than would otherwise have prevailed.

But our internal and external deficits are a bit like doses of medication. One sleeping pill may be the key to a good night's sleep when you need it. But ten sleeping pills will not produce a night's sleep that is ten times better. Our internal and external deficits have risen, in my judgment, to levels much larger than what any sensible economic doctor would prescribe.

In discussing these issues with you today, let me caution you that I will be giving you my own personal opinions, not those of the Federal Reserve Board.

Let me begin with the external side.

Over the past several years, deficits in our merchandise trade and current accounts have risen to proportions that are astonishing by historical standards. During the thirty years ended in 1980, the U.S. current account, on average, showed a small surplus--amounting to about one quarter of one percent of GNP. Current account deficits, when they occurred, never exceeded one percent of GNP in any year during those three decades.

Our external balances began to deteriorate early in 1981. By the first quarter of this year, the deficit on current account was up to about \$85 billion, or 2-1/4 percent of GNP, and will very likely increase significantly further in the period immediately ahead.

A large part of this deterioration stemmed from the tremendous increase in imports during the current economic recovery. Since the fourth quarter of 1982, merchandise imports in real terms have risen more than five times as fast as real GNP. Weakness in the demand for U.S. exports has also been a factor. The volume of exports did begin rising last year, after a prolonged decline, but the level in the first quarter of 1984 was still about 15 percent below the peak volume of 1980.

What accounts for these extraordinary developments? The reasons are many and varied, and I will mention only the main ones.

First, there is the contribution of troubled industries--particular industries that, over time and for a variety of reasons, became less competitive in international markets. Steel is one example.

Second, our domestic economy has grown more strongly than the economies of foreign countries, especially since late 1982. Part of the increase in our external deficit is thus a normal cyclical development that will be reversed as activity picks up abroad and the pace of expansion slows at home.

Third, the internal adjustment programs put in place by countries such as Mexico and Brazil to deal with their external debt problems have had a significant effect on our trade and current account positions. For example, our exports to Mexico last year were \$9 billion, or 50 percent, below their 1981 level, although very recently our exports to Mexico have turned up again.

Fourth, and most important, our competitive position in world markets has worsened dramatically because of the rise in the international value of the dollar during the past four years. Adjusted for rates of inflation at home and abroad, the dollar has risen in value in relation to other major currencies by roughly 50 percent since the fourth quarter of 1980. More than half of the deterioration in our current account balance since that time is probably due to the resulting loss of price competitiveness.

Restoration of our competitive position is, obviously, essential to obtaining a reasonable balance in our external accounts. Barring a marked acceleration of inflation abroad relative to the U.S., a substantial improvement in international competitiveness will require a rather pronounced decline in the value of the dollar in exchange markets. The dollar is, in this sense, overvalued.

Why has the dollar's value gone up so much? Again, there is no simple answer, but a dominant factor has probably been the rise in U.S. interest rates relative to those abroad. During the past five years, interest rates in the U.S.--adjusted for inflation--have risen about six percentage points relative to those of other major industrialized countries. The U.S. is, of course, a country with a long history of political stability, and its money and capital markets are free and open. Moreover, the dollar serves as both the medium of exchange for international trade and payments, and the key reserve currency around the world. These institutional factors mean that the demand for dollar assets is quite sensitive to U.S. interest rates, so that a rise in our rates relative to those abroad pushes the exchange value of the dollar strongly upward.

An extremely strong dollar creates problems for industries that compete in international markets, even healthy ones. For industries beset with serious problems arising from other sources, the loss of price competitiveness in international markets is even more serious.

Problems are created abroad as well as at home. Countries whose exchange rates have declined sharply with respect to the dollar have had to cope with the resulting increase in inflationary pressures. And when the U.S. is importing capital from abroad on so large a scale, developing countries in need of significant amounts of international capital to achieve their economic and social objectives become deeply concerned.

Perhaps those that are disadvantaged by an overvalued dollar and large external deficits should take comfort in the fact that the present situation cannot last indefinitely. Dollar assets are accumulating in the portfolios of non-residents on an unprecedented scale. Some time soon, if it has not happened already, the U.S. will switch from its long-standing position as an international creditor to that of a debtor country. (Available data do not permit a precise pinpointing of when that will happen.) Within a couple of years thereafter--unless external deficits decline--the U.S. will become the world's largest debtor country.



It is hardly surprising, then, that a significant decline in the value of the dollar in exchange markets is widely forecast. Such a decline is clearly essential to restoration of international competitiveness to U.S. industry, and in that sense it would be welcome. But when it occurs, it will have two effects that will be most unwelcome--namely, it will add to our inflation rate, and it will put upward pressure on our interest rates.

Interest rates are already extremely high in the U.S. by historical standards. They have been rising strongly since late last year as a consequence of burgeoning overall demands for credit. Earlier in the recovery, the financing of an enormous Federal deficit was accomplished with relative ease--partly because of large capital inflows from abroad, but also because private domestic credit demands were still weak. With the passage of time, however, borrowing by the private non-financial sectors became progressively larger. By the first quarter of this year, the flow of such credit, combined with Federal borrowing, amounted to 18-1/4 percent of GNP, the highest ratio ever recorded.

Do Federal deficits really matter? Both traditional economic theory and common sense suggest that they do--that increases in government spending, or reductions in taxes, tend to stimulate the economy, raise total credit demands relative to supplies, and push up interest rates.

But if any doubt remained, developments in financial markets this year should have laid the argument to rest. The damaging effects of greatly excessive fiscal stimulus on our external balances, on interest rates, and on the stability of domestic and international financial markets have become abundantly obvious in recent weeks and months. Our fiscal chickens have begun coming home to roost.

I am not going to speculate on whether or not interest rates have reached their cyclical peak for the current period of expansion. Certainly, all of us hope that they have. But we may have to face the unhappy fact that real interest rates in the U.S.--on average, in good times and bad--could remain high in relation to historical levels, and high in relation to those of other countries, unless we take dramatic steps to reduce the competition between public and private demands for credit.

The reason for this is that the United States has money and capital markets in which there are fewer barriers to the flows of money and credit than any other country in the world. Over the past three decades, and especially over the past five to ten years, innovation and deregulation of U.S. financial markets have increased the mobility of funds from one region of the country to another and from one market to another. Nearly all of the legislative and regulatory impediments to payment of market-related rates of interest to savers have been removed. And, most importantly, the usury ceilings and other artificial barriers to credit flows that used to play so prominent a role in the rationing of available supplies of credit among potential borrowers have largely disappeared. In the financial world we live in now, therefore, the rationing of credit is done almost entirely by real interest rates. As a consequence, real interest rates in a period of economic expansion are forced to much higher levels than we were accustomed to seeing in the 1960s and the 1970s.

There is a way for economic policies in our country to compensate for this tendency of our financial markets to generate high real interest rates. It is to adopt Federal budgetary policies that minimize the conflict between Federal

and private credit demands. We need to aim, on average over the business cycle, at a balanced Federal budget, or even moderate surpluses. Instead, what we have done is to adopt fiscal policies in recent years that have produced large and growing structural deficits.

Since fiscal 1981, the structural deficit in the Federal budget--that is, the deficit adjusted for cyclical changes in Federal receipts and expenditures--has increased by approximately \$100 billion. The effects of this magnitude of fiscal stimulus on the economy and on interest rates are hard to estimate precisely. Some econometric models suggest that, assuming a given stock of money, an increase of fiscal stimulus of this magnitude would raise short-term interest rates by two percentage points or more. And, unfortunately, rising fiscal stimulus will continue under current law. Indeed, estimates by the Congressional Budget Office indicate an increase in the structural deficit of almost \$200 billion more between now and fiscal 1989, unless specific steps are taken to lower Federal expenditures or raise taxes.

We need prompt and forceful action to deal with this problem. We need it for farmers in Minnesota and Iowa, for banks from New York to California, for home builders and thrift institutions across the nation, and for our friends in Latin America and elsewhere.

I am quite hopeful that a "downpayment" on deficit reduction will be accomplished yet this year. A serious process of political negotiation does seem to be underway. I am concerned, however, that the amounts of deficit reduction currently being discussed for the near term are so small relative to the size of the problem. Under current law, the structural deficit will increase by about \$25 billion in fiscal 1985. The two bills before the Congress provide for deficit-reducing measures of between \$25 to \$30 billion in the upcoming year--that is, about enough to keep the problem from getting worse. Thus, unless the Senate-House conferees adopt stronger measures of deficit reduction for fiscal 1985, the near-term effects of the fiscal "downpayment" on the economy and on financial markets are likely to be quite small.

These large internal and external deficits that I have been discussing with you today pose a serious threat to the sustainability of the current economic recovery. The main concern is not that high interest rates will, in and of themselves, slow the growth of demands in interest-sensitive sectors and thereby plunge the economy into recession. While that could happen, it is unlikely. The principal danger is that particular industries will be so severely damaged, that financial markets will become so shaky, that confidence will be so seriously eroded as to precipitate events that economic policies cannot effectively control.

There is also a danger that, in such an environment, we will succumb to the temptation to adopt policies that, in the long run, we will come to regret. Proposals for industrial policies will be treated more sympathetically; so also will calls for more protectionism. Bail-out plans for individual industries will proliferate. Most worrisome of all is the likelihood that pressures will increase for the Federal Reserve to "do something" to bring down interest rates.

Attempts to lower interest rates by speeding up the growth of money and credit would, under present circumstances, be a serious mistake. The economy is growing strongly; total credit demands are extremely large; inflation, although not yet accelerating, is still proceeding at an annual rate of four to five percent. If people here and abroad gained the impression that the Federal Reserve had thrown in the towel in the fight against inflation, we would be faced, in my judgment, with potentially chaotic conditions in financial markets.

We in the Federal Reserve have no intention of succumbing to any pressures of that kind. The best contribution we can make to prolonging the recovery is to continue to follow a disciplined money policy--providing sufficient growth in money and credit to finance a sustainable economic expansion, but avoiding the excesses that would lead to a resurgence of greater inflationary pressures.

To increase the chances of prolonging the recovery, however, discipline must be brought to bear on Federal budgetary policies. Reduced fiscal stimulus is the single most important step that could be taken to reduce interest rates, to encourage a gradual decline in the value of the

dollar and thus to improve the competitiveness of American industry in international markets, to calm domestic and international financial markets, and in all of those ways to increase the durability of the economic recovery.

Our economic problems are not insurmountable. But we must find the political will to come to grips with them while there is still time to do so.

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